

SERVING UP MORE OPTIONS IN HEALTH INSURANCE THROUGH CAFETERIA PLANS

BY SARAH MCINTOSH

Executive Summary

During the 2008 legislative session, Kansas lawmakers passed Senate Bill 81 which clarifies that under federal law employers who provide health insurance to their employees can also set up Premium Only Plans (POP). These plans allow employees to use pre-tax dollars to pay for health insurance.

The Kansas legislature should consider taking a further step in improving health insurance choices for Kansans by allowing employees to purchase their own health care plans through their employer's cafeteria plan. This would make the employee the actual owner of the policy and allow them to retain the tax advantages of such an option.

Some of the advantages to the employer include:

- Tax advantages;
- Use as a recruitment tool;
- Lower human resource cost; and
- Better business budgeting through increased predictability.

Some of the advantages to the employee include:

- Portability;
- Increased choices;
- Better affordability;
- Better tailored plans;
- Family-centered and couples-centered plan options; and
- Health Savings Account options.

The legislature took a step in the right direction by acknowledging the choice employers have to establish POP plans under federal law, but they should take a further step towards insurance reforms by making individual plan ownership through cafeteria plans an option in Kansas; and employers, particularly small business owners, should consider whether these plans would be of benefit to them and their employees.



Introduction

The debate about how to address the issue of the uninsured or “underinsured” continues at both the national and state levels. Numbers indicates that around 46 million Americans are uninsured¹ and roughly ten percent of Kansans are without insurance.² In Kansas, many individuals work not for large companies, necessarily, but for smaller Kansas-based businesses. According to the Kansas Health Policy Authority, more than 77% of the uninsured in Kansas work for small businesses with less than 51 employees and most of those individuals actually work in businesses with fewer than 25 employees.³ The high cost of health insurance is one reason for the number of uninsured and underinsured. The current one-size-fits-all approach that many of these individuals are offered does not make good economic sense and thus results in higher uninsured rates.

Unemployment and job transition also contribute to the high uninsured numbers. When individuals change jobs they generally lose their employment-based insurance. And the waiting periods for insurance changes prolong the amount of time people are uninsured.

One option for alleviating some of the problem is for states to pass laws allowing employers to offer employees the option of purchasing their own personal health insurance policies through the business’ cafeteria plan. The federal government authorizes cafeteria plans under 26 U.S.C. Section 125---hence the term 125 plans. During the last legislative session, Senate Bill 81 was enacted providing that employers who offer health insurance coverage where employees also contribute, may offer a 125 plan. For the most part, this step was a restatement of the status quo since federal

law already allowed this and there appears to be no law against it in the state of Kansas.⁴

An Explanation of the Plans

What is a 125 Plan?

According to Section 125 of the IRS tax code, a cafeteria plan is “a written document which allows employees to convert certain taxable benefits into non-taxable benefits.” It can include a cafeteria of options like health care premiums and childcare expenses, which is why they are sometimes referred to as cafeteria plans. Senate Bill 81 addressed the Premium Only Plan (POP) portion of the cafeteria plan. A section 125 plan allows employees to purchase employer-offered health care policies with pre-tax dollars.

What is the Difference between a POP Plan and an Individual Plan?

While a POP plan is an employer-offered insurance program, the individual plan addition would allow the employee to pick the plan. This means that the health insurance plan is self-owned---even though the employer may contribute to the cost. Simply put, an employer can say to an employee, “I’m going to contribute x dollars to your health insurance premium (or Health Savings Account).” Then it is up to the individual to identify the plan he or she wants. The remainder of the premium is then deducted from the employee’s paycheck in pre-tax dollars.

What are the Advantages of Individual Ownership Plans Administered through Section 125 Cafeteria Plans?

Tax Advantages

Section 125 plans offer a multitude of advantages, not the least of which are the tax advantages. These plans save businesses



and employees in FICA and Medicare taxes. It also saves the employees money because it reduces their taxable income since their payments for health insurance are not then considered taxable.⁵ The net effect for middle class families can be a nearly 40 percent reduction in federal (25 percent) and state (6.25/6.45 percent) income taxes, as well as FICA taxes (7.65 percent).⁶

As a Recruitment Tool

Employers may find that offering an individual policy through their cafeteria plan is a great recruitment tool.⁷ Instead of offering no insurance or offering a one-size-fits-all plan, the employer can stress to potential employees the options they have for choosing their own health care plans. Often individuals consider insurance coverage a key factor in their employment decisions.

Business Budgeting

Yet another advantage these plans offer to employers is their simplicity. This is especially important for small businesses that do not have a human resources department.⁸ In fact, during the 2008 legislative session, the government approved grants to help start up POP plans through section 125.⁹ The Topeka Independent Business Association is working to help small businesses with the initial start-up of these health care plans.¹⁰ But the extra step of allowing individual plan ownership would be of greater benefit and allow small businesses to better budget and predict costs. Current employer-based plans, especially in smaller businesses, are affected by the number of employees, and hirings and firings can affect the group plan.¹¹ These changes in dynamics can be somewhat unpredictable for the employer and can cause radical insurance cost adjustments.

