



Premium Conversion of Health Insurance

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Summary

Premium conversion allows employees to pay their share of employment-based health insurance premiums on a pre-tax basis. The tax treatment is difficult for people who are not tax experts to understand, as are the rules that limit its use in a manner some consider arbitrary and unfair. Premium conversion is sometimes referred to as “premium only” or “section 125 plans,” causing further confusion.

Premium conversion is authorized by section 125 of the Internal Revenue Code, a section entitled “cafeteria plans.” In general, the section allows taxpayers to choose among taxable and nontaxable benefits offered by an employer without paying taxes if they select the latter. As a rule under tax law, when taxpayers are offered a choice between taxable and normally nontaxable income they will be taxed on whichever they choose. Section 125 makes an exception to this rule for benefits such as health insurance that meet the section’s requirements.

Some cafeteria plans allow workers to choose among a number of benefits (hence the name), though others allow only a choice between cash and one nontaxable benefit. Premium conversion is restricted in this manner, with cash being in the form of wages that are not given up and health insurance being the one nontaxable benefit. Employers that offer premium conversion may also offer separate cafeteria plans with other choices.

All cafeteria plans must be in writing and meet a number of nondiscrimination rules regarding highly compensated employees and company officers and owners. The rules are complex, and some make it difficult for small businesses to have the plans.

Section 125 was included in the tax code in 1978, but it is not clear when employers began adopting premium conversion. It likely became more common as rising health care costs led employers to limit their insurance contributions and to help employees manage their own. Employers might obtain results similar to premium conversion by restricting wage growth and using the savings to increase what they pay for premiums. However, only premium conversion allows workers the flexibility to individually choose this outcome.

Retirees sometimes complain that they cannot take advantage of premium conversion. The barrier is not section 125 but an IRS determination that distributions from qualified retirement plans are always subject to taxes, aside from several minor exceptions. Legislation, H.R. 1203 (Van Hollen) and S. 491 (Webb), has been introduced in the 111th Congress to allow premium conversion for federal retirees.

In its 2006 health care reform legislation, Massachusetts required all employers with 11 or more full-time equivalent workers to adopt premium conversion. Consideration might be given to whether a similar requirement might be included in health care reform legislation now before Congress. If it is included, Congress might also consider making it easier for small businesses to establish premium conversion, as it might establishing separate nondiscrimination rules for it. However, some in Congress are considering limiting the tax exclusion for employer-provided coverage, not expanding it; presumably they would not favor extending premium conversion to more employees.

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Introduction

Premium conversion allows employees to pay their share of employment-based health insurance premiums on a pre-tax basis. Although plans vary, on average employers pay about 84% of the premium for single coverage and 73% of the premium for family coverage, leaving employees to pay the remaining portion.¹ The employer share is always excluded from the employees' income and employment taxes (i.e., Social Security and Medicare taxes). In contrast, the employee share is paid either in after-tax dollars without premium conversion or in pre-tax dollars with it. Paying with pre-tax dollars results in tax savings for both the employee and the employer.

For example, consider an employee whose share of the premium is \$1,000. If the employee were in the 15% federal tax bracket, the employee would need to earn \$1,293 in wages to have \$1,000 left over after paying \$194 in income taxes and \$99 in employment taxes.² With premium conversion, the \$1,000 is not subject to taxes, reducing the taxable part of the \$1,293 to \$293 and income and employment taxes to \$66, a tax savings of \$227.³

To some, premium conversion seems like an accounting trick. It is difficult for people who are not tax experts to follow the calculations or understand the rationale. Rules limiting its use strike some as arbitrary and unfair. Premium conversion is sometimes referred to as premium only or section 125 plans, causing further confusion.

This report provides more explanation of premium conversion and requirements for its use. It summarizes the statutory and regulatory background and briefly discusses whether it is sound public policy. Finally, it discusses two policy issues, whether premium conversion should include retirees and what role it might play in health care reform.

Premium Conversion Basics

Premium conversion is authorized by section 125 of the Internal Revenue Code, a section entitled "cafeteria plans." In general, the section allows taxpayers to choose among taxable and nontaxable benefits offered by an employer without paying taxes if they select the latter. As a rule under tax law, when taxpayers are offered a choice between taxable and normally nontaxable income they will be taxed on whichever they choose; they will be deemed to be in "constructive receipt" of the taxable income whether or not they take it. Section 125 makes an exception to the constructive receipt rule for benefits such as health insurance that meet the section's requirements.⁴

¹ *Employer Health Benefits, 2008 Annual Survey*. The Kaiser Family Foundation and Health Research and Educational Trust, p. 72. Using the average employer payments, the employees would then pay 16% or 27%, respectively. However, employers pay varying amounts, with some even paying all of the premium cost and others none.

