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TRENDS IN INSURANCE COVERAGE

Using Section 125 Premium-Only Plans to Expand Health Coverage

by Lynn Quincy

Internal Revenue Service (IRS) Section 125 employee benefit plans allow employees to pay their portion of the premiums for employer-sponsored health insurance on a pretax basis, which lowers taxable income and tax liability. Sometimes referred to as cafeteria plans, Section 125 plans can take several forms. When they are used only to shelter employee health premium dollars, they are called premium-only plans. Section 125 premium-only plans are simple to implement, have minimal filing obligations, lower the cost of health insurance for employees, and may even save employers money. This brief explores how states are expanding the use of these plans to increase access to health coverage.

How 125 Plans Can Expand Coverage

Many states are exploring policies to reduce the cost of health insurance and increase coverage by expanding the use of Section 125 plans. These plans lower the cost of health insurance through tax savings.

Table 1 illustrates how this type of plan would work for an employee whose monthly premium contribution is \$250. If earnings used to pay that premium are not taxed, then federal and state income tax obligations, as well as Federal Insurance Contributions Act (FICA) taxes, are lower. (Also known as payroll taxes, FICA taxes include Social Security and Medicare taxes.) In this example, the tax savings add up to \$146—more than half the cost of the premium. Note that tax sav-

ings vary by employee, reflecting differences in family income, filing status, and other factors.

Despite the advantages for workers, many small employers do not offer these plans (Table 2). Employer survey and focus group data suggest that many small employers are not familiar with Section 125 plans or with the tax treatment of employer-sponsored health benefits more generally. While Section 125 plans are unfamiliar to most people, they are not costly or onerous for employers. They may even save employers money: for example, when an employee's taxable earnings are reduced, the employer's share of the FICA obligation also goes down (Table 1).

Policymakers in several states have recently instituted programs that expand the use of Section 125 plans. The box below summarizes recently implemented state policies, from least to most aggressive.

RECENT STATE POLICIES EXPANDING THE USE OF SECTION 125 PLANS

- Montana has aggressively promoted Section 125 to voluntarily increase its use among firms participating in the InsureMontana coverage initiative.
- Maryland and Indiana require employers to offer Section 125 plans as a condition of participation in a subsidized coverage initiative.
- Connecticut, Missouri, Minnesota, Rhode Island, and Massachusetts mandate that certain types of employers offer Section 125 plans to their employees.
- Minnesota, Rhode Island, and Massachusetts provide a way to purchase coverage through a Section 125 plan even when there is no employer contribution.

A summary of policies by state is available at www.mathematica-mpr.com/health/section125table.pdf.

TABLE 1		
SAMPLE TAX SAVINGS FROM SHELTERING PREMIUMS— SINGLE PARENT, 2 CHILDREN, 200% FEDERAL POVERTY LEVEL		
	Monthly	Annually
Employee premium for a family policy (before tax savings)	\$250	\$3,240
Tax savings, if sheltered in Section 125 plan:		
Federal income tax @ 36%	\$97	\$1,166
FICA tax* @ 7.65%	\$21	\$248
State income tax @ 11%	\$28	\$341
Total employee tax savings	\$146	\$1,756
Net cost of coverage after tax savings:	\$124	\$1,484
Percentage savings	54%	54%
Employer savings (from reduction in FICA)	\$21	\$248

* Also known as payroll taxes.

Potential Tax Savings Vary

Because high-income employees are likely to be insured and pay their premiums on a pretax basis already, policymakers' interest in Section 125 plans has focused on ways to help middle- and lower-income workers afford health insurance. The potential tax savings for low-income workers can be quite high—sometimes exceeding 50 percent of their premium contributions.

The value of a Section 125 plan depends on the rate of tax a worker pays on his or her last dollar of total earnings, referred to as the marginal tax rate. In most states, three separate taxes contribute to the marginal rate: federal income tax, state income tax, and FICA.

Although lower-income workers have little income tax liability and tend to be in the lowest tax brackets, they can face surprisingly high marginal tax rates. Federal tax credits, in particular the Earned Income Tax Credit (EITC), can cause a worker's marginal federal income tax rate to diverge from the nominal tax bracket. At certain income levels, the tax credit is reduced or phased out as income increases. Looked at another way, for taxpayers in the "phase-out" income range, the value of the EITC increases if taxable income is reduced, such as when it is sheltered through a Section 125 plan.

Mathematica used a tax simulation model to explore the magnitude of marginal tax rates and variations that exist among lower and middle-income workers. The highest marginal rates accrue to lower-income workers with children in states that complement the federal EITC by offering a state EITC. Although all families with incomes over 125 percent of the federal poverty level (FPL) experience nontrivial tax rates, families with children and incomes of roughly 150 percent to 225 percent of FPL typically experience very high overall marginal tax rates of 40 percent or more. Single filers with incomes exceeding 200 percent of FPL face overall marginal tax rates as high as 28 percent.

Responsiveness to Tax Savings

How uninsured workers will respond to opportunities to shelter health premiums from taxes is uncertain. Most will not know the amount of tax savings they are likely to realize. Even for those who can reduce their after-tax price of insurance by a substantial amount, the price change may not be apparent. Their pay stub will still list the full (before-tax) premium, and they may not see an immediate reduction in income tax liability if they do not adjust their tax withholding on a W-4 form.

