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Employers most often implement flexible benefits plans to meet their employees' diverse needs or control benefit expenditures.

Flexible Benefits Plans and Changing Demographics

- Among full-time employees in private firms employing 100 or more workers in 1989, 9 percent were eligible to participate in cafeteria plans, and 23 percent were eligible to participate in flexible spending accounts (FSAs). Generally, the percentage of employers sponsoring flexible spending plans increases with employers' size.
- In 1989, 93 percent of employer-sponsored plans that offered employees some choice among benefits were at least partially funded by employees, although 84 percent of these plans also received an employer contribution.
- Employees are not required to pay federal income or Social Security taxes on individual salary reduction contributions to qualified flexible benefits plans. Similarly, employers do not pay unemployment or Social Security taxes on these contributions.
- Among employees eligible for FSAs in 1989, less than 20 percent contributed to a health care FSA, and only 3 percent contributed to a dependent care FSA.
- Cafeteria plans differ from traditional benefits plans by providing an alternative delivery system that focuses on limiting employer expenditures and promoting individual choice while maximizing tax effectiveness.
- Regulations released in 1989 require employers to make the maximum reimbursement under an employee's health care FSA available at all times throughout the plan year even if the employee has not contributed enough to cover the expenses at the time of the claim.

◆ Introduction

The U.S. labor force and population have changed substantially in the latter part of the 20th century, particularly in the last 20 years. An increasing number of women in the labor force, higher divorce rates, and a growing percentage of births outside of marriage have led to a decline in the prevalence of traditional two-parent, one-worker families and a corresponding increase in the number of single-parent families (primarily headed by women) and families with children in which both parents work.

The proportion of married women in the labor force increased from 41 percent in 1970 to 57 percent in 1988 (U.S. Department of Labor, 1989). More women with children, both married and single, are also choosing to work. In 1975, only 39 percent of women with children under age 6 were working; by 1988, this figure had increased to 56 percent. Women whose youngest child was aged 7–17 represented 73 percent of the female work force in 1988. Overall, the number of households maintained by women increased from 21 percent in 1970 to 29 percent in 1990 (U.S. Department of Commerce, 1991).

These changes in household characteristics and increases in female labor force participation are not the only demographic changes shaping families in the United States. In addition, the population is aging; birth rates, after declining for many years, are now relatively stable; and the average age of people marrying for the first time is increasing (U.S. Department of Commerce, 1988).

The continuing evolution of the American family is likely to increase the attractiveness of flexible work practices throughout the next decade. **Some employers are already responding to changing employee needs. The newest benefits being offered include child care or elder care benefits, flexible work scheduling, and long-term care insurance.** Child care benefits range from simple, low-cost information and referral services to more expensive on-site child care centers, both of which can represent significant benefits for working single parents and families with two working parents. A few firms offer similar benefits to workers who have responsibility of caring for an aged parent. Among other flexible work practices, one of the most popular is "flex-time," which gives employees the freedom to choose a work schedule that best suits their needs. Many employers who offer this option report that absenteeism and tardiness decreased after its adoption (Bureau of National Affairs, 1988). Other flexible work-scheduling approaches include work-at-home arrangements and job sharing. These are administratively more complex and difficult to manage.

Section 125 allows employers to give employees a choice among benefits without requiring them to include the value of such benefits in their taxable income unless they choose taxable options.

Employers' original objective in adopting flexible benefits was to increase employee understanding of the value of benefits. Now, as families and the work force have become more diverse, demographic issues are more important. Employers acknowledged changing employee needs by modifying benefits packages in the early 1970s. In 1974, TRW Defense Systems Group pioneered the first flexible compensation program—which was the precursor of today's flexible benefits plans.

Section 125 of the Internal Revenue Code (IRC), created by the Revenue Act of 1978, formally introduced tax-qualified flexible benefits plans. These plans include all those that offer employees a choice between at least one qualified nontaxable benefit and one taxable benefit (including cash). Section 125 allows

employers to give employees a choice among benefits without requiring them to include the value of such benefits in their taxable income unless they choose taxable options. In this *Issue Brief*, the term *flexible benefits plans* refers to all qualified plans under section 125. Premium conversion plans, flexible spending accounts (FSAs), and cafeteria plans are specific types of flexible benefits plans. Premium conversion allows employees to pay for group health plan premiums through pretax salary reduction.[1] FSAs provide employees with the option of setting money aside for qualified unreimbursed medical or dependent care expenses through pretax salary reduction. Both premium conversion and FSAs offer limited employee choice when compared with cafeteria plans, which provide employees with a choice among several qualified nontaxable and taxable benefits (including cash).

Since the enactment of section 125, flexible benefits plans have grown as legislative and regulatory guidance laid the groundwork for their implementation (chart 1). It was not until the mid-1980s, after regulations were released, that many employers began to realize the potential advantages of flexibility. **Early experience of companies implementing flexible benefits plans suggested that flexible plans could improve employee perception of the total compensation package and control employers' benefit expenditures.** Interest in these plans grew in the 1980s as regulations clarified legal requirements and computer software emerged that facilitated plan administration and development.

In response to spiraling health care costs in the late 1970s and 1980s, most firms made efforts to control health care expenditures. Many employers increased cost sharing with employees, introduced utilization control measures, and encouraged the use of alternative delivery systems such as health maintenance organizations (HMOs) and preferred provider organizations (PPOs). **Increasingly, employers are using flexible benefits plans to control expenditure growth.** Today, cafeteria plans are usually developed in conjunction with other expenditure control measures.

This *Issue Brief* investigates flexible benefits plans as a means of offering employees greater choice. In particular, it will focus on the plans' current status, including regulations and tax considerations, as well as their prevalence and design.

◆ Why a Flexible Benefits Plan?

Employers adopt flexible benefits plans for a variety of reasons. Some want to provide employees with a choice among benefits or control their health care expenditures through a cafeteria plan. Others want to offer their employees a tax-favored way of paying for qualified health care or dependent care expenses through an FSA or premium conversion plan. FSAs may also be a method employers use to ease increased cost sharing with employees.

Under some plans, the employee may choose to receive cash in lieu of benefits or to set aside money for retirement through a qualified cash or deferred arrangement.

Generally, cafeteria plans provide benefits similar to those included in a traditional benefits plan. However, they differ from traditional benefits plans by providing an alternative delivery mechanism that focuses on limiting employer expenditure and promoting individual choice. With a traditional benefits plan, employers pay their employees a base salary and provide them

[1]Without a section 125 plan, qualified individual expenditures on health care are deductible from gross income only if they exceed 7.5 percent of a taxpayer's gross income. Premium conversion plans and health care FSAs allow employees to exclude these expenditures from gross income even if they do not exceed this amount.

Chart 1
Legislative and Regulatory History of Flexible Benefits Plans

Legislative or Regulatory Action	Important Provisions
Revenue Act of 1978	•Created section 125 and section 401(k) of the Internal Revenue Code (IRC). •Section 125 allows employees to choose between taxable and nontaxable benefits (which do not defer the receipt of compensation) without taxing the cash that could have been chosen. •Section 401(k) allows employees to choose between cash and deferred contributions to a profit-sharing or savings plan without taxing the cash if it is not chosen.
Miscellaneous Revenue Act of 1980	•Permitted section 125 plans to include 401(k) plans as a qualified benefit (only exception to the deferred compensation restriction).
Proposed section 401(k) Regulations (1981)	•Among other things, permitted *individuals* to choose to defer a portion of their compensation. Final regulations were issued in late 1988 that reaffirmed this provision.
Information Release 84-22 (1984)	•Prohibited the use of salary reduction after incurring an expense.
Proposed section 125 Regulations (1984)	•Defined terms, indicated which benefits may be included in a plan, specified flexible spending account (FSA) rules, and addressed tax issues, nondiscrimination rules, and effective dates. •Imposed three major restrictions on the design of flexible benefit plans: (1) Neither a cafeteria plan nor an FSA may allow more frequent than annual elections of the sources or uses of funds unless changes are due to a change in family status; (2) FSA funds may be used only for health care, dependent care, or personal legal expenses; (3) FSA funds must be used for expenses incurred during the plan year, all unused funds are forfeited (use-it-or-lose-it rule).
Deficit Reduction Act of 1984	•Confirmed section 125 proposed regulations and established reporting requirements for section 125 plans.
Tax Reform Act of 1986	•Confirmed the permissibility of FSAs and individual salary reduction under section 125. Reaffirmed the exemption of section 125 deferrals from FICA taxation. •Introduced section 89 of the IRC that included complex nondiscrimination rules for all welfare plans, including cafeteria plans. Under proposed rules for section 89, a nonhighly compensated employee was considered ineligible for any noncore health care benefits available through individual salary reduction if the maximum available reduction was greater than $2,000 or the amount actually elected by nonhighly compensated employees encourages many employers to lower the maximum on their health care FSAs to $2,000.
Section 125 Regulations (1989) (Proposed but effective for plan years beginning after December 31, 1988)	•Regulations clarified the kind of benefits that can be included in a plan, circumstances under which participants may change or revoke elections, and requirements that health care FSAs must exhibit insurance characteristics. •Benefits are now divided into several categories: (1) qualified benefits (do not defer the receipt of compensation and are not includable in an employee's gross income); (2) currently taxable benefits treated as cash; (3) qualified cash or deferred arrangements (pre- and post-tax contributions to 401(k) plans); and (4) nonqualified benefits. •Participants may now change or revoke elections under the following circumstances: (1) significant cost changes of an independent third party health plan; (2) family status changes; (3) separation from service; and (4) cessation of required contributions. Elective contributions to 401(k) plans may be changed at any time. •FSAs must function as accident or health plans so that: (1) the maximum amount of reimbursement under a health care FSA must be available at all times during the period of coverage; (2) the period of coverage must be generally 12 months; (3) a health care FSA may only reimburse medical expenses covered under section 213 of the IRC; (4) medical expenses must be substantiated by a receipt from a third party; (5) medical expenses must be incurred during the period of coverage; (6) the excess of premiums paid and income of an FSA over claims reimbursements may be used to reduce premiums for the following year or returned to participants as long as funds are allocated on a reasonable and uniform basis (not based on claims experience); (7) analogous rules apply to dependent care spending accounts except for uniform coverage (see (1) above).
Repeal of section 89 (1989)	•Pre-section 89 nondiscrimination testing was reinstated for all welfare plans.

