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TAX AND BUSINESS Alert™

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# Cafeteria Plans Benefit Employees *and* Employers

The Tax Code allows employers to offer a substantial benefit to their employees by providing employee benefits through a cafeteria plan. Cafeteria plans, also referred to as *Section 125 plans*, are written plans that allow employees to choose among a menu of cash and qualified benefits and pay for these benefits with pretax dollars.

**Why Are Cafeteria Plans So Popular?**

Cafeteria plans are a popular way of providing employee benefits because both employers and employees alike find them advantageous. Employers benefit by maximizing tax deductions, as well as reducing payroll taxes. Employees, on the other hand, are able to increase take-home pay by paying for benefit coverage on a pretax basis.

**What Type of Benefits Can Be Offered?**

Cafeteria plans can be structured in a variety of ways. One of the simplest options is a premium only plan (POP), which is funded solely by insurance. In these plans, employees enter into a salary reduction agreement for an amount equal to their portion of the premium cost. POPs can provide group-term life insurance, dental, disability income, vision care, accidental death and dismemberment, and/or health care coverage.


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Other levels of cafeteria plans are also available. At the other end of the spectrum is a *full cafeteria plan* offering employees a wide variety of benefits and choices where employees can create their own benefit package.

The following benefits may be offered on a pretax basis under a cafeteria plan:

1. Accident or health coverage (i.e., medical coverage), including accidental death and dismemberment coverage.

2. Up to $50,000 of group-term life insurance on the life of an employee. (Benefits in excess of $50,000 can be provided, but employees may be taxed on the excess coverage.)

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The information contained in this newsletter was not intended or written to be used and cannot be used for the purpose of (1) avoiding tax-related penalties prescribed by the Internal Revenue Code or (2) promoting or marketing any tax-related matter addressed herein.

# Standard Mileage Rates for 2008

Beginning January 1, 2008, the standard mileage rates for the use of an automobile (including vans, pickups, or panel trucks) are (1) 50.5¢ per mile for business miles, (2) 19¢ per mile for medical or moving purposes, and (3) 14¢ per mile for service to a charitable organization.

The 2007 rates were 48.5¢ for business miles and 20¢ for medical and moving. These rates are based on an annual study done by an independent contractor of the fixed and variable costs of operating an automobile. The charitable rate is unchanged because it is set by statute.

A taxpayer may not use the business standard mileage rate for a vehicle after using any depreciation method under the Modified Accelerated Cost Recovery System or claiming a Section 179 deduction for that vehicle; for any vehicle used for hire (such as a taxi); or for more than four vehicles used simultaneously.

# Honda Hybrid Vehicle Credit Phases Out

Honda Motor Company

The Alternative Motor Vehicle Credit for hybrid vehicles is phased out once the manufacturer sells 60,000 qualifying vehicles. The IRS recently announced that Honda Motor Company sold its 60,000th credit-qualified hybrid vehicle and the credit will begin to phase-out for vehicles purchased on or after January 1, 2008. Vehicles purchased from January 1, 2008 through June 30, 2008 will be eligible for 50% of the original credit. Those purchased from July 1, 2008, through December 31, 2008, will be eligible for 25% of the original credit. Honda vehicles purchased after December 31, 2008, will no longer be eligible for the credit.

# Alternative Fuel Tax Credit for Propane-powered Forklifts

Congress has enacted legislation providing for a 50¢ per gallon tax credit for companies using propane in forklifts and airport tugs. Although forklifts are normally exempt at the time of purchase from the federal excise tax on propane, they are still eligible to claim the full 50¢ per gallon credit for business use.

This credit could be a nice benefit for a warehouse or manufacturing operation using propane-powered forklifts. As an example, a warehouse operator consuming 3,000 gallons of propane annually is eligible for a $1,500 (3,000 × $.50) tax credit. Keep in mind that a tax credit, unlike a deduction, offsets your tax liability on a dollar-for-dollar basis. So, every dollar of credit is one less dollar you will pay in taxes.





