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State use of 'Cafeteria plans' to expand health insurance coverage

Richard Cauchi, NCSL Health Program. August 23, 2007

The policy of authorizing and using so-called "cafeteria plans" to allow employees to pay for a variety of health care expenses has been around for over a decade, based on federal IRS law and regulations, commonly labeled "Section 125 cafeteria plans". In the past six years, the federal law has become somewhat expanded and more "consumer-friendly", allowing for example, spending on over-the counter drugs, certain insurance premiums and allowing a three-month grace period for using up the employee-selected annual pre-tax withheld amount.

How Section 125 plans work:

Under federal tax law, a Section 125 Plan is a written plan that permits employees to choose between receiving cash (the employee's normal cash wages) and certain qualified benefits that can be paid for on a pre-tax basis by employees.

A Section 125 Plan may be established by any of the following:

- C Corporations
- Partnerships
- S Corporations
- Limited Liability Corporations (LLC)
- Sole Proprietorships
- Professional Corporations
- Non-Profit Organizations

IRS regulations state that self-employed individuals are not employees. Therefore, self-employed individuals may establish but may not participate in a Section 125 Plan, although spouses or other family members who are employees may participate in some cases. A *Section 125 "premium-only plan"* allows employees to pay their health care coverage premiums on a pre-tax basis, thus lowering their taxable income and, consequently, their tax liability.

An employee's election to pay for benefits on a pre-tax basis is made by entering into a salary reduction agreement with the employer. Under a salary reduction agreement, an employee elects to reduce his/her compensation by a stated amount on a pre-tax basis and those amounts are considered by the IRS to be employer contributions. In effect, it is as if the employee has given up the right to receive that part of his/her salary before actually becoming entitled to it. Therefore, the employee's salary reduction contributions are not actually received by the employee, and thus, are neither considered wages for state and federal income tax purposes nor subject to FICA withholding. It is important to note that, under a Section 125 Plan, health care coverage premiums may be paid entirely by employee salary reduction – employer contributions are not required. *[-excerpt from Massachusetts "Section 125 Plan Handbook for Employers"]*

Many employers sponsor and offer such cafeteria plans as an additional benefit to workers, often combined with a direct employer contribution to a group health insurance plan. Now some states are seeking to adopt the cafeteria plan approach into state-based health reforms. So far, Massachusetts, Rhode Island and California measures have been discussed and examined the most.

Massachusetts in 2006 became the first location to require that most employers offer such a cafeteria plan. That requirement (binding on all employers with 11 or more

Over...

workers) was a smaller provision within a much larger near-universal health plan, requiring employer payments and individual enrollment in an insurance plan. The following is the state's description and resource for this part of their law:

"The goal of the Mass Health Care Reform Law is to increase access to medical (health) care coverage for residents of the Commonwealth. The guiding principle behind this reform is one of shared responsibility: individuals, employers, health plans and state agencies all have new responsibilities under the law.

One of the primary employer responsibilities under the Mass Health Care Reform Law is the requirement that employers with 11 or more full-time equivalent employees adopt and maintain a Plan that satisfies both a) Section 125 of the Internal Revenue Code and b) regulations established by the Commonwealth Connector (the Health Connector, 956 CMR 4.00). This requirement went into effect on July 1, 2007.

The state has published a 52-page "**Section 125 Plan Handbook for Employers**" that provides extensive practical, financial and legal information that may be applicable to other state plans and proposals. See online:

http://www.mass.gov/Qhic/docs/section125_handbook.pdf

Rhode Island, in July 2007, became the first state to base a health insurance reform plan primarily on required use of Section 125 cafeteria plans (for employers with 25 or more workers,) when Senate Bill 448 was signed on July 3. The RI law is brief and simple in its wording:

On or before July 1, 2009, each employer with annual average employment of more than twenty-five (25) employees for six (6) consecutive months of the year in the state of Rhode Island shall adopt and maintain for its employees a cafeteria plan that satisfies the Internal Revenue Code 26 U.S.C. 125 and the rules and regulations promulgated by the office of the health insurance commissioner and through which the employees and their dependents may purchase health insurance. Nothing in this section shall be construed to require an employer covered by this section to pay for, or otherwise contribute to, the cost of any health insurance purchased through the cafeteria plan.