Sources: Dale. L. Gifford and Christine A. Seltz, eds. *Fundamentals of Flexible Compensation* (New York, NY: John Wiley and Sons, Inc. 1988). Spencer's Research Reports, "IRS Issues Proposed Regulations for Sec. 125 Cafeteria Plans, Flexible Spending Accounts" (December 1989).

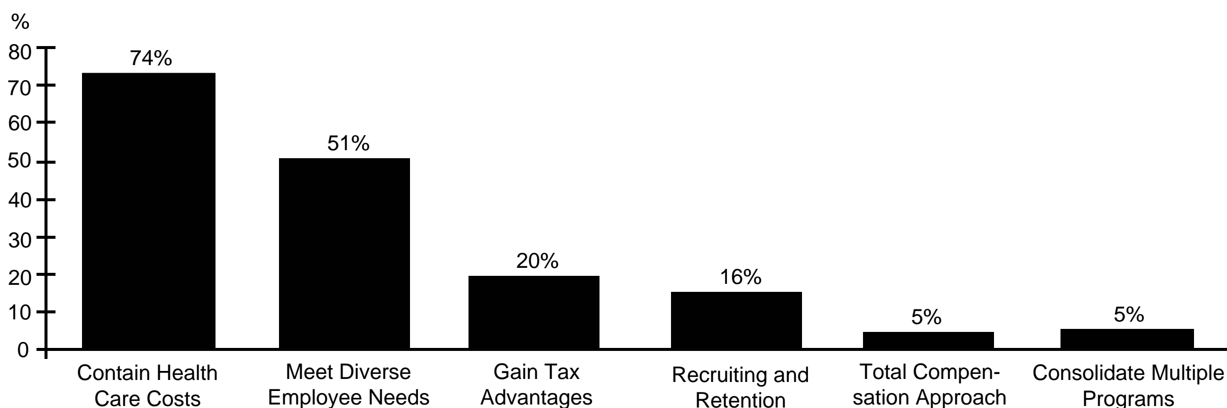
with a uniform benefits package, allowing little or no employee choice. A cafeteria plan, on the other hand, provides each individual with the opportunity to determine the relative proportion of wages and benefits by choosing how employer credits are to be allocated. Employees are free to choose, within plan limits, among different *types* of benefits and *levels* of coverage. Under some plans, the employee may choose to receive cash in lieu of benefits or to set aside money for retirement through a qualified cash or deferred arrangement.[2]

Both employers and employees may benefit from the implementation of a cafeteria plan. **Employees may be able to make their total compensation more valuable by choosing their desired combination of pay and benefits.** If employees become more satisfied with their benefits plan, employers may benefit from a more productive and satisfied work force. Surveys of employers with cafeteria plans indicate that meeting diverse employee needs is often a major plan objective (chart 2). These employers understand that employees often appreciate having the opportunity to design their benefits package and that, even without increasing their contribution to benefits, employers may be able to increase the employees' perceived value of these benefits.

Employers also cite health care cost containment as one of the most important reasons for adopting a flexible benefits plan. Employers with a traditional health indemnity plan may seek to reduce expenditure growth by introducing alternative delivery systems (HMOs and PPOs), adding managed care features, or increasing cost sharing with employees. Cafeteria plans may provide an additional expenditure control mechanism. As employers introduce the concept of total compensation to

[2]Cafeteria plans are allowed to include a qualified cash or deferred arrangement under section 401(k) of the IRC. These plans allow employees to elect to have a portion of their compensation (otherwise payable in cash) contributed to a qualified retirement plan.

Chart 2
Employer Objectives for Implementing Flexible Benefits Plans, 1990[a]



Source: A. Foster Higgins, Inc., *Health Care Benefits Survey, 1990: Report 3, Flexible Benefit Programs* (Princeton, NJ: A. Foster Higgins, Inc., forthcoming).
Note: A. Foster Higgins surveyed nearly 2,000 employers with 1,000 or more employees. A flexible benefits program was defined as any plan that offered employees a choice among several benefits and that allowed employees to become involved in the design of their own benefit packages.
[a]Employers were asked to name their primary and secondary objectives for implementing a flexible benefits plan. Both responses are represented here, but because some respondents reported only a primary and not a secondary objective, the sum of the responses is slightly less than 200 percent.

their employees, they can implement a “defined contribution” approach to benefits. **Employers can determine the level of funding for the flexible program each year rather than providing the same level of benefits annually, shifting part or all of any cost increase to employees.** In this way, employers can effectively limit inflation-driven escalation in employer health care expenditures (Hewitt Associates, 1988). However, employers may experience growing employee dissatisfaction as a result of this cost shifting.

Table 1
Employee Tax Savings Realized from a Flexible Spending Account (FSA), 1990[a]

Tax Effects	With FSA	Without FSA
Payroll Tax Effects		
Earnings	$24,000	$24,000
Less		
FSA contribution[b]	594	0
Equals FICA taxable income	23,406	24,000
FICA tax (7.65 percent)	1,791	1,836
Income Tax Effects		
Gross income	24,000	24,000
Less:		
FSA contribution	594	0
standard deduction and personal exemption	5,300	5,300
Equals taxable income	18,106	18,700
Federal income tax	2,719	2,808
Disposable Income		
Gross income	24,000	24,000
Less		
FICA	1,791	1,836
federal income tax	2,719	2,809
medical expenses	594	594[c]
Equals net disposable income	18,896	18,761
Net Savings[d]	135	0

Source: Employee Benefit Research Institute.

[a]This example is based on an employee whose only income is wage earnings and who takes the standard deduction and one federal exemption, pays no state income taxes, and uses all eligible funds in his or her FSA.

[b]Average contribution to health care FSAs in 1989. See Hewitt Associates, *Flexible Compensation Programs and Practices* (Lincolnshire, IL: Hewitt Associates, 1991).

[c]The employee without the health care FSA cannot deduct his health care expenditures because they do not exceed 7.5 percent of the employee’s gross income.

[d]Net employee savings with an FSA will be higher if the salary reduction is higher or the individual is in a higher tax bracket. Similarly, net savings will be lower if the employee forfeits some of the funds at the end of the year, or is in a lower tax bracket. Workers with income above the FICA limits will no longer realize savings on earnings above that amount because FICA tax is not collected on those earnings.

Other reasons for offering a flexible benefits plan are less frequently cited in surveys but may be important. For example, FSAs provide a simple and inexpensive method for employers to offer their employees a tax-favored way of paying for uncovered dependent care or health care expenses. **FSA participants can increase their net spendable income because pretax salary contributions are exempt from both federal income tax and Social Security (FICA) tax** (table 1). Employers can also realize tax savings when employees contribute to an FSA because they are not required to pay FICA tax on employee salary reduction contributions to these accounts (table 2). The tax savings realized through an FSA may be used to at least partially offset the cost of plan administration.

Employers can also use flexible benefits plans to recruit new employees or to compete with other firms for skilled workers.

Employers can also use flexible benefits plans to recruit new employees or to compete with other firms for skilled workers. Employers who have national or global work forces can use a flexible benefits plan to reflect regional cost differences and/or allow for cost variation based on separate lines of business within an organization. Some employers are exploring the possibility of tying the annual level of employer cafeteria plan contributions to business performance (Hewitt Associates, 1991).