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3. Long-term disability coverage. However, to the extent employees pay premiums on a pretax basis, benefit payments received are taxable.

4. Dependent care assistance up to $5,000 per year.

5. Flexible spending arrangements (FSAs) for medical expenses, dependent care assistance, or adoption assistance.

6. Health savings accounts (HSAs) for qualified medical expenses.

7. Contributions to a 401(k) plan. (However, due to the complexity and cost involved in meeting IRS requirements, this option may not be a good one.)

8. Adoption assistance benefits.

Elective paid vacation days may also be provided. However, this benefit is taxable to the employee and the vacation days must be used or cashed-out before the end of the year.

**What Benefits Cannot Be Offered?**

The following benefits may not be offered under a cafeteria plan, even though they may be nontaxable when provided outside of the plan:

1. Scholarships and tuition reductions.

2. Educational assistance.

3. Nontaxable work-related fringe benefits; including no-additional-cost services; qualified employee discounts; working condition fringe benefits; employer-operated eating facilities; *de minimis* fringe benefits; qualified transportation benefits; qualified moving expense reimbursement benefits; and on-premises athletic facilities.

4. Meals and lodging furnished for the employer's convenience.

5. Contributions to an Archer medical savings account.

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6. Long-term care insurance.

7. Long-term care services.

8. Group-term life insurance on the life of any individual other than an employee.

9. Certain health reimbursement arrangements (HRAs).

10. Elective deferrals to a Section 403(b) plan.

**What Is Required to Receive Special Tax Treatment?**

To qualify for special tax treatment, a cafeteria plan must meet very specific requirements. The plan must be in writing and contain certain information that is set forth by the IRS. This information includes a specific description of each of the benefits available under the plan, eligibility rules governing participation, procedures for participant selections, and the maximum salary deferral employees and maximum contribution employers can make. In addition, specific nondiscrimination requirements must be met by the cafeteria plan.

**Summary**

With the upward trend in rising health care costs, cafeteria plans can be a solution to providing employee benefits at a greatly reduced cost to the employer and employee. If you have questions or want additional information on cafeteria plans, please don't hesitate to call.

# Deducting Retirement Community Fees

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Some retirement communities require a substantial one-time entrance or founder's fee in exchange for the facility's promise to provide lifetime living accommodations and care that includes medical care (i.e., lifetime care). In addition, the retirement community may charge a monthly fee. The IRS does not have a published position regarding the method of allocating fees between deductible and nondeductible medical expenses. However, the IRS has indicated that, to the extent the retirement community can document a reasonable estimate of the percentage of its overall operating expenses spent for providing medical care, that percentage can be applied to the one-time and continuing payments to the facility. The Tax Court has also supported use of a percentage to determine the amount of monthly service fees for lifetime care allocable to medical care.

The amount of operating expenses allocated to the facility's cost of providing medical care to the taxpayer, spouse, or dependent qualifies as a medical expense in the year paid, even though medical services will be provided in future years. However, current deductions of payments for future medical care (extending substantially beyond the close of the tax year) generally are not allowed unless the future care is purchased in connection with obtaining lifetime care.

**Example: Medical expense portion of payments to retirement care facility.** Betty, age 71, made arrangements to enter the Shady Oaks Retirement Community in 2008. For Shady Oaks' promise to provide her with living accommodations, meals, activities, and lifetime care, including medical care, she paid an entrance fee of $90,000 and will pay a monthly fee of $1,900. Shady Oaks provided Betty with documentation that supports an estimate that 35% of its expenses are related to the provision of medical care to the residents.

Based on this information, Betty should be entitled to claim 35% of the $90,000 entrance fee (or $31,500) as well as 35% of the monthly fees as medical expenses in the year paid.

If Betty is the spouse or dependent of another taxpayer who makes these payments, that taxpayer can treat the same amounts as medical expenses. If an individual is chronically ill and under a prescribed care plan when the entrance fee is paid, a greater percentage of the fee may be deductible since qualified long-term care encompasses a broader range of services than medical care.





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