Given this situation, workers are likely to make health coverage enrollment decisions independently of any anticipated tax savings. As a result, the extent to which health coverage is expanded may depend, in large part, on coverage options that accompany states' Section 125 policies. If requirements for employers to offer Section 125 plans are paired with an individual health coverage mandate (as, for example, in Massachusetts) or a connection to a subsidized coverage program (Maryland), workers are more likely to take advantage of the tax savings newly available to them.

Potential Reach of Expansion

Among those who could readily benefit from a Section 125 expansion policy are workers who already have an employer offer of health coverage but pay their premiums after taxes. Implementing a Section 125 plan could help these workers better afford the offered coverage. As Table 2 illustrates, many smaller firms that offer coverage don't offer a Section 125 plan.

At the same time, increasing the use of Section 125 plans among employers who offer coverage would only reach a minority of uninsured workers. Most uninsured workers either work for employers that do not offer coverage (64 percent) or are not eligible for coverage when it is offered (17 percent). A Section 125 plan would help these workers only if they also gain access to group or individual coverage that can be purchased through a Section 125 plan. For example, Maryland provides a subsidized small group insurance program that requires participating employers to sponsor a Section 125 plan—providing a new coverage option employers can offer and ensuring that employees’ premium shares can be paid on a pretax basis. In Massachusetts, workers in firms of 11 or more employees with no employer health insurance contribution can purchase individual (nongroup) coverage through a Section 125 plan.

Depending on how a Section 125 expansion policy is implemented, many groups stand to benefit. Policymakers should be aware, however, that Section 125 expansion policies would not benefit the following:

- Self-employed workers, for whom IRS Section 125 does not authorize tax-exempt contributions for coverage. (These workers benefit from advantageous health coverage tax treatment under a different section of the IRS code.)
- Families lacking a wage earner and, therefore, no access to a Section 125 sponsor.
- Workers who pay no premium for employer-sponsored coverage — including approximately 50 percent of employees with single coverage in small private-sector firms.
- Workers with very low incomes (roughly 125 percent FPL or less), who are unlikely to be able to afford premiums and for whom the tax savings are minimal or negative.

State vs. Federal Considerations

Section 125 expansion policies may not require the direct appropriation of new state funds, but they can represent a tax expenditure—that is, a loss of tax revenue—for states with an income or state-specific payroll tax. However, federal tax savings typically account for most of the total tax savings (Table 1). Increasing the purchase of coverage through Section 125 plans essentially leverages additional federal funding for state residents.

Firm Size	Employees in Firms Offering Health Coverage*
	Without a Section 125 Plan
2-9 workers	65%
10-24 workers	50%
25-99 workers	30%
100 or more workers	8%

Source: Agency for Healthcare Research and Quality. Unpublished National MEPS-IC Data for 2004 (Private-Sector Employees).

* May include employees who are not eligible for their employer’s offer of coverage.

Legal Issues

The Employee Retirement Income Securities Act of 1974 (ERISA) does not govern Section 125 plans. Consequently, ERISA does not preempt state policies that require employers to offer these plans. Nonetheless, policymakers considering Section 125 expansion policies should be familiar with responsibilities facing employers who offer these plans and be prepared to offer employers assistance.

Under IRS code, employers that offer a Section 125 plan must maintain a written plan document and comply with IRS nondiscrimination provisions. These requirements, which usually affect only very small firms (with three or fewer eligible employees), are generally considered fairly easy to comply with.

State policies requiring employers that do not contribute to health coverage to offer Section 125 plans are likely to impose unexpected, additional requirements on employers. Significantly, coverage offered through a Section 125 plan is considered a group health plan under the IRS code. This is true even if the employer does not contribute to coverage or otherwise appear to be sponsoring the coverage. Employers not contributing to coverage are subject to employer notice provisions under the Consolidated Omnibus Budget Reconciliation Act (COBRA), as well as employer and insurer nondiscrimination and benefit design requirements under the Health Insurance Portability and Accountability Act (HIPAA), just as employers contributing to coverage are. Further, coverage must

be compliant with HIPAA's private-sector group provisions with respect to guaranteed renewability, portability, and guaranteed issue of the coverage.

States instituting Section 125 policies can help employers comply with these requirements. Massachusetts, for example, used a series of meetings, mailings, and a website to educate brokers, benefits consultants, employers, and others about Section 125 plan requirements. The state also merged its small group and individual insurance markets to ensure that individual coverage offered through a Section 125 plan was compliant with HIPAA's small group provisions. Recent employer surveys in Massachusetts show that a majority of employers found it easy to set up Section 125 plans.

Directions for Policy

As tax-based initiatives that strengthen employer-based coverage and are partially paid for by the federal government, Section 125 policies have broad appeal for states. Given the often significant tax savings and low employer cost of instituting these plans, there is little downside to promoting them. However, the policy reach of Section 125 plans is uncertain and may be small when they are used as a stand-alone effort. Section 125 expansion policies will have a greater impact if they are part of a larger health coverage expansion effort. To make the most of any expansion, states will need to educate employers about the use of these plans and help them comply with regulatory requirements.

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For a complete description of Section 125 plans, and the associated employer requirements, see IRS Publication 15-B, "Employer's Guide to Fringe Benefits."

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