Table 2
Employer Tax Savings from a Health Care Flexible Spending Account (FSA), 1990[a]

Expenses	With Health Care FSA	Without Health Care FSA
Annual Payroll Expense	$2,400,000	$2,400,000
Less:		
employee health care FSA contribution[b]	11,286	0
Taxable Payroll Expenses	2,388,714	2,400,000
Add:		
FICA tax	182,737	183,600
Total Payroll Expenses	2,582,737	2,583,600
Net Employer Savings[c]	863	0

Source: Employee Benefit Research Institute.
[a]Example is based on a firm that employs 100 workers with an average salary of $24,000.
[b]Average participation in health care FSAs is 19 percent, and the average contribution is $594. This example assumes that 19 percent of employees contribute an average of $594 to the health care FSA. See Hewitt Associates, *Flexible Compensation Programs and Practices* (Lincolnshire, IL: Hewitt Associates, 1991).
[c]Employer savings will be higher if more employees contribute a greater amount, on average, to the FSA. This example does not adjust for administrative costs.

◆ The Development and Current Status of Flexible Benefits Plans

Before the enactment of section 125 of the IRC, employers who offered their employees a choice between taxable and nontaxable benefits triggered a tax doctrine called constructive receipt. Generally, this doctrine provides that if employees have the right to receive taxable benefits they will be taxed as if they received cash even if they do not choose this option. Under section 125, employers can offer their employees a choice among taxable and nontaxable benefits without automatically triggering the doctrine of constructive receipt as long as specific nondiscrimination standards are met. The value of a particular benefit is included in an employee's gross income only if the benefit chosen is taxable. Flexible benefits plans were granted an exception to the constructive receipt doctrine because they were thought to be consistent with certain social policy goals. The estimated federal revenue loss attributable to flexible benefits plans was $1.9 billion in 1989.[3] **Flexible benefits plans may be affected by revenue raising efforts during the 102nd Congress in an attempt to meet budget deficit reduction targets.**

Prior to the enactment of section 125, employers who offered their employees a choice among benefits generally included either all nontaxable benefits or all taxable benefits in order to avoid the application of constructive receipt. Today many employers still offer employees a choice among only nontaxable benefits, particularly in the area of health insurance. However, these plans are not flexible benefits plans as defined under section 125 because they do not offer a choice between nontaxable benefits such as health insurance and taxable benefits or cash.[4]

Generally, cafeteria plan benefits fall into four categories: qualified nontaxable benefits, taxable benefits, benefits that defer the receipt of compensation, and nonqualified benefits. Cafeteria plans must offer both qualified nontaxable benefits and taxable benefits (or cash). The former category includes health or sickness and accident insurance, long-term disability insurance, accidental death and dismemberment plans, group term life insurance up to $50,000, dependent care assistance plans, and both health and dependent care FSAs. Taxable benefits may include elective vacation days, group term life insurance above $50,000, group legal services, and cash. Employees may purchase taxable

[3]The EBRI Tax Estimating and Analysis Model (EBRI-TEAM) calculated the tax loss based on laws in effect in 1988. The model determines the change in total tax liability if section 125 were repealed and all employee contributions and employer-provided credits were then included in the employee's gross income.
[4]In this *Issue Brief* "choice-making plans" refers to any combination of cafeteria plans and plans that provide employee choice among only taxable or only nontaxable benefits (not both). This term will be used where survey data do not differentiate between section 125 qualified plans and other plans offering employee choice.

benefits with after-tax dollars or be treated for all purposes, including reporting and withholding, as having received the cash equivalent of employer-paid taxable benefits. **Cafeteria plans may not offer benefits that defer the receipt of compensation except pre- or post-tax contributions to 401(k) plans.** After this exception was made, employers could provide a comprehensive benefits package through a cafeteria plan. 401(k) plans allow individuals to make contributions to a qualified retirement plan, often with an employer matching feature. Other benefits, although excluded from a taxpayer's gross income under specific sections of the IRC, may not be offered through a cafeteria plan as qualified nontaxable benefits. These include scholarships and tuition assistance, transportation expenses, educational assistance, and other benefits such as employee discounts or subsidized meals.

Each benefit offered within a cafeteria plan must satisfy nondiscrimination rules specific to it and the rules governing cafeteria plans. Section 125 prohibits discrimination in favor of either highly compensated participants or key employees.

A highly compensated participant in a cafeteria plan includes any employee who during 1991: (1) owned more than 5 percent of a company, (2) earned more than $90,803 (indexed), (3) earned more than $60,535 (indexed) and was among the top paid 20 percent of all employees, or (4) was an officer who earned more than $54,482 (one-half of the 1991 defined benefit limit). Spouses and/or dependents of any of these employees also fall into this category. Flexible benefits plans must not discriminate in favor of highly compensated employees in terms of eligibility to participate.[5] Section 125 also requires that the value of benefits provided to key employees must not exceed 25 percent of the total value of benefits provided to all employees. A key employee is any employee who, at any time during the current plan year or the four preceding plan years, is a (1) 5 percent owner, (2) a 1 percent owner with compensation above $150,000, (3) an officer with annual compensation above $54,482, or (4) an employee who is 1 of 10 employees owning the largest interests in the employer. Health benefits included in a cafeteria plan must also pass a special contributions and benefits nondiscrimination test. Contributions made on behalf of each participant must equal either 100 percent of the cost of health coverage provided for the majority of highly compensated participants or 75 percent of the cost of health coverage provided for the participant with the highest cost coverage.[6] If a flexible benefits plan does not meet the section 125 nondiscrimination tests, highly compensated participants and/or key employees in whose favor the plan discriminates will be taxed as if they chose the maximum amount of taxable benefits or cash even if they chose all nontaxable benefits.

Employee salary reduction contributions to flexible benefits plans are granted preferential tax treatment only if the plan meets all requirements of section 125. Generally, because pretax salary reduction contributions are considered employer contributions to a nontaxable benefits plan, the employer does not pay any unemployment tax (FUTA) or Social Security tax (FICA) on these contributions.[7] These contributions are not included in the employees' gross income and are exempt from FICA and federal income taxes. State tax laws are often patterned after federal laws, so many states have similar laws with respect to salary reduction contributions to flexible benefits plans. However, some states have chosen to collect income tax, FUTA, or workers' compensation premiums on employee salary reduction amounts.

[5]A flexible benefits plan is not considered discriminatory merely because highly compensated employees choose to participate in the plan in greater numbers than do other employees.

[6]The health benefits nondiscrimination test applies to "similarly situated" highly compensated participants, referring to the participants' age, years of service, and other similar characteristics.

[7]Individual salary reduction contributions to a 401(k) plan are subject to different rules. Elective, nonelective, and matching contributions to a 401(k) plan are excluded from the employee's gross income until distribution but are not exempt from FICA taxation or FUTA taxation. The employee is able to defer federal income tax and most state and municipal tax.

Most states do not tax individual salary reduction contributions to flexible benefits plans. Of the 40 states with income tax, 38 states and the District of Columbia do not tax employee salary reductions, while New Jersey and Pennsylvania tax all such contributions. The states are split on the treatment of salary reduction for unemployment taxation purposes. Twenty-nine states and the District of Columbia collect unemployment tax from employers on employee salary reduction contributions to flexible benefits plans. However, the tax does not represent a significant percentage of compensation except for part-time, very low-income, or seasonal employees, because the taxable wage base in the majority of states is less than $15,000 (Maslen, 1990). Of the remaining states, 15 do not collect unemployment tax on pretax salary reduction contributions, while 6 collect tax only on contributions for benefits that are not exempt from taxation under their state unemployment insurance law. Individual state laws are consistent in their assessment of workers' compensation premium charges on employee salary reduction contributions. Generally, states require employers to contribute to a state workers' compensation fund or pay premiums based upon a percentage of an employee's total compensation (Maslen, 1990). Every state, except California, considers contributions to flexible benefits plans to be compensation that is subject to workers' compensation premiums.

◆ Legislative and Regulatory Action Affecting Flexible Benefits Plans

In the past four years, two significant changes were made to flexible benefits plans. The Tax Reform Act of 1986 (TRA '86) introduced section 89 of the Internal Revenue Code, which attempted to impose a set of uniform regulations for welfare plans similar to those that regulate pension plans. However, the section was repealed in late 1989. The release of regulations for section 125 in 1989 represented a more permanent change for flexible benefits plans. The regulations required health care FSAs to exhibit an insurance-type element of risk, exposing employers to potential loss under an FSA that did not previously exist. Although no additional changes were made in 1990, some employers have been reluctant to implement flexible benefits plans because they have been unable to measure the effects of the changes made in 1989 and are unsure of the potential for future legislative and/or regulatory action.

Section 89

Prior to the enactment of section 89, each benefit included in a cafeteria plan had to satisfy all regulations and nondiscrimination rules applicable to that benefit as well as supplemental section 125 regulations in order to qualify for tax-favored treatment. Section 89 imposed uniform qualification and nondiscrimination rules for employee welfare and benefits plans. The qualification rules required *all* welfare plans to meet certain minimum requirements. For example, every plan had to be in writing and legally enforceable in order to ensure that employee benefits were effectively made available to all eligible employees. The nondiscrimination rules affected only accident and health insurance plans and group term life insurance. Cafeteria plans were required to comply with these rules when they included these benefits.

Many employers argued that the nondiscrimination rules were complex and imposed burdensome recordkeeping requirements.