² The federal income tax calculation is $\$1,293 \times .15 = \194 . Social Security taxes are 6.2% of wages (or \$80 in this example) and Medicare taxes are 1.45% of wages (\$19 in this example). Employers would pay the \$80 in Social Security taxes and \$19 in Medicare taxes as well. The 15% income tax bracket would apply to many workers, though some would have lower tax rates (15 or even zero) and others higher rates (25%, 28%, 33%, or 35%, depending on their income).

³ The federal income tax calculation is $\$293 \times .15 = \44 , the Social Security tax calculation is $\$293 \times .062 = \18 , and the Medicare tax calculation is $\$293 \times .0145 = \4 .

⁴ IRS regulation 1.451-2 provides that income is constructively received by a cash-basis taxpayer if it is credited to his (continued...)

Cafeteria plans can be established only by employers.⁵ They must always offer a choice of taxable and nontaxable benefits. The taxable benefit usually offered is cash, but it might include benefits normally purchased with after-tax dollars, such as group term life insurance. Allowable nontaxable benefits include accident and health insurance, health care flexible spending accounts, accidental death and dismemberment insurance, dependent care assistance, adoption assistance, and others.⁶ Certain nontaxable employer benefits may not be offered, such as scholarships, education assistance programs, and long-term care insurance or services. In addition, cafeteria plans cannot offer benefits that defer compensation to a later year aside from 401(k) account contributions. Short carryover periods (i.e., several months) are permitted.

Some cafeteria plans offer employees choices among a number of benefits (hence the name), whereas others limit the choice to cash and one specific nontaxable benefit. Premium conversion is an example of the latter. It is possible for employers to offer both premium conversion and a separate plan with choices among other benefits.

The cash option may be wages. Under salary reduction agreements, employees in effect agree to work for reduced wages in exchange for having their employer provide an equivalent amount of nontaxable benefits. Premium conversion uses these agreements: employees are given the choice of receiving taxable wages or reducing their wages by their share of the health insurance premium (\$1,000 in the earlier example) and having the employer use that sum to pay the premium.⁷ Taxable wages are thus converted to an employer payment for a nontaxable benefit.⁸

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account, set apart for him, or otherwise made available to him, provided the taxpayer's receipt is not subject to substantial limitations or restrictions. The doctrine of constructive receipt is often used to determine the tax year in which the taxpayer must recognize income, but it has also been used to determine whether a taxpayer must recognize income at all, as in the case of the choice between a taxable and nontaxable benefit. See Daniel C. Schaffer and Daniel M. Fox, *Tax Law as Health Policy: A History of Cafeteria Plans 1978-1985*, *The American Journal of Tax Policy* vol. 8 no. 1 (Spring, 1989), p. 10. The authors quote from Boris Bittker and Lawrence Lokken that constructive receipt is the "pervasive but nonstatutory principle that taxpayers who choose nontaxable benefits in lieu of cash must be viewed as though they had taken the cash and used it to purchase the benefits actually chosen."

⁵ Unless otherwise specified, the cafeteria plan requirements discussed in this report are based upon statutory provisions in section 125 of the Internal Revenue Code, IRS regulation 1.125-4, and proposed IRS rules for cafeteria plans that were published in the *Federal Register* on August 6, 2007, pp. 43938-43967. The IRS has stated that taxpayers may rely upon the proposed rules for guidance pending issuance of final rules (p. 43944).

⁶ The benefit must be excludable from current taxation by an express provision of the Internal Revenue Code, for example, section 106 in the case of employer-provided health coverage. Section 125 does not by itself create new nontaxable benefits.

⁷ Most employers with premium conversion plans assume that nearly all workers will elect to have their wages reduced. When workers sign up for employer health insurance, they are given the chance to opt out of the arrangement (i.e., not have their wages reduced and instead pay for their share of the premium with after-tax dollars); this satisfies the legal requirement that workers must choose between taxable and nontaxable benefits.

⁸ Cafeteria plans may also be funded with employer contributions. For example, an employer might provide (say) \$3,000 in benefits, leaving the choice among them to individual employees. Some employees might choose supplemental health insurance, some dependent care, and some a mixture of the two. In this case, whatever they choose would be exempt from taxes. Other employees might elect to take some or all of the \$3,000 in cash; this would be taxable. If an employer pays the entire cost of health insurance it would not be done through a cafeteria plan since no choice would be involved.

