

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-0315

To: Members, Subcommittee on Economic Growth, Tax, and Capital Access, Committee on Small Business
From: Committee Staff
Date: March 14, 2017
Re: Hearing: "Cafeteria Plans: A Menu of Non-Options for Small Business Owners"

On Thursday, March 16, 2017, at 10:00 AM., the Subcommittee on Economic Growth, Tax, and Capital Access of the Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building to discuss cafeteria plans in the context of small businesses. Cafeteria plans allow participants to pay for certain types of benefits on a pre-tax basis. Common benefits include health care and dependent care flexible spending accounts, vision and dental coverage, and group life insurance. Cafeteria plans are available across the board to large and mid-size companies, non-profits, schools, universities, and the federal government. However, one major category of people who are not allowed to participate in a cafeteria plan is small business owners. They can sponsor these plans for their employees, but they cannot participate themselves. As a result, small business employees often do not have access to this valuable benefit.

The Subcommittee will meet to examine why small business owners are not treated on par with larger employers. The Subcommittee will also consider the effects of this policy on small business employees and whether the policy should be changed.

I. Introduction

Cafeteria plans are a popular form of employee compensation. While they are embedded in Section 125 of the tax code and raise issues of tax policy, Section 125's 1978 enactment was actually part of a larger plan to provide a tax incentive for employers to provide fringe benefits to lower-paid employees.¹

The tax code has long recognized exceptions for medical expenses and insurance. The deduction for medical expenses dates back to 1942, while the exclusion for medical insurance benefits go back to 1918.²

However, the design of the cafeteria plan raised questions of constructive receipt. In other words, in the case where an employee has a choice between nontaxable benefits or cash, should the

¹ Daniel C. Schaffer and Daniel M. Fox, *Tax Law as Health Policy: A History of Cafeteria Plans 1978-1985*, 8 Am. J. Tax Pol'y 1, (Spring 1989) at 2.

² *Id.* at 3.

employee be treated in both cases as having received taxable cash?³ Prior to the enactment of section 125, the clear answer was “yes,” but section 125 changed that answer to “no.”⁴

The Treasury Department was willing to concede on the constructive receipt issue in enacting section 125 because what it really wanted was “new statutory rules requiring employers who provided tax-free benefits like medical insurance to their more highly-paid employees to provide similar benefits to all of their employees,”⁵ in other words, antidiscrimination rules. The law prior to section 125, Treasury argued, led to abusive situations. Some companies adopted plans that would reimburse medical expenses for shareholders and officers, but not for other employees.⁶ Treasury envisioned antidiscrimination rules as levelling the playing field.

At the same time, Treasury, and apparently Congress, thought that the antidiscrimination provisions would essentially have the effect of a poison pill and discourage companies from offering cafeteria plans overall.⁷ As such, the provision was deemed to have no budgetary impact.⁸ Of course, section 125 has changed over the years, but it is still fair to say that, at that time, no one envisioned what an important and widely-used benefit cafeteria plans would turn out to be.

II. Background

The Small Business Administration (SBA) Office of Advocacy recently held a roundtable on cafeteria plans and their use in the small business context.⁹ The discussion centered around the benefits of cafeteria plans and the unavailability to small business owners operating as pass-through entities. Under current law, the owner of a small business pass-through may offer a cafeteria plan to employees but may not personally participate.¹⁰ This result stems from IRS interpretation rather than statutory language, and there is a difference of opinion as to whether it can be changed administratively or requires legislation. In any event, the policy goal of expanding employer-provided coverage would seem to be frustrated by this restriction.

III. Cafeteria Plans, An Overview

Cafeteria plans are benefit plans established by the employer under which employees may choose between cash and normally nontaxable benefits.¹¹ While the general rule of taxation is that, given these options, a taxpayer would be taxed on whichever they choose, based on deemed constructive receipt of the cash (and deemed purchase of the benefits with such cash if benefits are chosen), section 125 provides an express exception as long as certain requirements are met.¹²

³ *Id.* at 10.

⁴ *Id.*

⁵ *Id.* at 5.

⁶ *Id.*

⁷ *Id.* at 22.

⁸ *Id.*

⁹ Small Business Employee Benefits Roundtable, Sm. Bus. Admin. Ofc. of Advoc., July 13, 2016.

¹⁰ Prop. Reg. §1.125-1(g)(2)(i), REG-142695-05, 72 Fed. Reg. 43938 (8/6/07).

¹¹ JANEMARIE MULVEY, CONG. RES. SERV., RL33505, TAX BENEFITS FOR HEALTH INSURANCE AND EXPENSES: OVERVIEW OF CURRENT LAW 5 (Jan. 10, 2012) (hereinafter CRS Report).