Although section 89 rules were supposed to take effect for plan years beginning on or before January 1, 1989, the effective dates were delayed while legislators discussed how to improve section 89. Many employers argued that the nondiscrimination rules were complex and imposed burdensome recordkeeping requirements. Others claimed that because of the high cost of compli-

ance the rules would effectively reduce health insurance coverage rather than promote its expansion to those who need it most.

The majority of employers with flexible benefits plans were able to pass the section 89 nondiscrimination tests because they already met similar tests under section 125. These plan administrators objected to section 89 nondiscrimination rules for two additional reasons. First, Treasury department regulations said that health care coverage attributable to salary reduction (that is, through a health care FSA) must be considered an employer contribution for some employees and an employee contribution for other employees, depending on the circumstances. Plan sponsors objected to this rule because it would have caused most plans allowing pretax salary reduction contributions to fail the nondiscrimination tests. In addition, employers with cafeteria plans wanted to be able to continue applying nondiscrimination tests based on employee *eligibility* for benefits rather than on the kinds of benefits actually chosen by employees. They argued that testing based on actual elections would require cumbersome recordkeeping and would discourage the growth of employee choice in total compensation.

Flexible benefits plans receive tax-favored status only if each participant makes benefit elections before the benefits become currently available.

Congress introduced a number of bills that attempted to simplify section 89 nondiscrimination rules. Although the proposed legislation did include design-based testing for cafeteria plans, it continued to maintain that highly compensated participants' salary reduction contributions should be treated as employer contributions for one nondiscrimination test, while similar contributions by nonhighly compensated participants should not be included. In testimony before the House Ways and Means Committee, employers and trade organizations representing cafeteria plans argued for more similar treatment of highly and nonhighly compensated employee contributions, recommending that affordable levels of salary reduction should be counted as employer contributions for both highly and nonhighly compensated participants.

Congress repealed section 89 in late 1989, returning the regulation of welfare plans to the IRC sections in effect prior to the enactment of TRA '86. Some legislators still believe that a comprehensive set of nondiscrimination rules for welfare plans is desirable, although many employers favor the present regulatory framework (Bruno, 1990). Legislative and regulatory concerns appear to have slowed the growth of flexible benefits plans, according to a mid-1989 survey of plan sponsors (A. Foster Higgins, 1990). Although these plans are likely to continue to grow in the 1990s, they will probably continue to be available to only a minority of the work force.

Section 125 Regulations

In March 1989, the IRS issued proposed supplemental regulations for section 125 plans that clarified and updated the regulations issued in 1984. These regulations were effective for all plan years beginning after December 31, 1988. The new rules expanded the situations under which employees can revoke or change annual benefit elections, created an insurance-type element of risk for employers who sponsor health care FSAs, and clarified the treatment of buying and selling vacation days under a cafeteria plan.

Flexible benefits plans receive tax-favored status only if each participant makes benefit elections before the benefits become currently available. Once an employee elects and begins to receive benefits, that choice is generally binding for the plan year. Even if an employee does not use a benefit, this choice cannot be revoked or cashed out without incurring a penalty. This use-it-or-lose-it rule applies to all benefit choices, including

elections under an FSA for health or dependent care expenses. For example, if an employee elects to contribute $1,200 to a health care FSA but realizes during the year that the total amount of unreimbursed health care expenses will be only $1,000, the employee may not change his or her initial election without penalty. At the end of the plan year, any contributions not used for qualified expenses are forfeited. If the employer allows employees to take the unused portion in cash, each employee will be taxed on the entire amount elected at the beginning of the year. The 1989 regulations expand and clarify the exceptions to this rule.

There are several circumstances under which a participant may change or revoke an election during the plan year without penalty. If the cost of a health care plan provided by an independent third party provider significantly increases during the year, an employer may allow participants either to change their election to cover the increased cost or to revoke their election and choose another health plan with similar coverage. Flexible benefits plans may also permit employees to revoke their elections and make new elections if they are consistent with a change in family status such as marriage or divorce, death of a spouse or dependent, birth or adoption of a child, termination or commencement of employment by the spouse, or a significant change in the health coverage of the employee or spouse attributable to the spouse's employment. A flexible benefits plan may also allow employees who terminate employment during the plan year to revoke their existing benefit elections. Although the plan may permit employees to make changes during the year for any of the foregoing reasons, it is free to restrict any changes. The more changes that an employer permits, the greater the administrative complexity and cost. The plan may also stipulate the receipt of benefits on the employees' continued payment of required premium contributions.

The regulations also require a 12-month period of coverage and tighter claims substantiation for all FSAs and include guidelines for the distribution of experience gains. **Expenses must be verified by a third party before an employer can reimburse claims under a health care FSA.** Experience gains, the excess of premiums paid and income over the cost of claims and administrative expenses, may be used to reduce the price of premiums during the following year. The plan may also rebate to participants as dividends as long as they are allocated to all participants on a reasonable and consistent basis that is unrelated to claims experience.

About one-quarter of full-time employees eligible for flexible benefits plans in 1989 could choose either to expand or reduce their vacation days through the plan.

Vacation days have become an increasingly popular option to include in cafeteria plans. About one-quarter of full-time employees eligible for flexible benefits plans in 1989 could choose either to expand or reduce their vacation days through the plan (U.S. Department of Labor, unpublished data). The supplemental section 125 regulations clarify how employers should allocate unused vacation days. Because cafeteria plans are generally prohibited from offering benefits that defer the receipt of compensation, vacation days selected through a flexible benefits plan may not be carried over from one year to the next. An employee who elects additional vacation days under a cafeteria plan but does not use all of the days must be counted as receiving nonelective vacation days before the optional days selected under the plan. The 1989 regulations introduced a cash-out option for vacation days. The cafeteria plan may now cash out unused days at the end of the plan year as long as the cash value is received on or before the plan year's last day or the last day of the employee's taxable year that includes the elective vacation, whichever is earlier.

Effect of Regulations on Health Care FSAs—The 1989 proposed supplemental regulations for section 125 plans dramatically affected health care FSAs. Most importantly, these plans were required to assume a risk of potential loss. The IRS ruled that, since FSAs receive preferential tax treatment, they also function as health insurance plans and should, therefore, exhibit risk shifting and risk distribution characteristics common to other insurance plans. **The regulations require employers to make the maximum reimbursement under an employee's plan available at all times during the plan year, even if the employee has not contributed enough to cover expenses at the time of the claim.** This is called the uniform coverage rule because it requires employers to make the entire amount by which an employee agrees to reduce his or her salary during the year available to the employee *uniformly* throughout the coverage period. For example, an employee electing to contribute $1,200 in equal pretax salary reductions throughout the year must be allowed to be reimbursed for covered expenses up to $1,200 during the second month of the plan year even if he or she has only contributed $100 to the account. Only reimbursements already paid from the employee's account can lower the maximum amount available. The regulations also restrict plans from determining the payment schedule for premiums according to the rate or level of claims incurred.

Many employers have been reluctant to implement FSAs due to legislative and regulatory changes. Employers are particularly concerned about the uniform coverage rule. They are at risk if an employee incurs a large claim in the beginning of the year and then terminates employment without contributing enough to cover the claim. Benefits experts have suggested ways employers can minimize their potential for loss under this rule while continuing to maintain an FSA. Their suggestions include reducing the maximum amount of salary reduction contributions allowed, restricting certain expenses (such as elective surgery), requiring continued participation throughout the plan year even if the employee terminates employment, and imposing an extended waiting period before an employee is eligible for participation (Spencer's Research Reports, 1990). Many employers indicated they would make these changes. In a survey conducted several months after the release of the 1989 regulations, 27 percent of employers with FSAs reported that they would reduce their maximum contribution limit, 4 percent would limit the types of expenses eligible for reimbursement, and 15 percent would eliminate their health care FSA completely (A. Foster Higgins, 1990). A more recent survey of employers with FSAs found that 32 percent of the respondents had made some changes in response to the regulations. These changes included lowering the annual maximum contribution (20 percent), restricting types of eligible expenses (3 percent), and increasing the waiting period for participation (6 percent) (TPF & C, 1990).

◆ Prevalence of Flexible Benefits Plans

Nine percent of full-time employees in private firms employing 100 or more workers were eligible to participate in cafeteria plans in 1989 (U.S. Department of Labor, 1989). These plans frequently offered employees a choice among health insurance, life insurance, long term-disability, and cash options. Twenty-three percent of these employees were eligible to participate in flexible spending accounts (table 3). While some participants (8 percent) were eligible to participate through their employers' cafeteria plans, others (15 percent) were eligible through stand-alone FSAs. The percentage of employees eligible for both cafeteria plans and FSAs in 1989 was nearly double that in 1988. Professional and administrative employees were more likely than all other workers to be eligible for cafeteria plans and/or FSAs during both years.