Premium conversion can apply both to health plans chosen by employers (which is the usual case) as well as insurance that individual workers obtain on their own. If employers allow the latter, they must ensure that payments they make in fact are used for health coverage.⁹

Like all cafeteria plans, premium conversion plans must be in writing. They must be limited to employees, though former employees may be included provided the plan is not maintained predominantly for them. Employee elections must be irrevocable for the plan year aside from changes due to changes in family status, in alternative coverage for family members, and other limited circumstances. Employers must file a report each year with the Department of Labor; separate IRS reporting requirements were suspended in 2002.¹⁰

All cafeteria plans must meet nondiscrimination tests. Plans may not discriminate in favor of highly compensated employees with respect to eligibility to participate, nor as to employer contributions or actual use of benefits. In addition, the nontaxable benefits of key employees cannot exceed 25% of the aggregate nontaxable benefits provided all employees under the plan.¹¹ Finally, cafeteria plans must comply with the nondiscrimination requirements for the benefit in question. Thus, coverage under employers' self-insured accident and health plans must meet the additional nondiscrimination standards in section 105(h).¹² Section 125(g) includes a safe-harbor test (a simplified test providing one way to meet the standards) for all accident and health plans, and the proposed regulations include another for premium-only plans.¹³ Nonetheless, applying the rules can be complex if not all employees are allowed to participate (e.g., part-time workers), if many eligible workers do not participate, or if participants choose different benefits.

The complexity of nondiscrimination rules is one reason that small firms generally do not use cafeteria plans.¹⁴ In particular, the rule regarding key employees would preclude use by many small companies since those employees would often account for more than 25% of the nontaxable benefits. The complexity contributes to the administrative cost of establishing plans and ensuring they remain in compliance. In addition, owners of small businesses reportedly are reluctant to establish cafeteria plans if they are sole proprietors, partners, or more than 2% owners of S-corporations. These owners are not classified as employees under the tax code and thus cannot participate in employee benefit programs.¹⁵

⁹ Premium conversion can apply to insurance that workers obtain themselves since section 106 of the tax code, which authorizes the exclusion for employer-provided coverage, extends to these arrangements.

¹⁰ IRS Notice 2002-24.

¹¹ Key employees are company officers having compensation greater than \$160,000 in 2009, 5% owners of the employer, and 1% owners having compensation greater than \$160,000.

¹² A self-insured plan is one in which the employer assumes the risk for a health care plan and does not shift it to a third party (i.e., purchase commercial insurance aside from stop-loss coverage). Most large companies with health care plans self-insure.

¹³ The proposed safe harbor test on p. 43967 is not entirely clear. The provision references section 125(c) of the tax code (which deals with discrimination as to benefits and contributions) as well as an undefined "this section," but the example refers to key employees for which there is a separate test under section 125(b) of the code. Some people concerned about nondiscrimination might not find the example reassuring since it would allow premium conversion where all key and highly compensated employees elect health insurance but only 20 percent of the other workers do.

¹⁴ Not only are the multiple written rules complicated, but to some they seem vague and uncertain. See "Practitioners Request IRS Clarification of Nondiscrimination In Cafeteria Rule," *Daily Tax Report*, August 24, 2007, referring to the proposed rules issued earlier that month. The safe-harbor test in section 125(g) which ostensibly was to make things easier has been criticized by a number of observers, such as David E. Gordon in "Adventures in Obscurity: Section 125(g)(2) of the Code," *Tax Notes* (March 2, 1987), pp. 919-924.

¹⁵ However, these owners can deduct 100 percent of the cost of insurance under section 162(l), getting roughly (continued...)

Some Background to Premium Conversion

Section 125 was included in the Internal Revenue Code by the Revenue Act of 1978 (P.L. 95-600). It has been amended a number of times, especially in the first decade after enactment. Nearly all of the current text consists of provisions dealing with qualified benefits and nondiscrimination.

Detailed rules regarding cafeteria plans appear not in the statute but in IRS guidance, particularly proposed rules issued in 1984 and 1989.¹⁶ These rules were never finalized, but they remained the position of the IRS and employers relied upon them. The 1984 and 1989 rules were withdrawn when the IRS issued comprehensive proposed rules on August 7, 2007.