Portability

Employer-based insurance creates portability issues for individuals when they change jobs and creates a high percentage of temporarily uninsured workers. Individual plans purchased through a cafeteria plan are employee-owned which means that when they leave their job they can take their plan with them. This will cut down on the temporarily uninsured numbers. Portability also affords them the benefit of keeping a consistent health care plan. This means they can avoid the waiting periods and transition costs from switching to a new plan when they take a different job.

Increased Family Options

Too often with small group plans, couples have separate plans and sometimes even a third plan for their children. Individual ownership of 125 plans eliminates this hassle by allowing couples and families to contribute to one plan that they have chosen. Each spouse's employer can contribute to the chosen premium, again, giving people more options to tailor their health insurance coverage to their personal needs. It is also a cost-savings to families who often can find discounted family plans as opposed to purchasing separate policies. It can eliminate the hassle of multiple insurance cards with different rules.¹²

Affordability

The key component to encourage people to become insured is to offer them products that make economical sense to them. According to the Council on Affordable Health Insurance, 19 to 34 year olds represent 56 percent of the uninsured in the United States.¹³ Not only does this age group often consider themselves "invincible," they also feel that it doesn't make sense for them to spend \$200, \$300 or even \$400 in premiums for health insurance they do not perceive a



need for. On the other hand, if they have the option to buy an individual plan (often for less than \$100) that might be a cost they can afford.

Individual plans purchased through a cafeteria plan can also help part-time workers who are not counted as part of a participation requirement and often lack employer-based coverage. Thus, employers are given more flexibility in offering benefits (because they do not have to provide a set percentage of contributions) and employees who otherwise would not be covered have the opportunity to purchase health care plans with pretax dollars.

Health Savings Account (HSAs) Options

Finally, section 125 plans whether, employer-based as with POPs or with the individual option as recommended in this paper, offer employees the option of establishing a Health Savings Account (HSA). The recently enacted Senate Bill 81 allows 125 plans to offer the option of “paying all or any portion of the health insurance premium or the option of receiving health insurance coverage through a high deductible health plan and the establishment of a health savings account.”¹⁴ With an HSA, people can put pretax dollars into an account, which covers medical expenses. Employers, then, can also contribute to the account.¹⁵ Federal law requires an individual or family with an HSA to also have a high-deductible health insurance plan. These high-deductible plans have much lower premiums than traditional plans. Some HSAs even allow unused funds to roll-over into retirement accounts.

What are the Disadvantages of Section 125 Plans?

Plan Drafting Costs

Businesses will have to pay the initial cost to make the transition which usually means

hiring a consultant to help. But, Kansas has grants to help small businesses and associations such as the Topeka Independent Business Association are offering to help small businesses with this transition. And consultant costs can run as low as \$99 depending on the size of the business and the complexity of the plan.

Individual Responsibility

Offering an individual plan purchased through section 125 requires that employees take control of their health insurance needs. This could be a challenging task at the onset, particularly for individuals who are used to simply signing on to whatever their employer’s plan is. But, the concerns of this new “burden” can be overcome in a couple different ways. First, the employer will have to provide pertinent information on how this plan works and may offer suggestions for where to look for plans. Second, in today’s information age a simple query on the Internet is all it takes to take a comparable look at plans offered. In the end, it truly is the individual who best knows his or her needs and it should be up to the individual to find the plan that fits those needs.

HIPAA Concerns

Despite its name, the Health Insurance Portability and Accountability Act (HIPAA), has the effect of restricting portability instead of promoting it. As amended by HIPAA, the Employee Retirement Income Security Act (ERISA) of 1974 is generally interpreted to say that “employers can only purchase group insurance with untaxed dollars.”¹⁶ This is in contrast to individual premium purchase through cafeteria 125 which results in an *increased* portability, rather than a restriction. It should be noted that this is a strict interpretation of the law and the reality is that enforcement is left to the states and “there appears to be no consistency in state regulation.”¹⁷



What Must a Business Do to Qualify for Section 125 Plans?

Disclaimer: this is not financial planning nor legal advice but rather a rough description of the guidelines. Individuals and employers should consult professional advice in setting up their plans.

Who Is Eligible?

A business must determine if they are eligible to offer the POP plans through section 125. Any business that has one or more employees may have this type of plan. So there must be at least one employee for whom the employer pays federal Social Security and Medicare taxes. But note, the employees are the participants in the plans, not the employer his or herself. Partners, those who are self-employed, and people who are more than 2% shareholders in a S corporation are not considered employees and may not participate in the plan (although they themselves may offer the plan).¹⁸ Sole proprietors without employees cannot have a plan as well as LLCs, LLPs, and standard partnerships. Some C corporation owners can participate but the majority cannot. Spouses and dependents of the business owner cannot be considered employees for purposes of the section 125 plan.

What are the Steps for Implementing a Plan?

Employers should first make an announcement to employees that they intend to establish the POP plan and/or the individual premium purchase option. Then the document explaining the adoption plan should be distributed to each employee as well as an opt-out form for employees who do not want to participate. Then nondiscrimination tests are performed. Finally, there is a change in the payroll system that accommodates this pre-tax treatment of employee contributions.