Generally, the proportion of employers sponsoring cafeteria plans or FSAs increases with the employers' size. Cafeteria plans generally offer employers a choice among levels and types of coverage, particularly health insurance. Because small employers are often unable to purchase reasonably priced health insurance for their

Table 3
Percentage of Full-Time Employees Eligible for Cafeteria Plans and/or Flexible Spending Accounts (FSAs), 1989

	All Employees		Professional and Administrative		Technical and Clerical		Production and Service	
Coverage	1988	1989	1988	1989	1988	1989	1988	1989
Total	100%	100%	100%	100%	100%	100%	100%	100%
Eligible for cafeteria plans								
and/or FSAs	13	24	20	38	18	33	6	11
cafeteria plans	5	9	7	14	8	15	2	3
with FSAs	4	8	7	12	7	14	1	2
FSAs-total	12	23	20	36	17	31	5	11
stand-alone	8	15	13	24	10	17	4	8

Source: U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in Medium and Large Firms, 1989* (Washington, DC: U.S. Government Printing Office, 1989).
Note: The survey covers only full-time employees in private-sector firms with 100 or more employees.

employees, implementing a cafeteria plan may not be feasible. Health insurance premiums are higher for small groups because the small pool of employees increases the insurers' risk, and therefore the price of coverage. Small employers are also less likely to implement a cafeteria plan because they have fewer resources to devote to administrative tasks. Large employers are able to spend more time researching and developing their plans than small employers, and they realize economies of scale in their research efforts and plan administration.

Even with significant barriers to implementation, some small employers decide to establish plans with an element of choice. A 1989 survey analyzing the prevalence of choice-making plans in companies with between 50 and 1,000 employees found that only 3 percent of these firms currently offered such plans (Life Insurance Market Research Association, 1989).[8] In addition, many employers familiar with flexible benefits indicated they were interested in implementing a plan in the near future. However, **small employers are more likely to implement stand-alone FSAs than cafeteria plans, because FSAs require a smaller initial investment and are less complex and costly to maintain.**

A greater proportion of large employers have chosen to implement choice-making plans and/or FSAs to meet their workers' needs. Large firms frequently employ workers from a variety of backgrounds who are at different stages in their lives. Their work force is likely to include single persons with no children; two-income couples, both with and without children; and single parents—each with distinct benefits needs. Twenty-seven percent of employers with 1,000 or more employees offered choice-making plans in 1990 in part to accommodate these diverse needs (A. Foster Higgins, 1991).[9] Separately, 69 percent of these employers offered premium conversion plans, and 50 percent offered FSAs, either in conjunction with cafeteria plans or as a stand-alone option (table 4) (A. Foster Higgins, 1990). **Compared with the 99 percent of large employers who offer health insurance to their employ-**

[8]In this survey, a *flexible benefits plan* includes any plan that provides employees with a choice among more than just medical benefits that the employer at least partially funds.

[9]A. Foster Higgins counts any plan that offers employees a choice among several benefits (such as health care, life insurance, vacation, disability, etc.), and allows employees to become involved in the design of their own benefits package as a *flexible benefits plans*. Most (91 percent) of the flexible benefits plans also qualified as cafeteria plans under Section 125.

ees, relatively few large firms have begun to offer choice-making plans or a tax-favored means of paying for health and dependent care expenses (ICF Incorporated, 1987).

Although many large employers offer their employees FSAs to pay for unreimbursed health or dependent care expenses, studies show that only a small percentage of employees actually take advantage of the potential savings (Hewitt Associates, 1991). **In 1990, less than 20 percent of eligible employees contributed to a health care FSA, and only 3 percent of eligible employees contributed to a dependent care FSA.** In contrast, a recent EBRI/Gallup poll found that 70 percent of respondents in worker families would contribute to such an account if it were available. Contributions to health care FSAs averaged $594 and those to dependent care FSAs averaged $2,696 (Hewitt Associates, 1991).

The prevalence of choice-making plans among firms with 1,000 or more employees varies only slightly by firm size but moderately by region (A. Foster Higgins, 1991). Mountain region employers report the highest incidence of flexible benefits plans, while employers in the south central region generally exhibit the lowest incidence. Such regional variation may be partially explained by different employer perspectives, levels of competition for skilled workers, or degrees of unionization. Generally, more traditional employers or those

Table 4
Percentage of Surveyed Firms Offering Pretax Premium Conversion, Health or Dependent Care Flexible Spending Accounts (FSAs), and/or Choice-Making Plans, 1990[a]

	Currently Offer			Plan to Offer by 1991		
Firms	Premium conversion	FSA	Choice-making plan	Premium conversion	FSA	Choice-making plan
All Employers with 1,000 or More Employees	69%	50%	27%	5%	10%	11%
Industry						
Consumer products	67%	48%	33%	17%	13%	4%
Manufacturing	67	48	24	5	7	9
Mining/construction	50	24	29	0	0	0
Energy/petroleum	75	42	17	4	21	21
Wholesale/retail trade	68	26	14	8	8	11
Technical/professional services	84	59	31	3	10	08
Utilities	56	51	27	6	16	18
Transportation services	50	28	28	4	8	4
Health services	62	48	30	6	12	20
Financial services	94	70	45	0	13	09
Communications	59	76	29	0	0	0
Government	59	42	26	5	9	13
Education	59	52	21	10	13	8
Insurance	62	67	30	6	12	19
Other	65	43	25	3	9	10

Source: A. Foster Higgins, Inc., *Health Care Benefits Survey, 1990: Report 3, Flexible Benefits Programs* (Princeton, NJ: A. Foster Higgins, forthcoming).
[a]Categories are not mutually exclusive. Employers who operate a choice-making plan with an FSA will be counted in each category. A. Foster Higgins surveyed nearly 2,000 employers with 1,000 or more employees. A flexible benefits program was defined as any plan that offered employees a choice among several benefits and allowed employees to design their benefits packages.

with highly unionized work forces are less likely to implement flexible benefits plans. Among firms employing 1,000 or more employees, 15 percent of those with work forces that are more than one-half unionized had flexible benefits plans in 1989, compared with 27 percent of similar, less unionized employers (A. Foster Higgins, 1990). However, recent survey data indicate that unionized employers who offer flexible benefits plans to salaried employees are likely to offer flexible plans to their union employees as well (TPF & C, 1990). Fifty-eight percent of firms that employ union workers and provide flexible benefits to their salaried employees also offer their union employees flexible benefits. **Twenty-one percent of employers offering a flexible plan to their union employees reported that it was rejected by the union (TPF&C, 1990).**

Flexible benefits plans vary by industry. They are most prevalent in the financial services (45 percent), consumer products (33 percent), health services (30 percent), insurance (30 percent), and professional services (31 percent) industries. The industries in which these plans are least common are energy and petroleum (17 percent), and wholesale and retail trade (14 percent) (table 4). The latter industry groups usually have highly unionized work forces, a large percentage of part-time employees, and/or high turnover. Employers often perceive that flexible benefits plans are not as effective in these situations (A. Foster Higgins, 1989).

◆ Plan Design

Sources of Funds, Benefit Allocation, and Pricing and Credit Determination

Cafeteria plans are frequently financed jointly by employers and employees, with employee contributions usually occurring through pre-tax salary reduction arrangements. Ninety-three percent of choice-making plans were at least partially funded by employee salary reduction in 1990, while 84 percent of these plans received an employer contribution (Hewitt Associates, 1991).[10] Employees of private firms with 100 employees or more who were eligible to participate in FSAs were most often allowed to use the funds for reimbursement of health care premiums, deductibles and co-insurance, or dependent care expenses (table 5). Employees eligible for an FSA through a stand-alone plan were more likely to have an arrangement financed through individual salary reduction only (no employer contribution) than were employees eligible for an FSA through a cafeteria plan (table 6).

Cafeteria plans are generally structured in one of three ways: core plus optional coverage, modular options, or mix and match benefits. A core plus optional coverage plan provides all employees with basic coverage in certain areas, often including health, life, and/or disability insurance. In addition, employees receive flexible credits that may be used to purchase additional coverage in either the core benefits areas or in supple-

[10]Hewitt Associates surveys plans that provide benefit choice-making (including both cafeteria plans and plans that do not offer taxable benefits) as well as plans that offer only FSAs.

Table 5
Percentage of Full-Time Employees Eligible for Stand-Alone Flexible Spending Accounts (FSAs) and FSAs within a Cafeteria Plan, by Type of Expense Covered, 1989

	Type of FSA	
Type of Expense Covered	Stand alone[a]	With cafeteria plan[a]
Full-Time Employees Eligible for FSAs	100%	100%
Health care premiums	47	25
Health care deductibles and coinsurance	71	95
Dependent care expenses	83	96

Source: U.S. Department of Labor, Bureau of Labor Statistics, Employee Benefits Survey, unpublished.
Note: The survey covers only full-time employees in private-sector firms with 100 or more employees.
[a]Columns do not sum to 100 percent because employers may allow reimbursement of different types of expenses within a single FSA.