Benefit choice did not originate with section 125 or the IRS guidance; instead, the statutory and regulatory rules were in response to plans starting to spread among employers. In particular, there reportedly was an increase in employers offering cash-or-deferred arrangements (CODAs), which allow workers to choose between receiving cash or having employers contribute to a qualified retirement trust without being taxed on the latter until withdrawals occur in later years. The IRS had previously issued revenue rulings supporting these arrangements, but in 1972 it proposed to tax workers at the time of the contribution if it were made in return for a reduction in wages or in lieu of an increase in wages.¹⁷ In response, Congress included a provision in the Employee Retirement Income Security Act of 1974 (ERISA, P.L. 93-406), that temporarily blocked application of the proposed rule for plans in existence on June 27, 1974, until it could study the issue.¹⁸ The provision was extended several times before the Revenue Act of 1978 added section 125. The conference report on ERISA explicitly states that the provision applied not just to CODAs but also to cafeteria plans.¹⁹

Although neither ERISA nor section 125 mentions premium conversion, they establish authority for its tax treatment. Premium conversion probably became more common after the 1970s when, in the face of rising costs, employers sought to limit health plan contributions and help employees manage their own.

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equivalent income tax (but not employment tax) savings. In addition, because they have ownership interests in the business entity, they often can restructure their own compensation packages to get much of the advantages of broader cafeteria plans.

¹⁶49 *Federal Register* 19321, May 7, 1984, 49 *Federal Register* 50733, December 31, 1984, and 54 *Federal Register* 9460, March 7, 1989. The proposed rules were especially important for health care flexible spending accounts. See CRS Report RL32656, *Health Care Flexible Spending Accounts*, by (name redacted).

¹⁷Revenue rulings 56-497 and 63-180, issued in 1956 and 1963, respectively. The proposed regulation was issued on December 6, 1972, 37 *Federal Register* 25938. The discussion here follows Leon E. Irish, "Cafeteria Plans in Transition," *Tax Notes* (December 17, 1984), pp. 1127-1141 at p. 1134. For more comprehensive analysis of prior law and the 1972 proposed regulation, see Patricia Ann Metzger, "Constructive Receipt, Economic Benefit, and Assignment of Income: A Case Study in Deferred Compensation," *Tax Law Review* vol. 29 (1973-1974), pp. 525-587.

¹⁸Section 2006.

¹⁹"Also to be covered under these principles are so-called cafeteria plans, under which the employees may have a choice between certain fringe benefits, some of which would constitute taxable income to the employee, whereas other forms of benefit might not." U.S. House of Representatives, 93rd Congress, conference report 93-1280, p. [5135 in U.S. Cong. and Admin News, to be replaced].

Employers might obtain results similar to premium conversion by restricting wage growth and using the savings to increase what they pay for premiums. Many probably follow this strategy even if they are reducing the percentage of the premium they pay (i.e., they are still increasing the dollar amount of their contributions). For workers who have employer-provided health care, the effect of premium conversion and restrictions on wage growth could be roughly the same, depending on how the employer changes the wage levels (it might not be the same dollar amount for all workers). However, restrictions on wage growth would be less advantageous for workers who decline employment-based coverage, either because they do not value it highly or because they have better coverage through a spouse. Only premium conversion allows them the flexibility to individually opt out of a wage reduction that otherwise would be imposed across the board.

Whether premium conversion is sound public policy has received little attention. It might be criticized since workers' tax savings depend upon their marginal tax rate, allowing higher-income workers to benefit more. In addition, because only employees are eligible for premium conversion, people who purchase insurance on their own cannot benefit. However, these criticisms apply generally to the exclusion for employer-provided health insurance, of which premium conversion is a minor part.²⁰ If one were concerned solely about equity, one might limit or end the entire exclusion, not just premium conversion. Moreover, if only premium conversion were limited, employers could always obtain the same tax benefits for themselves and most of their employees by restricting wage growth and using the savings to pay premiums, as described in the previous paragraph.

Some Policy Issues

In recent years, the principal premium conversion issue before Congress has been whether it should be extended to federal retirees. If health care reform were enacted, consideration may also be given to what role premium conversion might play.

Retirees

Retirees sometimes complain that they cannot take advantage of premium conversion. The barrier is not section 125, for as indicated above cafeteria plans may include former employees provided the plan is not maintained predominantly for them. Instead, the restriction is due to an IRS determination that distributions from qualified retirement plans are always subject to taxes, aside from several minor exceptions.²¹ The IRS ruling precludes former employees from recasting pension payments as pretax income, as active workers can recast their wages.²²

²⁰ For a discussion of these equity issues, see CRS Report RL34767, *The Tax Exclusion for Employer-Provided Health Insurance: Policy Issues Regarding the Repeal Debate*, by (name redacted).

²¹ Rev. Rul. 2003-62. The ruling is an interpretation of sec. 402 of the tax code.

²² The one exception to this rule is that the Pension Protection Act of 2006 (P.L. 109-280) allows certain retired public safety officers to pay up to \$3,000 of qualified health insurance premiums directly from their pensions on a pre-tax basis each year. Technically, the amount is excluded from the retirees' gross income. The premiums do not have to be for a plan sponsored by the former employer; however, the exclusion does not apply to premiums paid by the retiree and then reimbursed with pension distributions. H.R. 1413 of the 111th Congress (Crowley) would extend the public safety officers exception to public employees in general; in addition, it would convert the exclusion to an above-the-line deduction and index the allowable amount for inflation.