For Full text see: <http://www.rilin.state.ri.us/BillText07/SenateText07/S0448B.pdf>.

The following news articles provide details:

Sen. Rhoda E. Perry at (401) 751-7165.
Rep. Eileen S. Naughton at (401) 738-7928

Rhode Island General Assembly passes 'cafeteria plan' health care bill

STATE HOUSE – The General Assembly has approved legislation that will require companies with 25 or more employees to offer a "cafeteria plan" through which employees could purchase health insurance on a pre-tax basis.

The legislation (2007-S 0448B and 2007-H 6137A), which was sponsored in the Senate by Sen. Rhoda E. Perry of Providence and in the House by Rep. Eileen S. Naughton of Warwick, would require employers to offer an option that allows their employees to purchase their own health insurance before taxes are deducted from their salaries. It would not require any employer to contribute money toward its employees' health insurance costs.

The two identical bills crossed their final legislative hurdles today with passage in the Senate and will now head to the governor.

Depending on the tax bracket of the employee, the option to purchase insurance before taxes could save the employee as much as 40 percent of the cost of the insurance.

"This is not a huge expense for employers, but it could save their employees a significant amount of money. For some, that savings might be the difference between going uninsured and having some health care coverage," said Senator Perry, a Democrat who represents District 3 in Providence. "And that small

investment by the employer is probably going to save the employer money in the end, since healthy employees are more productive."

Also called "Section 125" plans after the federal tax code that allows them to be deducted before taxes, "cafeteria plans" are named as such because some large employers offer a variety of services, like child care and life insurance, through them and allow employees to choose the ones they want. Only health care, however, would be required under this bill.

The only cost to employers, unless they choose to contribute to their employees' health plans, would be administrative costs associated with setting up the payroll deduction mechanisms. When Massachusetts adopted similar legislation (although the Bay State applied it to businesses of 10 employees or more), that cost was estimated to be about \$300 per employee.

"At a time when health care coverage is becoming more and more difficult to afford, we want Rhode Islanders to have every option available to them. Cafeteria plans are an alternative that will make sense for some employees and will save them money. Employers should allow their employees to take advantage of this tax break, particularly if they're not offering a health insurance benefit," said Representative Naughton, a Democrat who represents District 21 in Warwick.

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RI: State to try out innovative insurance plan Rhode Island news

Providence Journal State House Bureau by Elizabeth Gudrais

Your employer may soon be offering something called a "cafeteria plan," but it has nothing to do with food.

Under a new law passed by the General Assembly, companies with 25 or more workers will be required to offer employees the opportunity to buy health insurance with pre-tax income.

The legislation does not force companies to pay anything toward their employees' insurance, or even to offer workers the chance to buy insurance at a group rate. But it is still expected to help bring health insurance within the realm of affordability for many workers who are currently uninsured.

About 39 percent of Rhode Island workers do not have access to employer-sponsored coverage, according to the office of the state health insurance commissioner. Some work for companies that do not offer insurance. Others aren't eligible for benefits, for instance, because they don't work enough hours per week to qualify.

The tax break will mean a savings of up to 40 percent of the premium cost, depending on the worker's tax bracket, the commissioner's office estimates.

The plans are called "cafeteria plans" because employees are free to opt in or out and employers can offer a variety of options for using the money, such as vision coverage, a dental plan and life insurance, in addition to regular medical insurance. The more technical term for the plans is "Section 125" plans, in reference to the section of federal law that allows employees to pay for the plans with pre-tax dollars.

Governor Carcieri signed the bill, sponsored by Sen. Rhoda E. Perry, D-Providence, into law last week. A companion bill, by Rep. Eileen S. Naughton, D-Warwick, was transmitted last week and is awaiting action from the governor.

The new law does not require employers to start offering the plans until 2009, and the state Department of Labor and Training has yet to issue regulations that spell out what companies must do to comply.

Matt Stark, policy director for the health insurance commissioner's office, said companies might choose to offer health-insurance plans that employees could buy through the company at a group rate. But he said the law does not require companies to do that, or anything else beyond setting up a payroll deduction mechanism so employees can set aside money.

Stark said employees would choose a health-insurance plan and that plan would bill the employer for the cost of the insurance premium. The costs would be paid with the money the employees set aside.

