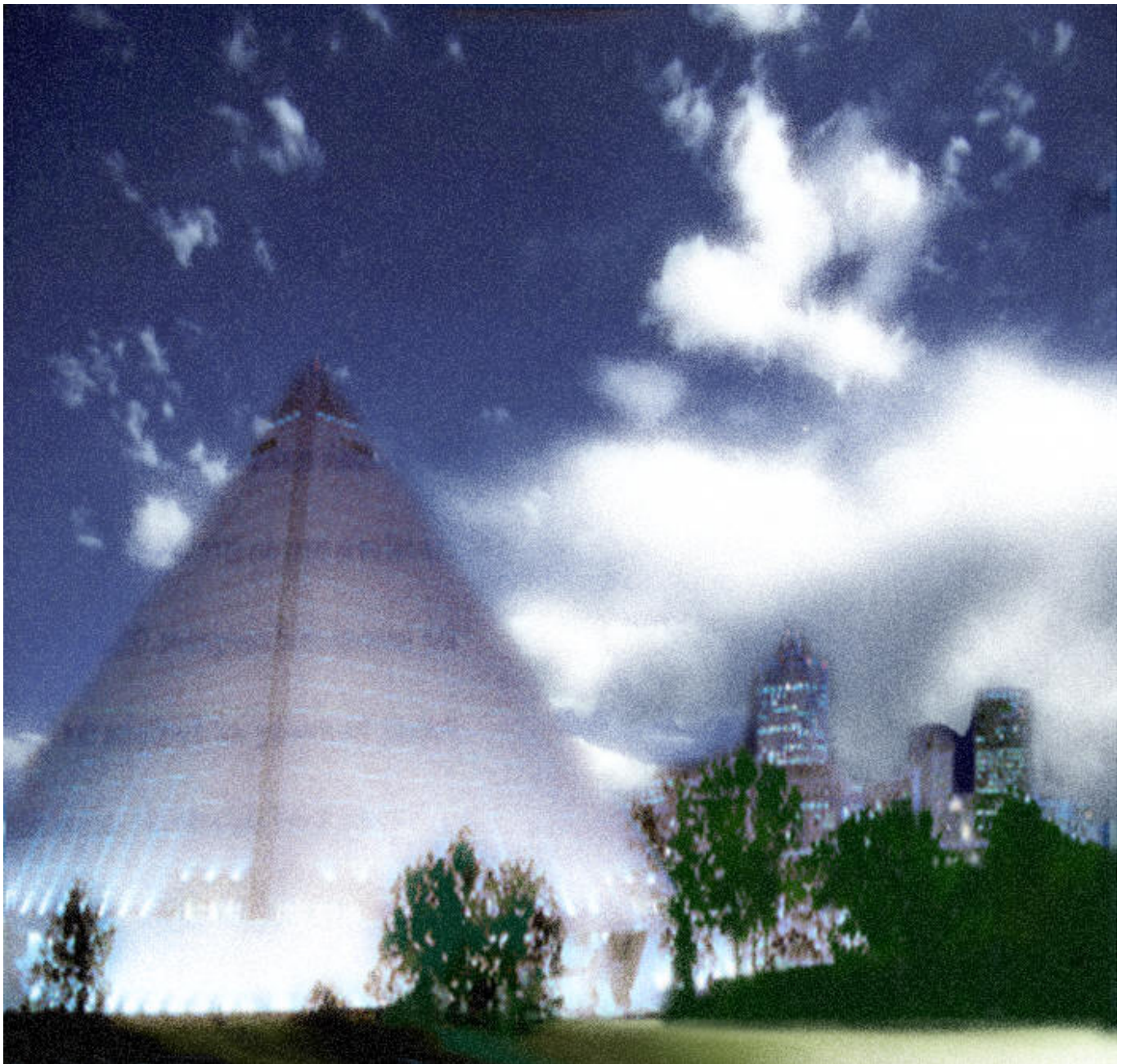


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Café Plans: A Creative Funding Strategy for Employers

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Now more than ever, employers are searching for ways to control the cost of doing business while at the same time keeping good employees.

According to the Grant Thornton Business Owner Council Survey, attracting and retaining employees is one of the most important challenges facing middle-market companies. Employers want competitive employee benefit packages to aid in accomplishing this goal, but often believe their ability to do so is limited by cost constraints.

Indeed, benefits are expensive. According to the U.S. Chamber of Commerce, employers spend over one third of payroll cost on benefits.¹ In addition, the cost of health care in the United States has been rising at an alarming rate. In fact, according to a Hewitt Associates study released in October 2002, the average health care cost per person from 2002 to 2003 will increase from \$5,157 to \$5,982 for HMOs, \$5,545 to \$6,367 for PPOs, and \$5,639 to \$6,485 for POs plans and \$6,304 to \$7,249 for indemnity plans.²

Expressed as percentage increases, average annual health care costs are trending upward.³

Average Health Care Cost Increases

Year	Percentage
1998	3.7%
1999	7.8%
2000	9.4%
2001	10.2%
2002	13.7%
2003	projected 15.4%

The Value of Flexible Benefit Plans

Many large employers have discovered the value of implementing flexible benefit plans, often called flexible spending accounts or cafeteria plans. Cafeteria plans can be established by organizations with or without employer contributions, called “spending credits.” Those plans with employer-provided spending credits are called café plans.