It might appear that this rule is unfair to retirees since in general their income is lower than current workers who have premium conversion. The outcome seems to conflict with the equity principles underlying cafeteria plan nondiscrimination rules. However, it is important to recognize that employer payments for retiree health insurance are excluded from taxes, just as they are for active workers. For many retirees, the employer pays much of the premium and tax savings on this share would generally be two to three times the additional tax savings from premium conversion. While allowing retirees the additional advantages of premium conversion would treat them like active workers, it would then seem even more unfair to retirees without access to employer coverage. The latter retirees are likely to have lower incomes yet.

In the 111th Congress, H.R. 1203 (Van Hollen) and S. 491 (Webb) would allow federal retirees to pay their share of Federal Employees Health Benefits Program (FEHBP) premiums on a pre-tax basis. Besides the equity discussion in the previous paragraph, it might seem difficult to justify extending premium conversion to federal retirees and not retirees with private sector or state or local government retiree health insurance. Extending premium conversion to other retiree groups would greatly increase the revenue loss of this proposal.

Health Care Reform

Massachusetts enacted a broad health care reform law in April 2006 called Chapter 58.²³ Among other things, the law requires employers with 11 or more full-time equivalent (FTE) workers to establish premium conversion plans, which it calls section 125 plans. The plans must be set up whether or not employers offer health insurance and whether or not they contribute to the cost of coverage.²⁴ As mentioned above, premium conversion is allowed for insurance that individual workers obtain provided employers ensure that payments they make (including those by premium conversion) in fact are used for that purpose.

The Massachusetts provision benefits workers of employers that previously had not offered premium conversion or extended it to all workers. Their employers would also save on employment taxes. The public cost of the provision is borne primarily by the federal government through reduced income and employment tax revenue, though Massachusetts would experience a small reduction in its own income tax revenue.

Chapter 58 also requires employers with 11 or more FTE workers to make a fair contribution to their health insurance costs or pay a penalty of \$295 per worker. Some observers think that once the reforms are well established smaller employers may be asked to make some contribution and set up premium conversion arrangements. However, some small employers might have difficulty meeting the nondiscrimination requirements that were described above. Massachusetts cannot by itself exempt employers from federal requirements.

A similar requirement for premium conversion might be considered in the reform legislation now before Congress. The tax savings could help employers and employees pay for the coverage that would be available through the exchanges the bills envision. Unlike Massachusetts, however,

²³ For an overview of the law and its early implementation, see John E. McDonough et. al., "Massachusetts Health Reform Implementation: Major Progress and Future Challenges," *Health Affairs*, vol. 27 no. 4 (2008), w285-297.

²⁴ Information about employer obligations with respect to 125 plans is available on the Massachusetts Connector website, <http://www.mahealthconnector.org/portal/site/connector/menuitem.50596a4574af0ace505da95c0ce08041/?fiShown=default>.

which could obtain an additional federal subsidy at little cost, the federal government would be the primary payer for this benefit. In addition, some in Congress are considering limiting the tax exclusion for employer-provided coverage, not expanding it.²⁵

If Congress were to require or encourage employers to adopt premium conversion, consideration may be given to enabling more small businesses to take advantage of it. Legislation introduced in the 111th Congress by Senator Snowe (S. 988, the SIMPLE Cafeteria Plan Act of 2009) would remove some of the barriers discussed above.

If premium conversion were included in health care reform, consideration may also be given to modifying the statutory and regulatory nondiscrimination rules. As described above, premium conversion is covered by rules applying to cafeteria plans generally, though the August 2007 proposed IRS rules would allow a simplified test. These rules originate in a concern reflected in a number of parts of the tax code that people with high income or influence over employer policies can take advantage of nontaxable benefits while others cannot. For example, if low-wage workers cannot afford to give up cash wages, then most of the tax subsidy associated with nontaxable benefits would accrue to higher-paid workers. Health care reform legislation now before Congress could change these circumstances: for example, the principal proposals now being considered would require everyone to have health insurance, making it no longer an option, and lower-income taxpayers would receive premium subsidies of some sort. Congress may consider establishing separate nondiscrimination rules for premium conversion that takes account of the new proposed subsidies.

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²⁵ For more information, see CRS Report R40673, *Limiting the Exclusion for Employer-Provided Health Insurance: Background and Issues*, by (name redacted) and (name redacted)

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