Table 6
Percentage of Full-Time Employees Eligible for Flexible Spending Accounts (FSAs), by Type of Financing and Expenses Covered, 1989

Type of Expense Covered	Total	Employer Financed Only	Jointly Financed	Employee Financed Only
Stand-Alone FSAs				
Health care premiums	100%	11%	36%	53%
Health care deductibles and coinsurance	100	11	15	73
Dependent care expenses	100	6	11	83
FSAs within a Cafeteria Plan				
Health care premiums	100	28	56	16
Health care deductibles and coinsurance	100	1	58	42
Dependent care expenses	100	1	57	42

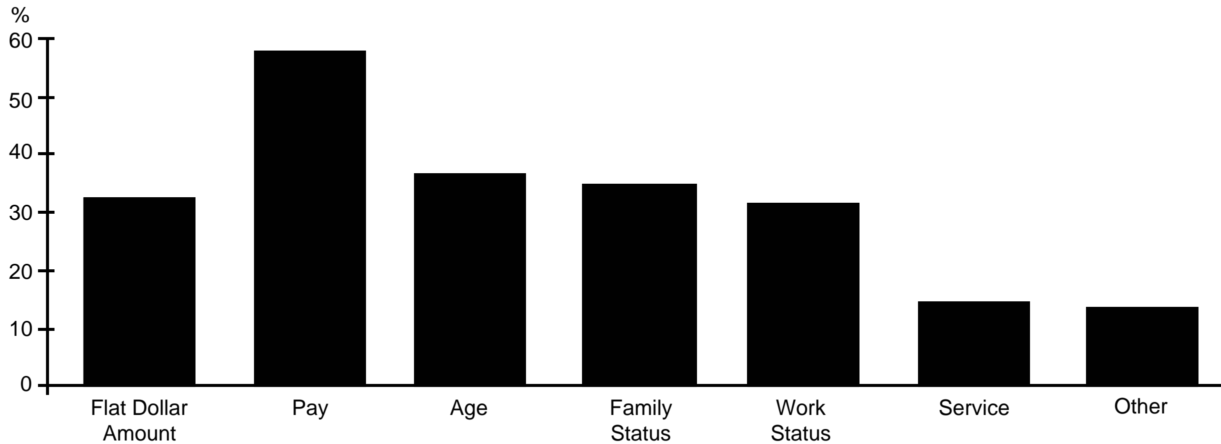
Source: U.S. Department of Labor, Bureau of Labor Statistics, Employee Benefits Survey, unpublished.
Note: The survey covers only full-time employees in private-sector firms with 100 or more employees.

mental benefits areas such as child care and vacation days or traded in for a cash equivalent. An employer using a modular approach provides employees with a choice among several different combinations of benefits. Generally, each package includes the same *type* of benefits but a different *level* of benefits designed to meet individual needs. A mix and match plan provides employees with the greatest opportunity to individualize their benefits package. Employees receive flexible credits to purchase any type and level of coverage desired among a variety of benefit options. **Some employers require their employees to choose at least a minimum level of coverage in particular areas such as health care or life insurance unless the employees demonstrate that they have coverage from another source.** Without these controls, employees could choose no coverage even if they are otherwise uninsured.

The most difficult features to design in a cafeteria plan are the allocation of employer contributions and pricing of benefit options. Employers make these decisions according to the plan's objectives. Common objectives include creating a pricing structure that conveys a realistic benefit value to employees, giving all employees equal credits, providing employees with coverage similar to that offered under the previous plan without increasing employee cost, and implementing the plan without added employer cost. Employers also need to consider the risk of incurring increased costs as a result of adverse selection. **In general, the potential for adverse selection increases with the degree of choice available to employees and their ability to predict their benefit needs.** For example, most individuals can accurately predict their need for vision care. If this coverage is offered as a stand-alone benefit within a cafeteria plan, only those employees who need the coverage will choose it.

Employers cannot meet all of these objectives in part because at the time of cafeteria plan implementation most firms do not allocate benefit dollars equally among all employees. This is especially true in regard to health insurance coverage. The following simplified example illustrates how employees who choose individual coverage subsidize those who choose family coverage in a group plan. A company offers a health insurance plan that requires no contribution from the employees regardless of whether they choose individual or family coverage. If two employees earn the same salary, but one chooses individual and the other chooses family coverage, total compensation of the later employee is higher than that of the former. If the company decides to implement a cafeteria plan, it must decide whether

Chart 3
Credit Allocation Factors for Flexible Benefits Plans, 1989



Source: Hewitt Associates, *Flexible Compensation Programs and Practices* (Lincolnshire, IL: Hewitt Associates, 1991).
Note: Because employers generally use a combination of credit allocation factors, their sum is greater than 100 percent. Hewitt Associates surveys flexible benefits programs sponsored by 444 organizations with 170 or more employees. These programs include plans with benefit choice-making, FSAs, or a combination of both.

to maintain this subsidy, move to a uniform allocation of credits, adjust the prices of benefit options, or use a combination of these methods.

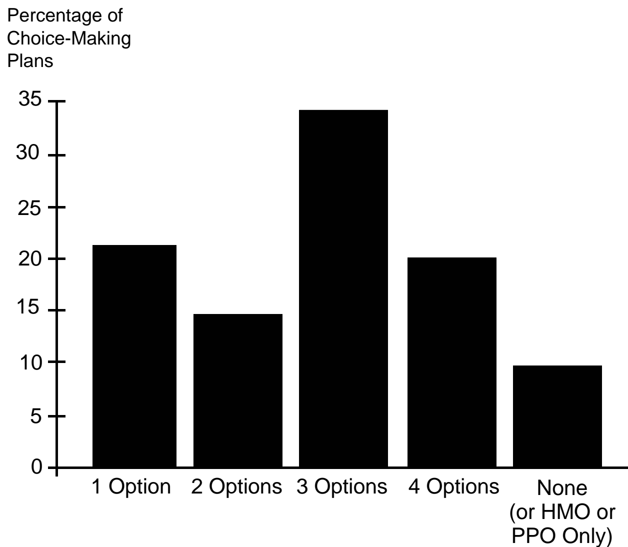
Although some employers allocate flexible credits on a per capita basis, most use a combination of factors, including years of service, salary level, age, family status, or work status (chart 3). In this way, employers can provide employees who have greater needs with more flexible credits, thus maintaining certain subsidies that were in place before the new plan. Pricing benefit options is a complicated and research-intensive process. Employers must analyze claims data and determine a fair price for each benefit option, including prices for alternative coverage categories (that is, employee only and family coverage). After arriving at realistic benefit option prices, employers may choose to adjust these prices to encourage employees to choose lower levels of coverage or subsidize particular benefits such as family health insurance.

Medical plans are usually the most common benefits in cafeteria plans.

Benefit Areas

Medical plans are usually the most common benefits in cafeteria plans. One survey reports that more than 90 percent of choice-making plans offer one or more medical options other than HMOs or PPOs (A. Foster Higgins, forthcoming) (chart 4). Another survey found that 97 percent of employers with choice-making plans offered a medical indemnity plan in 1990, 82 percent offered an HMO or PPO, 88 percent offered dental coverage, and 23 percent offered vision care plans (chart 5) (Hewitt Associates, 1991). On average, choice-making plans offered more choices for medical coverage than for dental or vision care coverage. **Offering a variety of medical plan options under a**

Chart 4
Number of Medical Plan Options Offered (Other than HMOs or PPOs) by Choice-Making Plans, 1989[a]



Source: A. Foster Higgins, *Health Care Benefits Survey, 1990: Report 3, Flexible Benefit Programs* (Princeton, NJ: A. Foster Higgins, forthcoming).

[a]A. Foster Higgins surveyed nearly 2,000 employers with 1,000 or more employees. A flexible benefits program was defined as any plan that offered employees a choice among several benefits and that allowed employees to become involved in the design of their own benefits package.

cafeteria plan provides employees with the opportunity to meet individual needs and weigh the relative cost and value of benefits. Medical options in cafeteria plans are also useful in controlling employer health care expenditures. Employers often change their core medical plan or introduce managed care features in conjunction with their cafeteria plan implementation. Although some employers who introduced choice-making plans retained their health plan without making changes in coverage provisions, fully 69 percent modified their medical plan. Frequent changes included increased cost sharing through higher deductibles, premium contributions, or annual out-of-pocket maximums (A. Foster Higgins, forthcoming). In addition, 55 percent of employers implementing flexible benefits plans introduced cost management features concurrently.

About 70 percent of employers who offer health insurance through a flexible benefits plan allow their employees to waive medical coverage. Giving employees this option can be beneficial for both the employer and employee in certain circumstances. The employer can reduce health care expenditures if employees covered by another plan are able to eliminate duplicate coverage. The employee can use employer benefit dollars that would have been spent on medical benefits to purchase more needed benefits or trade them for additional cash compensation. However, employees who do not select health insurance coverage may lose future rights to receive it. Nearly one-half of cafeteria plans permitting employees to waive medical coverage require proof of other coverage in order to discourage employees from choosing no health insurance coverage. The remaining plans may unintentionally increase the percentage of the population who are uninsured and therefore the level of uncompensated health care. More than 60 percent of employers report that fewer than 10 percent of employees who are given the option choose to waive their health coverage (A. Foster Higgins, forthcoming).

More than one-half of surveyed employers restrict future medical benefit elections for employees who choose to waive medical coverage.