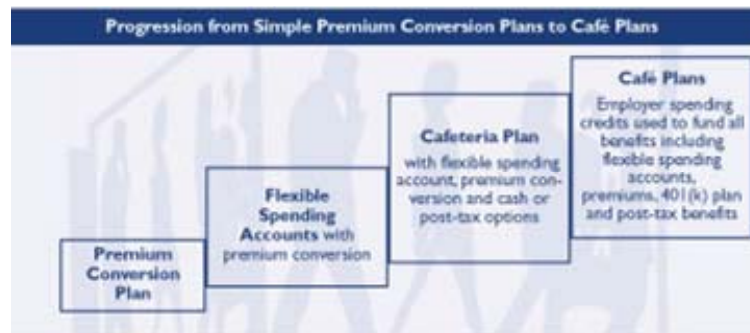
With a café plan, the employer calculates how much it is spending on employee benefits per employee, per year. The employer then converts this cost to a credit and gives the credit to each eligible employee to spend on various benefit options available on the café menu.

Employees will first use the employer credit toward the cost of menu items, which are typically provided on a per-pay basis rather than on an annual basis. Employees may add their own dollars through payroll deductions. Each benefit item is placed in one of three categories on the menu—Pre-Tax (governed by Section 125 of the IRC), Retirement (governed by Section 401k of the IRC), and Post-Tax (cash or benefit options without pre-tax treatment).

The employer credits are added to each employee's paycheck as taxable income. However, if the employee defers the entire credit into Section 125 pre-tax benefits, then the employee will not pay federal, state, or FICA taxes and the employer saves the matching FICA (and in certain situations FUTA and SUTA taxes except for dependent care). The employee will also save federal and state taxes on deferrals to a 401(k) plan.

Consequently, the employer will pay FICA, FUTA, and SUTA taxes and the employee will pay FICA taxes on amounts contributed to a 401(k) plan. All employer and employee taxes will be payable on contributions to post-tax benefits. Any credits that are not allocated by employees are forfeited, thus saving the employer additional costs that might otherwise be spent in a traditional benefit plan.

The chart below illustrates the progression from simple premium conversion plans to café plans.



The Café Plan: Advantages and Pitfalls

The café plan approach has many advantages and some potential pitfalls if the plan is not established correctly.

The first major advantage of the café plan approach is cost control. In the traditionally funded benefit package, the employer subsidizes a specified percentage or dollar amount of actual benefit cost and the employee pays a certain percentage or dollar amount. For instance, according to Foster-Higgins research on health care cost, employers, on average, pay for approximately 75 percent of group health insurance premiums and employees pay for 25 percent.⁴

With the café plan, the employer funding is unbundled from the actual cost of the underlying benefits such as health, dental, life or disability insurance and other benefits. Thus, at the beginning of each benefit plan year, the employer decides how much to allocate to spending credits rather than simply subsidizing the actual cost of insurance.

Most employers that use the credit approach will take into account the cost of the underlying benefits when determining the credit, but they are separate items in a café plan and provide the employer with a way to control cost.

The second major advantage, and one that enables the first advantage to work effectively, is increased choices made possible by the addition of several benefit options available to employees. The café plan menu will typically include several options. Among these options are one or more medical plans, dental insurance, life insurance, short and long-term disability insurance, vision insurance, long-term care insurance, cancer or critical care insurance, flexible spending accounts (unreimbursed medical and dependent care), health club memberships, pre-paid legal plans, house cleaning services, clothing allowances, buying and selling of paid time off, corporate concierge services and retirement programs

such as 401(k) plans. In fact, there are virtually endless possibilities to the number and type of items that may be put on the café plan menu.

The cost control mechanism for employers makes café plans an excellent delivery vehicle for employee benefits. The increased control and choice that employees enjoy make café plans highly popular and aid in the attraction and retention of a quality workforce.

Employers should be aware, however, of some drawbacks to establishing café plans. First, many insurance carriers have minimum participation requirements (70-75 percent is typical). If a large percentage of employees opt out of the insurance plan and direct their credits to other areas, the insurance plans may be in jeopardy.

The way to solve this problem is to require one of three types of participation for each item on the café plan. The first type is mandatory, meaning that each eligible employee must purchase this item using the employer credit. Typically, group term life insurance and long-term disability are mandatory. Mandatory participation for certain options ensures compliance with the insurance carrier rules and keeps the cost per employee very low.

The second participation category is compulsory, meaning that employees must participate unless they can prove that they are covered under a spouse's group plan. Typically, health insurance is compulsory and valid waivers of coverage do not count against the participation requirements of the insurance carrier.

The final category is voluntary, meaning that employees may choose to participate or waive participation at their discretion.

Other Considerations

Many other planning considerations go into the design, implementation and administration of a café plan. First, there are numerous ways to structure the café credits, such as a flat amount, percentage of pay, by class of employee or tied to tenure. Second, the decision to add the retirement plan to the café plan or keep it as a separate benefit needs careful evaluation. Third, one of the most critical success factors of café plans is education. A café plan empowers employees as consumers and allows them to design their own benefit package to meet their specific needs. As a result, it is imperative that employees understand the plan and have information and resources to help them make appropriate decisions. Fourth, the selection of each benefit option is very important. Finally, the plan must be established correctly in the payroll system.

Because of design, administration and communication issues, many small- to mid-sized employers have not implemented café plans. With the availability of these services from outside firms, smaller employers are discovering that café plans are available to them on a cost-effective basis.

If the plan is properly established and effectively communicated, it may be one of the most powerful weapons in the arsenal of the human resource professional to find good employees, keep them motivated and keep them employed.

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(2) Hewitt Health Value Initiative 2002.

(3) Ibid.

(4) Ibid.