The Section 125 Plan Requirement and Massachusetts Employers: Experiences, Reactions, and Initial Results

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Introduction

This report seeks to evaluate the progress of Massachusetts' Section 125 plan requirement during its initial implementation (July 2007 through April 2008). As part of the Commonwealth's health reform law, employers with 11 or more full-time employees in Massachusetts are now required to provide a Section 125 plan that allows employees to pay their health insurance premiums using pre-tax wages. This requirement applies whether or not the employer offers health insurance to his/her employees. In addition, the Section 125 plan must be extended to most part-time and all full-time employees. While beneficial to all types of employees, the Section 125 requirement is particularly helpful to individuals without access to employer-sponsored insurance (ESI), because it effectively reduces the net cost of insurance.

Two years after passage of the state's landmark health reform law, we look back to evaluate how this requirement has been received by the employer community and what effect it has had on take-up rates among employees for whom the employer does not contribute toward the purchase of insurance. Our findings are based on data and feedback from employers of varying sizes and industries gathered through survey tools and one-on-one interviews with benefits professionals.

Summary of Findings

Our findings indicate a wide range of experiences and attitudes among employers with regard to the implementation of the Section 125 requirement. By and large, the majority of employers describe their experience as relatively positive. However, across employers of all sizes, Section 125 take-up rates among non-benefits-eligible employees have been extremely low during the initial months of implementation. We surmise this is largely due to the fact that the vast majority of these workers have insurance through other means (e.g., spousal coverage, publicly-subsidized programs). Therefore, there are relatively few residents who are both employed <u>and</u> uninsured, which diminishes the potential pool of individuals who might benefit from a Section 125 plan.

Those who are employed but do not have access to subsidized insurance represent some of the most difficult-to-reach uninsured individuals. For this target population -- i.e., employed, uninsured and not eligible for employer or publicly subsidized coverage -- the largest obstacle to coverage is the cost of health insurance, even when one factors in the significant savings associated with the pre-tax payment of premiums.

In addition, we found that a minority of employers appeared to be actively engaged in educating their employees who could benefit from a Section 125 plan, and this lack of outreach and education on the part of employers likely has a material affect on the relatively low take-up rate at this early stage of implementation.

Despite these obstacles, over the first nine months of effort by the Commonwealth Health Insurance Connector Authority ("the Connector") to reach employees, we have witnessed a gradual increase in the take-up of Section 125 plans by employees not eligible for ESI. For example, among the non-ESIeligible employees of the Commonwealth of Massachusetts, take-up of insurance using a Section 125 plan has risen from 32 subscribers in the first month of availability (October 2007) to 84 as of May 2008. Overall, Section 125 enrollees purchasing insurance through the Connector grew from 206 in October 2007 -- or 3.3% of total Commonwealth Choice subscribers -- to 992 as of May 2008, or 7.0% of Commonwealth Choice subscribers. This increase suggests the potential of outreach and promotion in reaching target employees, especially as the tax penalties for not having insurance increase.

Five Key Recommendations to Improve Section 125 Program:

- 1. Target specific types of employers and individuals, such as employers in industries that tend not to offer ESI and individuals purchasing coverage in the non-group market who do not pay their premiums on a pre-tax basis.
- 2. Simplify the administrative processes for employers and provide continuous education to employers on key administrative requirements.
- 3. Stress the importance of outreach to employees and provide suggestions and "best practices" on how employers can effectively explain the benefits of a Section 125 plan to their employees.
- 4. Produce and make easily accessible outreach materials (e.g., template letters, flyers, posters, payroll stuffers, brochures) for employers to give to their employees that are understandable (i.e., free of technical jargon) and available in multiple languages.

5. Establish regular communications with employers and engage in direct outreach to their employees.

Although it is beyond the purview of this analysis, further incentives for employers and employees may also be warranted. For example, employers might be asked to actively promote the availability of their Section 125 plans as a condition of relief from the Free Rider Surcharge and/or employers might be encouraged to make at least some modest contribution toward the purchase of non-group insurance by employees under a Section125 plan.