More than one-half of surveyed employers restrict future medical benefit elections for employees who choose to waive medical coverage. These restrictions are designed to prevent employees from choosing to waive coverage when they are healthy and resume coverage when they are sick (Hewitt Associates, 1991). They usually require employees to provide proof of insurability (16 percent) or limit coverage to exclude preexisting conditions (19 percent); 13 percent of employers impose both of these restrictions, and

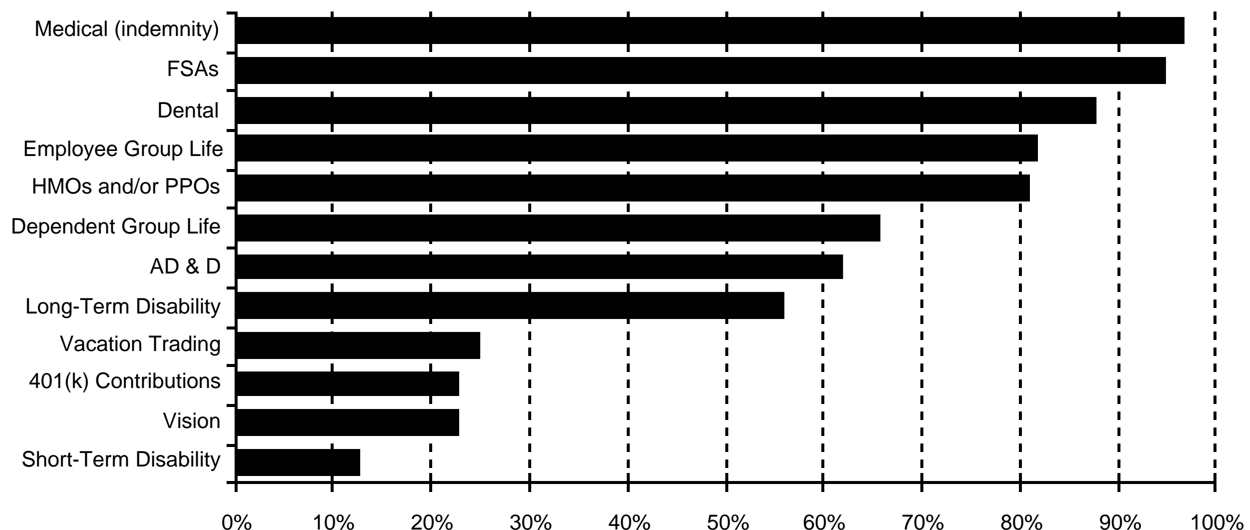
7 percent impose other restrictions. Ninety percent of employers do not allow employees who have waived their medical coverage to choose to continue coverage under the terms of the Consolidated Omnibus Reconciliation Act of 1985 (COBRA) (Hewitt Associates, 1991).[11]

Cafeteria plans often limit election changes from year to year for dental and vision coverage. Without such restrictions, an employee could choose a high option dental plan in a year in which he or she expects to undergo oral surgery and in a subsequent year reduce or even eliminate coverage. This kind of behavior can adversely affect insurance premiums. Many choice-making plans allow an employee to make a dental benefit election only once every two years or package dental and/or vision care benefits with other medical benefit options (Hewitt Associates, 1990).

In addition to health benefits, cafeteria plans may include an FSA, group term life insurance, accidental death and dismemberment insurance (AD & D), and long-term disability insurance (chart 5). After health insurance, FSAs are the most common benefit offered through a cafeteria plan. The tax code allows individuals to deduct health care expenditures that exceed 7.5 percent of annual gross income. With a health care FSA, an employee can exclude any health care expenditures from his or her gross income even if total expenses do not reach this threshold. Dependent care expenses are usually paid for with after-tax dollars. To offset these expenses, the tax code allows workers below certain income levels to take the earned income tax

[11]COBRA requires employers with 20 or more employees who sponsor health insurance plans to offer employees and their dependents continued access for 18 months (or 29 months if disabled) to group health insurance if they lose coverage for a reason other than gross misconduct. The qualifying employee or dependent may be required to pay up to 102 percent of the premium.

Chart 5
Percentage of Flexible Benefits Plans Offering Selected Benefits, 1990



Source: Hewitt Associates, *Flexible Compensation Programs and Practices* (Lincolnshire, IL: Hewitt Associates, 1991).
Note: Hewitt Associates surveys flexible programs sponsored by 444 organizations with 170 or more employees. These programs include plans with benefit choice-making, FSAs, or a combination of both.

credit (EITC)[12] and all taxpaying parents who pay for the care of a child under age 13 to take the dependent care tax credit (DCTC).[13] A dependent care FSA sponsored by an employer provides an additional tax-favored means of paying for dependent care expenses. Employees can set aside up to $5,000 through pretax salary reduction to pay for dependent care expenses without income restrictions. Since 1989, every dollar of employer-provided dependent care benefits (that is, provided through a FSA or any other dependent care assistance plan) reduces the DCTC available by the same amount. Employees in higher tax brackets who have large dependent care expenses realize greater tax savings by contributing to a dependent care FSA than by using the tax credit (U.S. Department of Labor, 1989). For employees in lower tax brackets, however, the DCTC generally provides the greatest tax savings.

Death and disability insurance plans protect employees and their dependents from loss of income due to an accident, injury, or illness. These benefits, employee and dependent group life insurance, AD & D, and long-term disability, are common options in cafeteria plans. Employees need a choice among types and levels of death and disability insurance because the need for these benefits changes with age and family status. However, special tax considerations often complicate the treatment of these benefits.

Most firms (78 percent) with life insurance options in their cafeteria plan require employees to choose a minimum level of coverage. However, because group term life insurance coverage above $50,000 must be included in an employee's gross income, employers need to decide whether to permit premium payment on a pre- or post-tax basis. In 1990, 78 percent of employers with group term life insurance used pretax premium payment, recognizing that for most employees any tax liability resulting from additional imputed income would be offset by the tax savings gained through salary reduction (Hewitt Associates, 1991). Generally, choices between pre- and post-tax life insurance premium payments are not offered within the cafeteria plan framework because the administration and communication of these options is complex.

Employees in higher tax brackets who have large dependent care expenses realize greater tax savings by contributing to a dependent care FSA than by using the tax credit.

Some employers also offer dependent life insurance coverage, most with premium payment on a pretax basis. Sixty-one percent of employers who offered dependent life insurance in 1990 allowed coverage to be purchased with pretax dollars. Many who currently allow pretax contributions may reevaluate their policies in response to these regulations.

Disability insurance is often used to expand the scope of choices under a flexible benefits plan rather than to meet employee needs because these needs do not change substantially over time (Hewitt Associates, 1988). Short-term disability options—offered by 13 percent of cafeteria plans— are a growing but uncommon benefit, perhaps because many employees are covered by sick leave policies that provide full or partial

[12]The EITC provides an advance refundable tax credit for low-income workers with one or more children. In 1991, the EITC is equal to 16.7 percent of the first $7,102 of adjusted gross income (AGI) (indexed) for families with one qualifying child and 17.3 percent of AGI for families with two or more qualifying children. The credit is phased out at a rate of 11.93 percent and 12.36 percent of AGI above $11,191 (indexed) for families with one qualifying child and those with two or more qualifying children, respectively.

[13]The DCTC gives workers a credit of 30 percent of dependent care expenses (up to $2,400 for one child and $4,800 for two or more children) for the care of children aged 13 or younger. The credit is reduced by 1 percent for each $2,000 AGI above $10,000 and remains at 20 percent for families with AGI above $28,000.

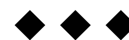
income replacement for a period of time. Long-term disability choices, on the other hand, are offered by more than one-half of cafeteria plans. Generally, employers include a disability plan similar to the plan in place prior to the flexible plan's implementation. Deciding whether employees can use salary reduction to pay for disability benefits is complicated. Benefits purchased with after-tax dollars are nontaxable to an employee who becomes disabled, whereas benefits attributable to pretax employee contributions are considered employer provided and are taxable when paid. The majority of employers who offer disability plans collect employee contributions on a pretax basis because salary reduction is more cost effective in paying for the coverage. The tax liability for an employee who becomes disabled is likely to be less at that time than during his or her working years (Hewitt Associates, 1991).

◆ Advantages and Disadvantages of Flexible Benefits Plans

The advantages and disadvantages of flexible benefits plans vary with the different perspectives of employers and employees. Actual experience is often based on the original employer objectives and plan design. Many employers gain from increased morale and productivity of their employees who may be more satisfied with their benefits package. **The extent of employee appreciation varies with the degree of choice offered, range of benefits offered, and level of benefits maintained.** If an employer implements a plan in which employees are forced either to reduce coverage or increase their net contribution to benefits, the reaction is likely to be negative. A strong commitment to employee communication and education is necessary for a successful plan. **Without proper communication, employees may be confused by the choices and unintentionally select inappropriate or inadequate coverage.**

Employers

By offering employees a choice among types and levels of coverage, employers may meet many of their work force's needs. With effective communication, many employees may appreciate their ability to choose, particularly those employees who currently have duplicate coverage or need coverage in other areas. Employers may also benefit from a cafeteria plan by introducing cost management strategies. By limiting annual increases in benefit credits, employers can introduce cost sharing to employees slowly.

