

April 2013



**Comments to the U.S. House of Representatives  
Committee on Ways and Means Working Groups on  
Pension/Retirement and Small Businesses  
On the Availability of Cafeteria Plans**

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Chairman Camp, Ranking Member Levin and Members of the Committee, the Small Business Council of America (SBCA) appreciates the opportunity to share its insight on the relationship between current tax laws and the ability of small business to sponsor cafeteria plans and comment on the potential impacts of various tax reforms.

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 be covered by health insurance and other valuable employee benefits just as it is for their counterparts who work for larger businesses.

Currently, cafeteria plans (also known as IRC Section 125 plans) allow participants to pay for health insurance 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, drugs, braces, eyeglasses and other health care expenses, as well as dependent care, adoption expenses, and group term life insurance. These important tax breaks currently allow many Americans, who would not otherwise have the opportunity, to obtain health coverage. The tax savings can be as much as 30 percent. An example of saving on a pre-tax basis is the dramatic success of employees saving for their retirement through 401(k) plans.

While employees of big businesses, mid-size employers, non-profits, schools, universities and the federal government 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 2% or more shareholders (and by attribution, their family members).
- Members in a limited liability company which has elected to be treated as a partnership.

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

The root of the problem is that small business owners are at a double disadvantage in offering health care and other employee benefits for their employees. 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. The employees of small businesses who do provide health care benefits face higher insurance premiums because these businesses lack the bargaining power of larger businesses. So not only are employees of large businesses far more likely to have health insurance than employees of small businesses, but they are also likely to pay a lot less for that insurance.

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 find out what is the best way to tailor a benefits program for its employees.

Under the current law:

Innovative Co. would offer some form of health insurance - 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 the employees would be covered whether they needed insurance or not. 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 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 their portion of health insurance 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 expenses on a pre-tax basis. This benefit is also available to older employees who have parents who are infirm or other dependents who need 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 eye glasses 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 which 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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