At least for now, getting insurance through Blue Cross & Blue Shield of Rhode Island's often-expensive Direct Pay plans is virtually the only option for individuals buying insurance on their own. In separate initiatives, state government and insurers are working together to create lower-cost options for individuals.

Although companies can set up their cafeteria plans directly with the Internal Revenue Service, Stark predicted most would pay a broker or a payroll company to do it. There is a small cost associated with the task; Stark said one payroll company quoted a rate of \$300 a year for a company with 10 employees. Laurie White, president of the Greater Providence Chamber of Commerce, estimated brokers would charge a flat fee of \$50 to \$100.

LEGAL ANALYSES AND COMMENTARY - July 2007

The federal ERISA statute and subsequent court opinions limits the types of state laws that impose requirements on employers. However, two national experts in ERISA law have examined the Massachusetts law and California proposals and concluded that state action is feasible and legal. These are excerpts of their comments, provided just after the Rhode Island law passed.

1) By Patricia Butler, JD; ERISA lawyer in Colorado

I wrote about this in the 2 NASHP/SCI papers on the MD case and MA law (www.statecoverage.net). A 1994 DOL advisory opinion indicated that 125 plans themselves aren't ERISA plans so I argue that a state requirement to create them shouldn't be preempted.

People at DOL advised Romney's staff that the MA provision shouldn't raise an ERISA problem but wouldn't put it in writing and, in my work for CA, I tried to get clarity recently but DOL officials won't talk about this any longer (maybe they'd talk to some other Governors...?).

There certainly are folks who'll disagree about ERISA implications and if anyone challenges the MA law, this issue might be raised. Thus far, no courts have been asked to consider it.

- Patricia Butler, JD, Boulder, Colorado butler@csd.net

2) By Phyllis C. Borzi, JD, MA

I agree with Pat. I talked myself to the DOL folks and urged them to issue guidance that this was OK, but they are reluctant to do it and even if they did, it wouldn't necessarily be binding on a court. But a word of caution: the DOL opinion letter only talks about a 125 plan that was not part of a normal cafeteria plan (i.e., there was no employer money nor any other benefits offered except a premium conversion opportunity to employees to have money withheld from their paychecks to make premium contributions to an insurance program not sponsored by the employer. If the states try to do anything else, it is probably going to trigger preemption.

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EXAMPLE OF STATE-AUTHORIZED 125 PLAN SAVINGS: (Massachusetts, 2007)

An employee who pays his/her health care coverage premiums on a pre-tax basis realizes a savings on state income, federal income and federal FICA taxes. This tax savings could amount to as much as 40% of the cost of health care coverage. The employer also realizes FICA withholding tax savings for each participating employee.

The example below illustrates the annual tax savings realized by an employee in Massachusetts with adjusted gross income of \$50,000 who participates in his/her employer's Plan:

	w/o Plan	with Plan
Adjusted Gross Income	\$50,000	\$50,000
Annual Pre-tax Health Care Coverage Contribution	\$0	\$ 2,100
Taxable Income	\$50,000	\$47,900
Estimated Taxes	\$12,676	\$11,880
Annual After-Tax Health Care Coverage Contribution	\$ 2,100	\$0
Net Take Home Pay	\$ 35,224	\$36,020

In this example, the employee achieves annual tax savings of \$796 and his/her employer saves \$161 in annual FICA taxes.

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Section 125 Plan Offering

- Allows employees to buy health insurance on a **pre-tax** basis, offered through the Connector
- Employer savings on FICA = 7.65%
- Employee in Mass. savings = 41%
- Enables employers with more than 10 full and part-time employees to avoid the "Free Rider" surcharge

Example: employee savings on \$3,000 premium

	w/o Plan	With Plan
Annual Income	\$70,000	\$70,000
Annual pre-tax Employee Contribution	\$0	\$ 3,000
Taxable Income	\$70,000	\$67,000
Estimated Taxes	\$14,670	\$13,530
Annual After-Tax Employee Contribution	\$ 3,000	\$0
Net Take Home Pay	\$52,330	\$53,470
Annual Savings from Pre-Tax Contributions	\$0	\$ <u>1,140*</u>

* In this example, Employer also saves \$230 in annual FICA taxes, for a total tax savings of \$1,370 on a \$3,000 premium