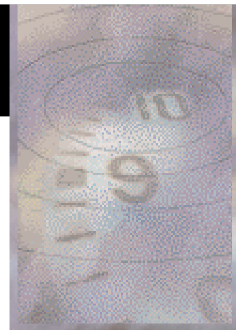

legal matters

Benefits On the Menu

For employees and employers, a cafeteria benefit plan can be a valuable benefit, saving employees money by purchasing benefits with pre-tax dollars and helping employers attract and keep good employees.

BY JOHN ALLEVATO

As a potential employer or employee (and conceivably both), physicians should be aware of the implications and advantages of some common forms of employee benefits. Some of the most valuable of these benefits offer tax advantages to both those who offer them and those who receive them. Other benefits may not be suitable for your practice since the tax laws will not allow the tax advantages which make them worthwhile. In any event, you need to understand some of the benefit options available which may be attractive in your practice—for you and for your employees.

In terms of recruiting quality employees, employee benefits could be the difference between attracting or retaining that key employee, especially in this era of very low unemployment where many jobs are going begging. While you may not see the need to consider these options, your competitors are trying to lure your employees into their fold. It may be to your advantage to read on.

While there are many alternatives when considering employee benefit options, some of the most appealing are those which provide attractive tax benefits to the employee and the employer. One such type of benefit plan, called a cafeteria plan, provides an array of benefits to both employer and employees.

Any employee who is reasonably savvy about paying taxes would be eager to take advantage of available benefits for which she doesn't have to pay any tax. Even better is if her employer is still entitled to a tax deduction for purchasing the items for which the employee is not taxed. Taking this even further, what if the benefit provided is one which the employee otherwise would not be able to deduct for tax purposes on her own tax return? The cafeteria benefit plan can offer all these advantages.

Cafeteria plan benefits are not available to self-employed individuals, nor to partners or shareholders of S corporations, although employees in either of these situations can be covered.

Briefly, a cafeteria plan allows employees to pay for certain items by reducing their salary and having their employer make the payments for them. Why would an employee do this? Because to the extent permitted, the salary reduction amounts are not taxed to the employee. Without such a plan in place, the employee would receive their salary, paying tax on all of it, and still have to pay for the items the employer pays for under a cafeteria plan. The savings for the employee? An amount equal to the tax they otherwise would have paid on the amount of the salary reduction—a very real savings.

A menu of benefits

Let's set out a scenario. Imagine you are the parent of a couple of

Continued from previous page

children, and are provided, at your cost, medical and dental benefits at work. You and your spouse work, and one of your children is in day care. Your medical and dental coverage costs you $600 per month. Assume your child care costs $150 per week, or over $7,500 per year.

Federal tax law requires that medical expenses, including medical and dental insurance, are deductible only to the extent they exceed 7.5 percent of your adjusted gross income. If we assume your and your spouse's adjusted gross income is $150,000, then you must have over $11,000 of such expenses before you can deduct the first dollar of them on your tax return—and then you can only deduct the amount in excess of the $11,000. Thus, you will pay for your health insurance coverage and child care, which combined cost you over $15,000 per year, on an after-tax basis (in other words, after the money has been taxed, you then must pay the expenses out of what's left). While there would be some limited tax benefits available without a cafeteria plan in the scenario set out (approximately $500 for child care), you are paying with after-tax dollars.

Before contrasting that with the economic advantages of a cafeteria plan, let's first spend a minute setting out the general requirements of such a plan.

Cafeteria Plan Basics. Absent a qualified cafeteria plan under federal tax rules, if your employer allowed you to choose whether you wanted your salary or some other benefit, effectively reducing your salary for the amount of the benefit, you would still be taxed on the receipt of the benefit. However, a qualified cafeteria plan allows your employer to give you such a choice, limited to the types of benefits allowed under cafeteria plans, without the benefit being taxable. While your take-home salary is reduced by the cost of those benefits, you save the tax that you would have otherwise paid on the value of the benefits.

Back to our scenario for a moment to see how this could work to your advantage. If your health insurance premiums were part of a cafeteria plan, you may be able to pay them on a pre-tax basis. In other words, although you pay for the benefit in the form of a reduced salary, you don't pay tax on that reduction amount, unlike paying for something with after-tax dollars. Assuming payments of $600 per month, your salary would be reduced by that amount, meaning your income would be $142,800 for the year rather than $150,000. The advantage to you—you pay tax on only $142,800. Without such a benefit plan, you pay tax on $150,000, and you still have to pay the health insurance premiums. So you are ahead by saving the tax on the amount of the health insurance premiums.

This can also work for a certain amount of child-care expenses. The law allows a maximum of $5,000 per year to be paid for child-care expenses with pre-tax dollars, and some taxpayers will qualify for less depending on their individual circumstances.

Not surprisingly, only certain expenses qualify for inclusion in a cafeteria plan. These include: health insurance premiums, medical and dental expenses not covered by insurance, dependent care expenses, group term life insurance, and adoption assistance expenses. Any employer may choose to include all or only some of these benefits in their cafeteria plan. In each of these situations, the employee must make a choice—take cash and pay their own expenses, or reduce their salary and have their employer pay such amounts on a pre-tax basis. These choices give this type of plan its name—cafeteria plan. You make the choice from among a menu of options. Once this choice is made, it is not necessarily irrevocable for the taxable year, but can be changed only if significant circumstances change surrounding the employee's family, health, job status, etc.

Cafeteria Plan Limitations. You want to do this for all your expenses, you say? Not so fast. Because of the obvious drain on the federal fisc, these benefits are limited. First, they must be provided to all employees on a nondiscriminatory basis. Second, the benefits provided to the highly paid members of the company (i.e., physicians), can be somewhat limited, depending on how the plan is structured.

Next, cafeteria plan benefits are not available to self-employed individuals, nor to partners or shareholders of S corporations, although employees in either of these situations can be covered. Even if the benefits are not available to you as an owner, think of how attractive this benefit would be to your employees.

A word of caution, however. Though it seems like an easy decision for an employee to participate, you are asking the employee to reduce his salary by an amount equal to the value of the benefit provided. Granted, they are better off economically to do it, but getting employees past the part where they are asked to reduce their salary may be more of a challenge than it first appears. Also, what the government giveth it has a tendency to taketh away. The complex Employee Retirement Income Security Act (ERISA) provisions may cover a cafeteria plan, depending upon the types of benefits made available to the employees. Even if ERISA does not apply, a thorough set of federal tax rules does apply. These require the plan to be in writing, and for employees to agree in writing to reduce their salary to participate.

The additional administrative burden associated with these plans might be a problem, particularly for smaller companies. But they can be delegated to cafeteria plan administrators who, for a fee, will administer your plan and make sure it complies with all the laws. Consider using their services to save your back office these additional burdens.

The limitations on these types of benefits may make the adoption of a cafeteria plan somewhat problematic for physician prac-

Continued from previous page

tices, but in most instances, its use should be considered a benefit for the staff, and it can be an attractive selling point for tax savvy job applicants. The ability to pay for some expenses on a pre-tax basis rather than an after-tax basis compels consideration of cafeteria plans for almost all organizations, since so many employees would be better off with such plans in place. ■

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