Background on Section 125 Requirement

Massachusetts' landmark health reform law, Chapter 58, became law in April 2006. The cornerstone of the reform is a mandate that adult residents maintain health coverage that meets a minimum benefits threshold ("Minimum Creditable Coverage"). Employers also face a new set of responsibilities. Employers with 11 or more full-time employees must either contribute to their full-time employees' health insurance premiums or be annually assessed a fine of no more than \$295 per employee. Employers are also required to offer all of their full-time employees, as well as part-timers that work regularly and others who many not be eligible for ESI, a mechanism by which employees can pay for health insurance premiums through a payroll deduction (i.e., via a Section 125 plan).

What is a Section 125 Plan?

A Section 125 plan, sometimes called a "cafeteria plan", refers to the section of the federal tax code that allows employers to offer employees a choice between taxable income and certain benefits, like health insurance, which are then paid for without subjecting the income to taxation and FICA contributions. The requirement uses the benefit of pre-tax payment of premiums to reduce the net cost of health insurance, thereby making it more affordable. Because of the avoided taxes, using a Section 125 plan can reduce the effective cost of health insurance in Massachusetts by 28% to 48%, depending on the subscriber's tax bracket. Based on the average tax bracket for Massachusetts filers, savings average 41%.¹

¹ Assuming 28% marginal federal income tax rate (the average marginal rate in the Commonwealth), 5.3% Massachusetts state income tax and 7.65% FICA tax. In addition, employers can save their share of the FICA tax (7.65%).

Example of Savings Available through a Section 125 Plan			
	Without Section 125 Plan	With Section 125 Plan	
Adjusted Gross Income	\$50,000	\$50,000	
Annual Pre-Tax Health	\$0	\$2,100	
Insurance Contribution			
Taxable Income	\$50,000	\$47,900	
Estimated Taxes	\$12,676	\$11,880	
Annual After-Tax Health	\$2,100	\$0	
Insurance Contribution			
Net Take Home Pay	\$35,224	\$36,020	
Savings from Use of	N/A	\$796	
Section 125			

Section 125 Requirement Details

Employers with 11 or more full-time employees are required to develop and administer a Section 125 plan, which legally documents the details of the pre-tax insurance purchasing arrangement for which employees are eligible. Companies without Section 125 plans whose workers access medical care through the state's free care pool may be assessed a penalty between 10% and 55% of the cost of these medical services that exceed \$50,000.

The Section 125 plan must satisfy federal regulations as well as the regulations set forth by the Connector. Some highlights of the Connector requirements include:

- Plan must be at least a "premium only plan" that allows employees to pay for or contribute to their health care coverage using pre-tax income. Offering only a flexible spending account (FSA) -- another option under section 125 -- does not satisfy the Connector's requirements;
- 2. Plan must offer eligible employees access to one or more health care coverage options;
- 3. Employers are not obligated to contribute to the cost of the premium;
- 4. Employers may exclude certain classes of employees from the Plan, but must offer the plan to most employees that work, on a regular basis, 64 hours or more each month; and
- 5. Employers may offer Commonwealth Choice health coverage options, but are free to offer coverage directly from an insurance carrier or third-party vendor.

Section 125 Plan -- Employer Alternatives

Throughout early 2007 the Connector was in the process of developing its Commonwealth Choice plans, which offer comprehensive benefits at different premium levels and cost sharing. The Connector issued its seal of approval and signed contracts with six health insurers for Commonwealth Choice plans in March 2007. These plans were to be available for purchase by both small businesses and individuals (regardless of whether a Section 125 plan is used or not).

As a way to make complying with the Section 125 requirement as administratively simple as possible, the Connector set up the "Commonwealth Choice Voluntary Plan" for employers' non-benefits-eligible employees. The Commonwealth Choice Voluntary Plan allows non-benefits-eligible employees to select a carrier and a health benefit plan that works best for them without burdening the employer with the administrative challenge of dealing with multiple health insurers. Therefore, the major benefit of offering Commonwealth Choice plans is that the employee may chose from a variety of carriers at different benefit levels, but the employer only needs to submit payments to one entity (the Connector). These plans became available in the late spring with effective dates starting July 1, 2007. Nearly 3,000 employers rushed to establish Section 125 plans through the Commonwealth Connector by July 1, 2007, but in accordance with state regulations, only began to enroll employees as of September or October 2007.

