



JENNINGS LAW FIRM

memorandum

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SALARY REDUCTION CAFETERIA PLANS

Many employers maintaining health care plans require participating employees to pay a portion of the monthly costs in the form of premiums or contributions and/or pay a portion of the benefit costs in the form of deductibles and coinsurance. A salary reduction cafeteria plan (or flexible benefits plan) can significantly reduce an employee's after-tax cost of paying for these benefits.

Contributions and benefits paid by employers for health care benefits are generally excludable from an employee's taxable income and are exempt from F.I.C.A. On the other hand, monthly premiums paid by an employee (generally through payroll deduction) are generally includable in the employee's taxable income and are subject to F.I.C.A. Premiums, deductibles and coinsurance payments are deductible on the employee's personal income tax return but only to the extent that aggregate eligible health care expenses exceed 7.5% of adjusted gross income. For an employee with adjusted gross income of \$40,000, the first \$3,000 of eligible health care expenses are nondeductible.

A salary reduction cafeteria plan recharacterizes employee payments for premiums, deductibles and coinsurance into employer contributions. The effect of this recharacterization is to exclude these amounts from the employee's taxable income and F.I.C.A. The employer also saves its shares of F.I.C.A. on these amounts.

To illustrate the potential savings of establishing a salary reduction cafeteria plan, assume an employee participates in his employer's health care plan and pays monthly premiums of \$350 (\$4,200 per year) and incurs \$3,000 in health care expenses during the year that are not reimbursed under the employer's health care plan. Additionally, assume the employee does not itemize his deductions on his federal return and his tax rate is 28%. If his employer establishes a salary reduction cafeteria plan, the employee reduces his federal income taxes for the year by \$2,016 ($\$7,200 \times 28\%$), his Illinois income taxes for the year by \$216 ($\$7,200 \times 3\%$) and his F.I.C.A. by \$551 ($\$7,200 \times 7.65\%$). His total income tax and F.I.C.A. saving for the year are \$2,783. His employer saves its share of F.I.C.A., or \$551. If the employer has 100 employees similarly situated, the employer's saving of F.I.C.A. is \$55,100.

An employer can also establish a salary reduction cafeteria plan to recharacterize other employee expenses such as dependent care, even if the employer does not otherwise maintain a dependent care plan. An employer can also establish an employee-pay-all plan and convert some or all of the employees' contributions under the plan to non-taxable benefits. An employer may also allow employees to pay for adoption expenses on a pre-tax basis.

An employer may also permit employees to pay for their commuting costs, including parking, on a pre-tax basis within certain dollar limits.

Implementing a salary reduction cafeteria plan requires the employer to adopt a written plan document and secure the written election of eligible employees to participate. Each benefit plan that is offered under the cafeteria plan must also be embodied in a written plan document. For example,

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an employer that adopts a salary reduction cafeteria plan to recharacterize employee contributions for dependent care must also adopt a written dependent care plan document even if all of the contributions under the plan are salary reduction contributions.

Like most other tax-favored fringe benefit plans, salary reduction cafeteria plans may not discriminate in favor of highly compensated employees. Additionally, the tax laws limit the amount of employer and salary reduction contributions that can be excluded from an employee's gross income for certain fringe benefits.

Every employer should consider the benefits of a salary reduction cafeteria plan as a means to convert an employee's cost for coverage and/or benefits to a nontax-taxable benefit and save the employer tax dollars.

If you would like to discuss establishing a salary reduction cafeteria plan, please call Lee T. Jennings at 312.332.7733.

Please visit our website at www.danaconsulting.com