What is a cafeteria plan and how does it work

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What is a cafeteria plan?

A cafeteria plan is a type of employee benefit plan that is offered in the USA. It allows employees to choose from a variety of pre-tax benefits. When an employee receives their salary, it has to be taxed and they receive the net amount. This reduces the amount of money that they receive as compared to their total remuneration. With a cafeteria plan, one can select some options which include insurance benefits, pension and other benefits that help with life events. These benefits are tax-free, therefore by using the cafeteria plan, the income they receive is increased. If they were to receive the salaries first and then pay for the life benefits afterwards, the amount that would be deducted through the tax would be higher, and their receivable income would be lower.

How does it work?

A cafeteria plan is given its name because it allows employees to choose from various pre-tax benefits like how people select food in a cafeteria. The USA's Internal Revenue Code allows some benefits, typically those that help with life events, to be excluded from their total receivable income. This is not a strict rule since employees can choose whether to get a salary deduction for these benefits or to receive the cash amount. Employees can also select which benefits they want, but this is for two or more benefits. Both highly paid employees and lower-paid employees must have a similar opportunity to become eligible for the plan and have access to similar benefits and employer contributions.

Some of the rules that apply for cafeteria plans are:

1. **Eligibility**.

The plan passes the eligibility test if all employees, including part-timers, are eligible for the cafeteria plan. If not, the plan can only pass the test if the ratio of lower compensated employees to highly compensated employees who are eligible for the plan meets the Internal Revenue Service standards. This is different from the benefit plans that we use in Zimbabwe. In some organizations, higher-level employees are eligible for some benefits that lower-level employees are not eligible for.

2. **Contribution**

The contributions made by employers must be offered at the same level for similarly situated highly paid employees and lower-paid employees. Also, highly paid employees must not use the contributions disproportionately. This is also different to the benefits policies for organizations in Zimbabwe. For benefits such as pension and medical aid, some employers contribute different amounts for employees depending on their level in the organization.

3. **Benefits**

Both groups of employees must have the same opportunity to elect benefits under the plan. Whether the plan is discriminatory will depend on how many employees are in each group, their aggregate compensation, which employees choose to buy coverage, and what coverage they buy. If lower-paid employees spend proportionally less than highly compensated ones, the plan could pass this test as long as the aggregate salary-reduction amounts of highly compensated employees as a percentage of their aggregate compensation does not exceed the aggregate salary-reduction amount for the other employees as a percentage of their aggregate compensation.

4. **Safe harbours.**

The safe harbour rule applies to plans offering health benefits and to premium-only plans (see the type of plans in the next section). It provides that a premium-only plan will be deemed non-discriminating if the plan meets the eligibility test noted above i.e. if a high enough proportion of employees are eligible for the same amount of salary reduction although some may choose not to use it. This safe harbour applies to salary-reduction premium-only plans where the employer sponsors a health plan, but it is not clear whether it applies to POPs where employees can set aside pre-tax income only to buy individual health insurance products.

Types of cafeteria plans

1. Core-plus

This is the most common type of cafeteria plan. It is provided to all employees and it includes a second layer of optional benefits that are offered. Additional benefits may also be purchased with employer contributions and after-tax employee contributions.

2. Modular

This plan allows employees to choose from several pre-designed benefit packages. One package is allowed at no cost whilst others will require employee contributions through salary deductions.

3. Salary reduction only

If health insurance is the only benefit, this can be called a premium-only plan. This is also called a premium conversion plan” or a “premium reimbursement account,” and is often referred to as a POP. Salary reduction only can be stand-alone or part of a broader cafeteria plan. It allows an employee to select a pre-tax salary reduction to pay for benefits. It allows funding for certain benefits such as medical and dental expenses on a pre-tax basis. These benefits may not be covered by an employer’s plan.

Benefits of cafeteria plans

1. They allow employees to be aware of the benefits they receive
2. They allow employees to have a choice
3. They allow employees’ receivable income to be increased

Do cafeteria plans work?

Cafeteria plans seem to work, according to some literature. This is due to employees realizing the value they bring to them. However, some employees would rather allocate the money for these benefits to other expenses that they have. Also, employees are only allowed to change the benefits they select once a year. This limits flexibility. For employers, this could be a disadvantage, especially in a country such as Zimbabwe where hierarchy in an organization is of importance. Higher-level employees may dislike receiving benefits that are at the same level as lower-level employees. However, this would be good for lower-level employees as companies tend to underpay benefits for lower-level employees. This is a plan that can be considered by Zimbabwe’s HR managers.

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