



**Comments to the U.S. Senate Committee on Finance
Business Income Tax Working Group
On the Availability of Cafeteria Plans**

Senator Thune, Senator Cardin and Members of the Senate Committee on Finance Business Income Tax Working Group, the Small Business Council of America (SBCA) appreciates this opportunity to share its insights on the relationship between current tax laws and the ability of small businesses to sponsor cafeteria plans and to comment on the impact that various proposed tax reforms could have on small business cafeteria plans.

The SIMPLE Cafeteria Plan provides an incentive for small business owners to sponsor cafeteria plans, thereby making it easier for the employees of these businesses to obtain greater health coverage and other valuable employee benefits that are generally available to their counterparts working for larger businesses.

Currently, cafeteria plans (also known as IRC Section 125 plans) allow participants to pay for certain types of limited-scope health coverage, dependent care costs (IRC Section 129) and out-of-pocket medical expenses (IRC Section 105) on a pre-tax basis. Cafeteria plans allow employees to obtain and pay for, on a pre-tax basis, employee benefits, such as deductibles, co-pays, prescription drugs, braces, eyeglasses and other health care expenses, as well as dependent care, adoption expenses, and group term life insurance. These important tax savings currently allow many Americans greater access to health services.

While employees of large businesses, mid-size employers, non-profits, schools, universities and the federal government can appreciate the valuable benefits provided by cafeteria plans, small business owners are presently precluded from participating in cafeteria plans. Under current law, cafeteria plans can be utilized by common-law employees, but not by:

- Sole proprietors.
- Partners in a partnership.
- S-corporation shareholders holding an interest of 2% or greater (and by attribution, their family members).
- Members in a limited liability company which has elected to be taxed as a partnership.

As a result, because most small business owners are not able to participate in cafeteria plans,



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employees of small businesses are seldom offered this valuable benefit. This is blatant discrimination against small business owners. This rule is also bizarre in that small business owners are, of course, allowed to participate in qualified retirement plans.

As mentioned above, IRC Section 125 does not include self-employed individuals in its definition of "employee." As a result, sole proprietors, partners, shareholders owning 2% or more in S-corporations, and members of most limited liability companies are all unable to participate in cafeteria plans. This creates a significant disincentive for small business owners to provide cafeteria plans for their employees.

Cafeteria plans should be able to provide employees of small businesses with long-term care insurance. If allowed to purchase long-term care insurance on a pre-tax basis and by payroll deduction, it is far more likely that employees will elect to be covered by long-term care. Encouraging citizens to finance their own long-term care is desirable as it will help to shift the burden away from the government in addressing the long-term care needs of the baby boomer generation. The entire country wins when Congress can incentivize individuals to purchase long-term care insurance on their own.

Example of SIMPLE Cafeteria Plan

Innovative Co., an LLC taxed as a partnership, has 5 owners and 15 employees. It has been in business for four years and wants to provide its employees with some benefits. It has some younger employees with young children and some older employees, some of whom have infirm parents. Some of its employees have come from the federal government or larger companies and have asked for the types of benefits previously available to them. Innovative Co. decides to consult with its employee benefits advisor to determine the best way to tailor a benefits program for its employees.

Under the Current Law:

Innovative Co. would offer some form of health insurance wherein the employees would have to pay for their portion of the premium on an after-tax basis. The company might offer a group term insurance benefit; all of the employees would be covered whether or not they needed insurance. If Innovative Co. were to inquire about offering a cafeteria (a.k.a. Section 125 plan) similar to that offered by the federal government or larger companies, the advisor would inform them that none of the owners could be covered, so in all likelihood the company would not be interested in the plan. It is possible that they might provide a premium-only plan for the non-owners, which would at least allow the non-owners to pay their portion of the health insurance premium on a tax-free basis.

If Small Business Owners Were Eligible for a Cafeteria Plan:

Innovative Co. would offer a SIMPLE cafeteria plan. Employees could pay for certain health-related expenses on a pre-tax basis. Employees with young children could opt for the dependent care coverage if they chose to do so by having their payroll reduced to pay these



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expenses on a pre-tax basis. This benefit is also available to older employees who have infirm parents or other dependents in need of care. Employees could choose to reduce their paycheck and put that money into a flexible health care spending account where it could be used to pay for medical expenses not covered by insurance, such as eyeglasses or braces. Alternatively, employees could opt for dental insurance. They could also choose to increase the amount of life insurance available to them if the plan so provided. And, if Congress allowed long-term care insurance to be a qualified benefit, an employee could select long-term care insurance if needed. Each employee is able to tailor his/her own benefits package to suit his/her own needs. The result is that the employees have a more active role in selecting their benefits and, by joining Innovative Co., are not robbed of the opportunity to enjoy valuable benefits routinely available with larger companies and the federal government.

The SBCA thanks this Committee for its consideration of these issues and would welcome the opportunity to discuss these comments further.

The Small Business Council of America (SBCA) is a national nonprofit organization that has represented the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters since 1979. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, virtually all of which provide health insurance and retirement plans.

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