However, employers are not required to offer Commonwealth Choice plans via the Connector and are free to contract directly with an insurer, a third-party vendor, or can administer the Section 125 plan requirement on their own. Private insurance carriers began reacting to the Section 125 requirement during 2007 by developing their own Section 125 products and services. The two largest Massachusetts-based carriers began offering Section 125 plan services as a way of helping their employer accounts comply with the new Section 125 requirements. One carrier offering a suite of non-contributory options also offered free Section 125 plan document set-up and management of payroll deductions for employers who chose to offer non-group health plans to their non-benefits eligible employees. This carrier handles any premium shortfalls directly with the employee, alleviating the employer from the responsibility of tracking down any shortfall in employee premiums.

A second carrier also began offering free Section 125 plan document development to small employers whose full-time employees purchase insurance from this carrier. This insurer also offers a product for part-time employees that is managed by an outside benefits administrator. The carrier will cover the cost of the implementation fee for employers who sole-source with it for their benefitseligible employees. This product is a "Premium Reimbursement Account" (PRA), which allows part-timers at the participating company to go into the non-group market themselves, purchase coverage of their choice (not limited to this particular carrier's plans), and then submit the premium receipts for reimbursement. Employee take-up in both of these carriers' voluntary plans has been almost non-existent, and the number of employers taking advantage of these services has been extremely low, according to representatives of these carriers.

Starting in 2007, employers were also required to file Health Insurance Responsibility Disclosure (HIRD) forms with the state. These forms document that the employer has offered ESI and/or a Section 125 plan to employees.

Throughout the spring and summer of 2007, the Connector held meetings around the state, sent out mailings to employers, and attempted to educate brokers, benefits consultants, employers and others about Section 125 plans and Commonwealth Choice plans. Furthermore, brokers, benefits consultants, law firms, employee benefits organizations and business groups also organized and facilitated Section 125 trainings and forums throughout the year.

Baseline Analysis: Health Insurance Coverage in Massachusetts

Massachusetts was well-positioned in its effort to achieve near-universal health coverage due to its already-low levels of uninsured residents. It is estimated that prior to health reform, between approximately 400,000 and 650,000 Massachusetts residents lacked health coverage, roughly six to 11 percent of the state's population. In addition, while the number of people who did not already have health insurance was low compared to the national average,² the number of individuals without access to group insurance via a contributing employer or otherwise eligible for a publicly-funded health insurance program -- the target population for the Section 125 requirement -- was also relatively small.

Non-Medicare Coverage Among Insured Residents of Massachusetts (6/30/2007) ³				
Private Group	4,297,000	84%		
Private Non-Group	51,000	1%		
MassHealth ^₄	732,000	14%		
Commonwealth Care ⁵	80,000	2%		
Total	5,160,000	100%		

² The 2006 Current Population Survey from the US Census Bureau estimated 15.8% of US population were uninsured.

³ Estimates provided by the Massachusetts Division of Health Care Finance and Policy, 2007 ⁴ Massachusetts' Medicaid program.

⁵ Newly created state-subsidized insurance program for people at or under 300% of the Federal Poverty Level.

Approximately one percent of insured Massachusetts residents purchased their own private non-group coverage directly from health insurers prior to the start of the state's Section 125 requirement effective date (July 1, 2007). Therefore, it would appear that a relatively small number of already-insured individuals could potentially benefit by purchasing their insurance with pre-tax dollars. While the use of a Section 125 plan would benefit the small number of individuals in Massachusetts who purchase non-group coverage, there are also tens of thousands of uninsured individuals who work but are not offered ESI and need to purchase insurance to satisfy the individual mandate.

Take-Up

As of April 1, 2008, over 2,800 companies had established Section 125 employer accounts with the Connector to enable their non-benefits-eligible employees to purchase Commonwealth Choice plans on a pre-tax basis. As of April 2008, approximately 920 employees had purchased a Commonwealth Choice plan using their employer's Section 125 plan.