¹² *Id.*

Generally, cafeteria plans can be divided into three separate categories: 1) employee pay all; 2) employer-provided dollars; or 3) some combination thereof.¹³ In the case where the employee pays, the employee is allowed to choose from a menu of benefits and pay for them through a voluntary salary reduction.¹⁴ In this case, the amount paid for the benefits is converted from taxable salary to pre-tax premiums, reducing both income and employment taxes.¹⁵

Employer-funded plans allot each eligible employee a set amount of employer dollars that the employee can allocate among the available benefits.¹⁶ The employer may require that they first be allocated to health insurance.¹⁷ Any unused dollars may be available, generally at a discount, to the employee as a cash out.¹⁸

The third plan provides for a combination of employer dollars and employee salary reduction.¹⁹ This plan design allows the employee to first allocate employer dollars to desired benefits. Then the employee can contribute additional dollars to increase or enhance those benefits.²⁰

An important feature of all of these cafeteria plans is that the employee must make an election prior to the start of the plan year with regard to salary reduction and how the dollars will be allocated among available benefits. This election is irrevocable and cannot be changed during the plan year absent a major life change.²¹

Benefits that can be offered through a cafeteria plan include:

- Accident or health insurance,
- Flexible Spending Accounts (FSAs),
- Vision,
- Dental,
- Prescription drugs,
- Group term life insurance, and
- Adoption assistance,

among other potential benefits.²² One benefit expressly excluded from cafeteria plans is long-term care insurance.²³

¹³ Paula A. Calimafde and Deborah A. Cohn, *Small Business and the Cafeteria Plan*, 15 NYU Ann. Inst. Fed. Tax'n § 1.02, at 8 (2002) (hereinafter Calimafde and Cohn).

¹⁴ *Id.*

¹⁵ CRS Report *supra* note 11 at 5.

¹⁶ Calimafde and Cohn, *supra* note 13 at 8.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.* at 9.

²² *Id.* at 13-14.

²³ *Id.* at 14.

As mentioned above, another hallmark of cafeteria plans is that they must not be top-heavy, i.e., if benefits are offered to highly-compensated employees, they must be offered to lower-paid employees as well. To accomplish this end, cafeteria plans are subject to a number of antidiscrimination tests to ensure availability of benefits across salary ranges in order to receive the tax benefit.²⁴

IV. Applicability to Small Businesses

Cafeteria plans apply only to “employees,” but benefits may extend to spouses and dependents of program participants.²⁵ Because section 125 does not specifically include self-employed individuals in its definition of “employee,” the Treasury Department has interpreted the statute to not include them. Under current law, the following are not considered “employees” for the purposes of participating in a cafeteria plan:

- Sole proprietors,
- Partners in a partnership,
- S corporation shareholders holding a 2% interest or greater, and
- Members in a limited liability company that has elected to be taxed as a partnership.²⁶

There does not seem to be any evidence for this interpretation, save the failure to include specific language to the contrary in the statute. In fact, this interpretation seems inconsistent with how other tax-preferred benefits are applied.

For example, in the context of retirement plans – which are similar to cafeteria plans in that both are tax-preferred benefit arrangements subject to strict antidiscrimination provisions – owners of pass-through entities have long been considered employees and have been permitted to participate in their own employer-sponsored programs.²⁷ In fact, section 125(b)(2) specifically refers to section 416(i)(1), which defines key employees to include owners of pass-through entities for the purposes of employer-sponsored retirement plans.²⁸ This would seem to make clear that pass-through owners were intended to be viewed as “employees” for the purposes of cafeteria plans. However, the Treasury Department obviously did not agree, given its guidance to the contrary. Similarly, the Joint Committee on Taxation does not agree to this interpretation and charges that had pass-through owners been intended to be included in the definition of employee, the statute would have specifically provided such, and that only a legislative change – rather than administrative interpretation – would remedy the issue and avail these small business owners the benefit of being able to participate in their own plans.²⁹

²⁴ *Id.* at 25-39.

²⁵ David L. Raish, *Cafeteria Plans*, 397-3rd Tax Mgmt. Port. (BNA) Pt. 2, 30 (2017).

²⁶ Prop. Reg. §1.125-1(g)(2)(i), REG-142695-05, 72 Fed. Reg. 43938 (8/6/07).

²⁷ Letter from Gary Kushner, President, Kushner & Co., to Mark Iwry, Senior Advisor to the Secretary and Deputy Assistant Secretary for Retirement and Health Policy, Department of Treasury (Aug. 17, 2016).

²⁸ *Id.*

²⁹ Conversations between Small Business Committee staff and Joint Committee on Taxation staff (Jan. 11 and 26, 2017).

V. Conclusion

As Congress and the Committee pursue the goal of overall tax reform, tax incentives for small business owners should be kept in mind. If it is decided that tax policy should continue to be used to provide an incentive for employer-provided benefits, then the question of cafeteria plan applicability to small business pass-through owners should be examined more closely. The current regulatory interpretation affects these owners and their numerous employees. The Subcommittee will explore the lack of parity between small businesses and other entities for the purposes of cafeteria plans in the context of this hearing.