

## States Mandate Cafeteria Plans – Effect on Employers Unclear

Once again we find ourselves navigating troubled waters due to confusing, overlapping – and perhaps conflicting – state and federal regulations. Several states have recently passed laws requiring employers to adopt and maintain cafeteria plans. (For purposes of these state laws, a cafeteria plan is a program that meets the requirements of section 125 of the federal tax code and allows employees to pay their health insurance premiums on a pre-tax basis.) While adopting a cafeteria plan seems simple, doing so can result in complex compliance problems under several federal laws.

### State Cafeteria Plan Mandates

**Massachusetts** enacted the first state cafeteria plan mandate as part of the Massachusetts Health Care Reform Act. This mandate would be problematic even if the only premiums to be paid under the cafeteria plan were for employer-sponsored health coverage. Under the Massachusetts law, however, the required cafeteria plans must provide for pre-tax payment of other health coverage premiums, including individual health insurance policies.

At least three other states have followed Massachusetts' lead and adopted their own mandates.

**Connecticut** (Public Act No. 07-185) Starting October 1, 2007, any employer that provides health insurance benefits must give employees the opportunity to make any required contributions on a pre-tax basis. There is no exception for

small employers, and the law applies regardless of the number of employees based in Connecticut. The law may be interpreted as applying only to employers that pay part of the cost of coverage and exempting employers that offer only employee-pay-all coverage or no coverage at all.

**Missouri** (House Bill Number 818) Effective January 1, 2008, employers that provide health insurance and pay part of the premium must establish a cafeteria plan. It appears that, like the Connecticut law, the Missouri law does not apply to employers offering only employee-pay-all health coverage. In addition, it does not apply to self-insured plans.

**Rhode Island** (Public Law No. 2007-125) This cafeteria plan mandate does not become effective until July 1, 2009. Like the Massachusetts law, this law applies whether or not the employer offers group health plan coverage to

employees or contributes to the cost of that coverage. Employers are not subject to this requirement, however, unless they have annual average employment in Rhode Island of more than 25 employees for six consecutive months.

## The Problems for Employers

As discussed later in this *Alert*, there is a good chance that some cafeteria plan mandates are preempted by ERISA. Even so, an employer that does not want to become a test case will have difficulty disregarding state cafeteria plan mandates until a court holds that ERISA preempts them. Furthermore, while adopting a cafeteria plan may seem like an insignificant step to assist employees in somewhat mitigating the rapidly increasing cost of health insurance, employers must be aware that cafeteria plans present some difficult and complicated compliance issues, a few of which are noted below.

- The first is simply the burden of complying. Cafeteria plan mandates require employers to undertake the effort and expense of plan design, adoption and implementation. At a minimum that requires drafting a legal document and having that document adopted by formal action – often a board of directors resolution – as well as modifying payroll deductions.
- Even for employers willing to undertake the actions necessary to establish a cafeteria plan, recent proposed regulations make clear that cafeteria plans must meet exacting federal tax requirements. Those requirements apply to both the terms set out in the plan document and to the actual operation of the plan. If an employer's cafeteria plan does not meet the requirements, the employer generally must treat all pre-tax amounts elected under the plan as taxable income. When the proposed regulations are finalized, employers are likely to find that maintaining a compliant cafeteria plan is more difficult than it used to be and that cafeteria plans are subject to much more regulatory scrutiny than before.
- Because the cafeteria plan mandates vary by state, a multistate employer may be subject to several of these laws and will need to track developments in each state in order to ensure that its cafeteria plan complies.
- The Massachusetts and Rhode Island cafeteria plan mandates require that employees be allowed to pay premiums for individual health insurance policies on a pre-tax basis. Under ERISA, an employer could be deemed to sponsor an individual policy in such circumstances, which would trigger compliance obligations under ERISA, COBRA, HIPAA and other authorities. Individual policies are not designed to comply with these requirements. For example, HIPAA prohibits using health information as a basis for determining individual eligibility or individual premiums,

while individual health policies generally determine both eligibility and premiums based on health information and past claims history.

## ERISA May Preempt Cafeteria Plan Mandates

ERISA preempts state laws relating to employee benefit plans that are subject to ERISA, and the Department of Labor (DOL) has ruled that a cafeteria plan providing only pre-tax premiums is not subject to ERISA. Therefore, ERISA arguably would not preempt a state cafeteria plan mandate. As discussed above, however, a requirement to adopt a cafeteria plan may be very close to a requirement to adopt the health benefits that are offered through the cafeteria plan as an employer-sponsored plan that *is* subject to ERISA.

Courts have routinely held that ERISA preempts state laws requiring employers to provide the types of benefits that are regulated by ERISA. If a court agreed that mandating a cafeteria plan is equivalent to mandating that an employer offer health benefits to its employees, the court would be very likely to find the cafeteria plan mandate preempted by ERISA. It is far from certain, however, that a court would reach that conclusion for any of the cafeteria plan mandates described above.

Cafeteria plan mandates in Connecticut and Missouri do not require availability of pre-tax premiums for any health insurance other than employer-sponsored and employer-subsidized coverage. The limited applicability of these two laws makes it very unlikely that a court would find that ERISA preempts them. First, they do not have the effect of requiring an employer to offer any health coverage other than what it already offers. Second, complying with these laws will not cause any employee-pay-all coverage that the employer treats as ERISA-exempt voluntary coverage to become subject to ERISA.

## Conclusion

The complexity of cafeteria plans and the significant compliance burdens that are imposed on them by federal law make state cafeteria plan mandates troublesome. While some of these laws may be preempted by ERISA, it appears that many may not. It is likely that only time will tell, and the courts will decide.

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