Adequate records must be maintained throughout the process.

What are Other States Doing?

Other states, including Missouri,¹⁹ Rhode Island,²⁰ Connecticut,²¹ and Minnesota²² have enacted legislation mandating the employers of a certain size and legal status establish section 125 POP plans. While having the option to establish plans is good, requiring that certain businesses do them is not so good---and potentially is in violation of federal law. In 2007, however, Missouri did take a step in the right direction by allowing the funneling of individual plan premiums through the cafeteria 125, which is what Kansas should consider doing as a next step.

Conclusion

The good news is that section 125 plans are already legal under federal law and recognized under Kansas law. Section 125 plans offer an excellent option for Kansas businesses, but a further step is needed to make individual plan ownership through cafeteria plans an option in Kansas. This alternative to employer-based health insurance should be acknowledged as both a way to reduce the uninsured problem in Kansas and as a way to provide a multitude of advantages to employers and employees.

The bad news is that not everyone is aware of the potential benefits of the currently allowed employer-based plans that can be offered through section 125 and the option other states are looking at for allowing individually owned plans to be purchased through the cafeteria plan. Legislators and businesses should consider this additional step---for these plans can reduce the number of uninsured, promote choice and affordability of insurance, create portable health insurance, as well as provide other benefits to the employees and employer. And finally, when considering this reform



option the legislature should be careful not to mandate participation but leave it up to the employers to determine if it is the right program for their business.

About the Author



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Notes:

¹ “Overview of the Uninsured in the United States: An Analysis of the 2005 Population Survey,” *U.S. Department of Health and Human Resources*, 22 September 2005. Available at: <http://aspe.hhs.gov/health/reports/05/uninsured-cps/index.htm#Introduction>.

² “Health Insurance Coverage by State for All People: 2005,” *CPS Annual Demographic Survey*, 2007, Table H106.

³ “Health Reform Column: Kansas Health Reform to Focus on Those Most in Need.” Kansas Health Policy Authority, 24 October 2007. Available at: <http://www.khpa.ks.gov/PressReleases/Releases/ArneathaMpolicescoverworkingpoor.pdf>.

⁴ Note that this law does not apply to “any employer who offers health insurance through any self-insured or self-funded group health benefit plan of any type or description.”

⁵ Joshua Kendall, “It’s on Uncle Sam: Making Section 125 Plans Work,” *Business Week*, 20 February 2008. Available at:

http://www.businessweek.com/magazine/content/08_62/s0802021589544.htm?chan=magazine+channel_bsmallbiz+--+frontline.

⁶ Tarren, Bragdon, “Rx NY: A Prescription for More Accessible Health Care in NY,” *Empire Center*, 11 December 2007. Available at: <http://www.empirecenter.org/Special-Reports/2007/12/RxNYReport.cfm>.

⁷ Kendall, 20 February 2008.

⁸ Mike Shields, “Missouri Health Reforms Intrigue Some Lawmakers Here,” *Kansas Health Institute News Service*, 17 September 2007. Available at:

<http://www.khi.org/s/index.cfm?aid=834>.

⁹ Senate Bill 11 section 13; 14.

¹⁰ See www.topekaiba.org for more information

¹¹ Beverly Gossage, “Missouri Leads the Way to Free-Market Health Care Reform,” *Show-Me Institute*, 1 June 2007. Available at: http://showmeinstitute.org/publication/id.61/pub_detail.asp.

¹² Beverly Gossage, “Free-Market Health Care Reform in Missouri: A Primer,” *Show-Me Institute*, 3 June 2007. Available at: http://showmeinstitute.org/publication/id.62/pub_detail.asp.

¹³ *Ibid.*

¹⁴ Senate Bill 81 Section 2(c)(1). The bill goes on to say that “In order for an eligible individual to obtain a high deductible health plan through the cafeteria plan, such individual shall present



evidence to the employer that such individual has established a health savings account in compliance with 26 U.S.C. Section 223 and any amendments and regulations.”

¹⁵ Shields, 17 September 2007.

¹⁶ John Goodman, “Employer-Sponsored, Personal and Portable Health Insurance,” *National Center for Policy Analysis*, 18 December 2006.

¹⁷ *Ibid.*

¹⁸ Lynn Quincy, “What are Section 125 Plans and How Can They be Used to Expand Health Coverage?” *National Health Policy Conference*, 7 February 2008. Available at:

http://www.statecoverage.net/0208/Quincy_Mathematica.ppt.

¹⁹ Gossage, 3 June 2007.

²⁰ Bragdon, 11 December 2007.

²¹ “CBIA Section 125 Plan Handbook,” *Connecticut Business and Industry Association*. Available at: <http://www.cbia.com/INS/hlt/br/2pdf/125Handbook.pdf>.

²² “2008 Health Care Reform Summary,” *Minnesota Department of Health*, June 2008. Available at: <http://www.health.state.mn.us/divs/opa/08reformsummary.pdf>.

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