As noted previously, anecdotal information from the two largest carriers in the state indicates that commercial insurance carriers have experienced negligible take-up in their non-group plans via Section 125 plans, making it appear that the bulk of the relatively low take-up of non-group coverage via Section 125 plans has been with the Connector's Commonwealth Choice plans.

Given that roughly 51,000 individuals in the state were purchasing their own nongroup insurance with post-tax income before Health Reform became law, and non-group coverage has grown by 50% since the merger of the small group and non-group markets in July 2007, we might have expected greater use of Section 125 plans, especially since the vast majority of these non-group purchasers are quite likely employed.⁶ By looking to employer reaction and experience, however, we can assess what may be impeding the use of Section 125 plans, as well as the obstacles that impact the use of a Section 125 plan for individuals who remain uninsured.

Changing Administrative Responsibilities for Employers

Many large employers were already offering Section 125 plans to their benefitseligible employees, but the introduction of the Section 125 requirement called on employers to offer Section 125 plans to an expanded class of employees: part-

⁶ We surmise this based on the fact that the full cost of unsubsidized insurance requires an individual to have a steady stream of income sufficient to pay the monthly premiums.

timers and other non-benefits-eligible employees. To satisfy the new requirement, employers had to navigate a variety of administrative decisions and responsibilities. The major administrative decisions facing employers included:

- 1) Where to get information about compliance;
- 2) How to create or amend a Section 125 plan document to include parttimers and other non-benefits-eligible employees;
- How to decide on criteria relating to which part-timers to include under a Section 125 plan;
- 4) How to create a payroll deduction mechanism;
- 5) How to keep track of hours for part-timers and make sure paychecks cover their monthly premiums;
- 6) How to choose coverage options;
- 7) How to implement coverage election and open-enrollment procedures;
- How to manage and explain the lag times between the date an employee signs-up, begins to have premiums deducted from his/her paycheck and the date that coverage takes effect;
- 9) How to inform employees about insurance options through a Section 125 plan and how to encourage sign-up; and
- 10) How to effectively administer the insurance options.

Survey Instrument

In order to better understand employers' responses to the Section 125 requirement, the Connector surveyed employers on their Section 125 experience. To capture a wide spectrum of experiences, we partnered with four separate organizations to help administer the survey to their unique samples of Massachusetts employers:

- 1. Employers who have designated the Connector in their Section 125 plans. The survey was designed to be completed by employers or brokers -- whoever took the lead on decision-making around Section 125 compliance.
- 2. Associated Industries of Massachusetts (AIM) The state's largest association of employers with roughly 7,600 members.
- 3. New England Employee Benefits Council (NEEBC) State association of benefits professionals with approximately 1,400 members.
- 4. Retailers Association of Massachusetts (RAM) State association of employers in the retail industry with over 3,000 members.

The Connector's Commonwealth Choice Voluntary Plan (VP) employers' survey, which was administered in February and March of 2008, was by far our largest, with over 725 respondents out of more than 2,800 firms who were sent the survey, a response rate of 26%. Therefore our analysis in the next section of this

report is devoted to the VP employers' survey. Please see the Appendix for additional details and survey raw response tables for the VP employers' survey, as well as an analysis of the AIM, NEEBC, and RAM survey responses.

Voluntary Plan Survey Findings

The majority of employers describe their experience with the Section 125 requirement as being reasonably easy to manage and generally positive. Most employers used outside help to establish and set up their Section 125 plans, and typically described the set-up experience as relatively easy. A majority (55%) used a broker or consultant. Most (73%) described the experience of setting up a Section 125 plan as "easy" or "somewhat easy," whereas the rest described it as either "difficult" or "somewhat difficult." Most respondents (80%) describe their current day-to-day administration of their Section 125 plans as "positive" or "somewhat positive," while the rest described their experience as "somewhat negative" or "negative." However, the fact that a majority of respondents do not have any employees enrolled in coverage and therefore have minimal, if any, ongoing responsibilities may help explain the high percentage of ongoing administrative experiences being described as "positive."