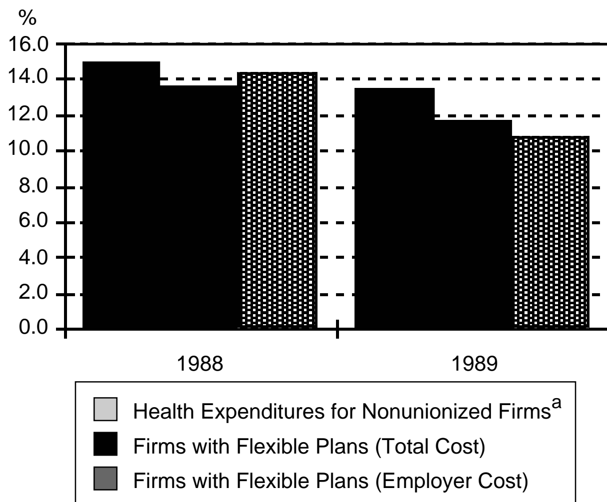


Employers with choice-making plans have lower annual health care expenditure growth, on average, than employers without such plans.

Employers report that cafeteria plans have been successful in meeting their major program objectives. In a recent survey, 99 percent of employers with choice-making plans reported that their major program objective of meeting diverse employee needs was reached, and only 1 percent felt that this objective was not met (Hewitt Associates, forthcoming). However, employers who cited controlling health expenditures as a major program objective were not as confident about their success. Only 76 percent felt they had met their goal, while the remaining 24 percent felt it was either too soon to tell or that their objective had not been met (Hewitt Associates, forthcoming).

Employers with choice-making plans have lower annual health care expenditure growth, on average, than employers without such plans (chart 6). However, lower costs are not necessarily a result of the choice-making plan. Employers often change their core medical plan or add managed care features to their existing plan when they implement a choice-making plan. These changes have been shown to slow the growth of health care expenditures for all firms (Hewitt Associates, 1991).

Chart 6
Annual per Capita Increase in Health Care Expenditures for All Nonunionized Firms and Firms with Flexible Benefits Plans, 1988–1989



Source: Hewitt Associates, *Flexible Compensation Programs and Practices* (Lincolnshire, IL: Hewitt Associates, 1991).
Note: Hewitt Associates surveyed 444 employers in firms with 170 or more employees for the flexible benefits plan data. These programs include plans with benefit choice-making, FSAs, or a combination of both.
[a]Health expenditure data for nonunionized firms are from Hewitt Associates, *Managing Health Care Costs* (Lincolnshire, IL: Hewitt Associates, 1989).

Employers cannot be certain that implementing a cafeteria plan will result in a net gain in terms of either reduced or stable benefit expenditures or employee satisfaction. Employers must understand tax regulations, the role of communication, and the cost of ongoing administration as well as determine the allocation of benefit credits and pricing of benefit options. **Without proper planning, a cafeteria plan could increase total employer expenditures and/or receive a negative reaction from employees.** Employers must consider that with increased choice employees may utilize services more often. Such adverse selection, particularly in medical, dental, and vision care, may result in higher premiums in subsequent years. As mentioned previously, small employers are at a disadvantage in implementing cafeteria plans because they do not experience the economies of scale of large employers and must, therefore, realize greater overall cost savings in order to be successful. The 1989 regulations that require health care FSAs to exhibit some of the characteristics of insurance plans also pose potential disadvantages for employers. Recent reports of actual experience indicate that the new regulations have had a relatively minor effect on FSA experience (TPF & C, 1990). This may be due in part to low average participation rates for FSAs.

Employees

Flexible benefits plans give individuals the opportunity to determine the mix of cash and benefits in their total compensation. Employees covered by such plans do not have to accept a uniform benefit structure designed to meet the needs of the majority of the work force. **As nontraditional families such as two-earner families, single parent families, unmarried partners, and single persons without children become the norm, a plan designed to meet the needs of all workers is less likely to fulfill that objective.** With a cafeteria plan, employees can eliminate duplicate coverage and/or expand coverage to other needed areas. In subsequent years, or as a result of family status changes, employees can alter their benefit elections to meet changing needs.

Even if employers undertake a communication plan to educate employees about benefit options, employees may not choose an appropriate mix of benefits and cash. Many employers try to limit election errors, particularly for health insurance, by requiring proof of coverage before benefits can be waived. Not all employers require such proof, however, and elections in other benefits areas are often not examined as carefully. In addition, employees who were satisfied with their total compensation package prior to the implementation of a cafeteria plan may dislike the plan, particularly if it is introduced in conjunction with a reduction in coverage in areas they consider important. Finally, employees who are eligible for an FSA but are unable to estimate uncovered health care expenses accurately may forfeit the unused balance of their account at the end of the plan year. Studies have shown, however, that only a

small percentage of FSA participants forfeit funds at the end of the plan year, and those who do, forfeit relatively small amounts (TPF & C, 1990).

◆ Conclusions

Employee benefits are an important component of total compensation for most American workers. In 1989, benefits represented 16.3 percent of total compensation, up from 8 percent in 1960. As the population continues to grow older and as women enter the work force in increasing numbers, the traditional compensation package is likely to adjust in response to diverging needs. Section 125, enacted more than 10 years ago, provided a means for employers to offer a different set of benefits to each employee, based on individual needs, as long as certain nondiscrimination tests were met. However, to date, only a small percentage of full-time employees are eligible for cafeteria plans. This may be due in part to the complex nature of these plans or perhaps to the large investment required to implement an effective plan. A relatively larger number of employees are given the opportunity to pay for unreimbursed health or dependent care expenses on a tax-favored basis through an FSA. However, only a fraction of eligible employees use this benefit. Low participation rates may be the result of employee uncertainty or misunderstanding of the tax savings available through an FSA. Employees may also be unable to accurately project their health or dependent care expenses over a year.

There are many potential advantages to flexible benefits plans for both employers and employees. Employers can avoid FICA and FUTA taxation on money set aside by employees through an FSA and can shift part of any increase in benefits' costs to employees by adopting a defined contribution approach to total compensation. Employee morale and productivity may rise as a result of increased satisfaction with their mix of benefits and cash compensation. Although if cost sharing is increased, the opposite may occur. Employees may place greater value on their benefit dollar because they are able to spend the money on the parts of the benefits package that are most important to them. They often have the opportunity to waive medical coverage if they are already covered by another plan. These opportunities may become increasingly important as employees' characteristics and needs continue to change.

Some policymakers feel that the tax advantages afforded to flexible benefits plans, and in particular to FSAs, should be revoked or at least limited. They argue that flexible benefits plans disproportionately benefit higher income employees and are only available to those workers whose employer chooses to sponsor an FSA. The child care bill introduced in the House in 1990 (H.R. 3) included a proposal to phase out eligibility for the dependent care FSA for families with AGI between $70,000 and $90,000. Families with AGI above $90,000 would not be eligible to participate. Advocates of the phase-out argue that the tax benefits for high-income workers should be limited and suggested that the savings realized from this restriction could provide revenue to pay for child care benefits for low-income workers. Opponents argue that employers could not accurately determine each employee's AGI because employers do not have access to information about employees' outside income and their spouses' income. They also say that the phase-out would be inconsistent with nondiscrimination rules. Although this provision was eventually dropped in the conference agreement, its proponents may in the future move to limit the benefits of FSAs for all workers, or for high-income workers.

Other policymakers maintain that health care expenses paid for through an FSA should not receive tax-favored treatment unless total expenses exceed 7.5 percent of gross income. This would provide equal tax treatment of health care expenses for all workers, rather than granting preferential treatment to employees who work for firms that sponsor an FSA. Some policymakers have suggested eliminating the tax exclusion for reimbursements from FSAs for health care plan deductibles and copayments. They say the exclusion promotes increased

health care utilization, and it therefore hampers cost containment. Rick Grafmeyer, minority tax counsel for the Senate Finance Committee, said March 12 that limiting the tax exclusion for FSAs that provide health care benefits is one of the top five ways Congress is currently considering to pay for expanding health care to the uninsured.[14] Other legislators want to limit the types of covered expenses that can be reimbursed through an FSA. The Omnibus Budget Reconciliation Act of 1990 amended the definition of medical care under the tax code. Cosmetic surgery and other similar procedures no longer receive tax preferential treatment, except under certain conditions.

A recent EBRI/Gallup poll found that a majority of Americans would like a choice in designing their benefits packages. Flexible benefits plans are likely to continue growing throughout the 1990s as the work force continues to change. However, legislators may decide to limit their availability or their tax-favored status in response to budgetary constraints or perhaps because they feel the plans disproportionately benefit higher-income workers. Proposals may be aimed at limiting the tax-favored treatment of employee salary reduction contributions to FSAs in an attempt to equalize the tax treatment of health and dependent care expenses for all workers.

This *Issue Brief* was written by Jill Foley of EBRI with assistance from the Institute's research and education staffs.

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[14]Statement made March 12, 1991, at a meeting of the Employers Council for Flexible Benefits.

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