Matt W. Zeigler
Zeigler & Associates, P.C.
ATTORNEYS AND COUNSELORS AT LAW
Phone: (248) 643-9530 • Fax: (248) 643-0843 • E-Mail: matt@zeiglerlaw.com

PREMIUM ONLY CAFETERIA PLANS:

AN ANSWER FOR MEDICAL INSURANCE PREMIUMS

By: Matt W. Zeigler, Esq.

The War in the Persian Gulf has brought a different perspective to all of the decisions that must be made in order to run a business. But one of the many reasons our servicemen and women are there now, and one of the reasons others have served our country in the past, is to permit those of us here to continue to make decisions and to take care of business at home.

This war has not changed the fact the cost of doing business and, in particular, the cost of medical insurance is predicted to rise steadily at the rate of 20% per year for the foreseeable future, being at least the next 3 years. This is expected to occur while prices for goods and services are under tremendous competitive pressure which will only increase with a recession, should it develop.

To remain competitive, businesses in cross-section industries are looking to solve the twin horns of the dilemma of attracting and keeping a qualified workforce, on the one horn, and easing the burden of the cost to provide employer paid medical benefits on the other horn. Some employers have found an answer in the shifting of all or part of the cost of or the increases in the monthly medical insurance premiums to the employees through the adoption of a simple form of a cafeteria plan.

What these employers have done is to adopt a premium only cafeteria plan. For those employers who have already shifted all or a portion of the cost of the medical insurance premium to the employees, the portion that the employee pays now with after-tax wages can be treated as pre-tax benefit. In other words, an employee's salary is reduced or "redirected" and withheld by the employer and deposited into a separate account used to fund the insurance premiums. Cafeteria plans are permitted under section 125 of the Internal Revenue Code.

The benefits to an employer adopting a cafeteria plan are:

- The 7.65% employer-portion of the FICA tax is not paid on the amount withheld or redirected;
- Since the employee's salary in reduced, there will be no unemployment compensation tax paid on the amount reduced. The employer's savings is based on their individual MESC rate.

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- The employer will not have to pay Federal Unemployment taxes ("FUTA") on the amount of the salary reductions.
- The salary reduction component of the plan will also reduce the wages that are reported for purposes of calculating the premium for workers disability insurance. An employer would save at its own rate.

The net effect of the adoption of such a plan, is two fold: First, in many cases, a participating employee will actually see his or her net take home pay increase without the loss of any benefits. Second, the employer's savings will continue from year-to-year and often pay for the cost of the adoption of the plan within the first year. The amount of the cost savings to a particular employer will depend on the rates of these various taxes discussed above.

If the plan adopted by the employer is a simple premium only plan, the employer's own benefits personnel can administer the plan and avoid the cost of third party administrators and the savings are increased. A 5500-C/R Form will have to be filed on an annual basis, but it, too, is a simple headcount of the number of employees participating, and whether they are or are not highly compensated employees. Further, there are some nondiscrimination rules in effect for these plan, but, if the plans are basically fair in design to begin with, the prohibition of no greater than a 25% disparity between the benefits of the highly compensated employees and the benefits of the nonhighly compensated employees will not be difficult to achieve.

One usually hears of a cafeteria plan in the context of large companies with sophisticated benefit structures which requires constant monitoring; for example, buying and selling vacation days, 401(k) plan contributions, guessing whether one should spend their specific benefit dollars among dependent care assistance, additional group term life insurance, or between an HMO or Blue Cross, dental or optical benefits, or other uninsured medical expenses. All of these benefits are available within the context of a cafeteria plan. When many kinds of benefits are available inside such a plan, it is generally referred to as a Flexible Benefit Plan or a "Flex Plan". Of course, any one or all of the benefits can be made available within the context of such a plan. The extent of the complexity is the employer's decision.

But the idea that is finding increasing acceptance, is not the complex plan but, rather, the premium only cafeteria plan designed for a single use. Such a plan becomes inexpensive to operate, easy to communicate to the employees and simple for recording, keeping and reporting purposes.

Large employers across the country have adopted these plans for the benefit of their employees and so they have a large constituency of use and support. Accordingly, the Internal Revenue Service has not taken a "Section 89" approach to these plans and most observers expect that they will supply a valuable way to provide benefits to employees in a cost-effective way for the 1990s.

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