Administrative simplicity was a key reason why employers, brokers and benefits consultants selected the Connector's Commonwealth Choice plans but many appear not to be meeting a key administrative requirement. Roughly half of respondents learned about the Commonwealth Choice plans via brokers and benefits consultants, indicating the significant role played by these advisors on behalf of Massachusetts employers. Respondents varied in their reasons for choosing to offer Connector plans as opposed to other insurance options, but the primary reason cited for choosing Commonwealth Choice was "administrative simplicity" (36%), "broad choice of plans" (32%), and "low cost/good value" (24%).

However, administering the Voluntary Plan requires employers to submit an initial census of eligible employees and provide updates to the census throughout the plan year (e.g., new hires, change in status). While eight percent (8%) of respondents did not submit an initial census, over 70% of those that did submit a census have, to date, not provided any updates to the census. While some of these employers may not have experienced any changes in employment since submitting their initial census, it's unlikely that a majority have had a completely stable workforce. These findings suggest that there may be a lack of understanding of this key administrative requirement or a lack of attention by the employer. In any event, this issue may be impacting the Section 125 plans' take-up rates.

The majority of employers made an effort to educate their eligible employees about new Section 125 plan offerings, although different forms of communication yielded disparate take-up rates. A relatively small number of employers held face-to-face meetings with eligible employees (20%). Most employers communicated to their eligible employees about the new Section 125 plans via e-mail or letter (73%), and a very small number (5%) made no formal effort to inform employees. Other employers used alternative communication methods: posting information on the employer's website for employees, benefits fairs, handing out flyers, and including information with employees' paychecks. The most common reason highlighted by employers to encourage sign-up was the new state mandate (70%). A majority (52%) also indicated that they emphasized potential savings to the employee, while 18% indicated that they did not highlight any features or reasons for employees to enroll.

Take-up by employees appears to be influenced by the level of employer engagement and outreach to employees. The rate of take-up was roughly twice as high among employers who arranged face-to-face meetings to inform employees of Section 125 plan offerings than among employers who used letters or e-mails (1.66 employees per employer versus .85 employees per employer, respectively). In addition, anecdotal information gleaned from conversations with employers suggest that firms that made a concerted effort to inform their nonbenefits eligible employees of the value of a Section 125 plan experienced greater take-up than those firms that simply put a Section 125 plan in place and did little to educate their employees.

Employers want more materials from the Connector to help them understand the new options and to help them educate their employees. Roughly half already use the Voluntary Plan employee communication materials available on the Connector website, but 72% say that they would use Connectorgenerated template letters to employees and 73% indicated that they would use Commonwealth Choice Voluntary Plan brochures in outreach efforts to employees.

Employers report that low take-up rates among their Section 125 eligible employees were due to the fact that most employees already have health insurance elsewhere. Respondents speculated that the primary reasons for low take-up are: employees' coverage elsewhere (78%), cost (30%), and lack of understanding about the new mandate (21%).

In general, smaller employers tended to spend more time educating their employees about the Section 125 plan and were more satisfied with ongoing administrative experience. Employers with fewer than 25 employees were more likely than larger employers to hold a meeting and to conduct face-toface outreach with eligible employees to educate them about Section 125 plans. Smaller employers were also more likely than larger employers to call the Connector for help, although these employers were less likely than larger employers to access the Connector website for information.

Very large employers conducted less face-to-face outreach and were slightly less satisfied with overall Section 125 experience. An overwhelming number (90%) of very large employers (500+ FTEs) informed eligible employees about Section 125 plans using letters and e-mails. Only six percent (6%) held meetings with employees. Large employers (100-500 FTEs) used letters and e-mails 81% of the time. Sixteen percent (16%) of the large employers held meetings. Thirty percent (30%) of very large employers say day-to-day administration is negative or somewhat negative– as compared to 20% that share this opinion among smaller employers.

Case Studies: Employers and Section 125 Compliance Experience

We conducted six case studies in which employers of varying sizes and industries were profiled. Human resource directors and company owners shared their reflections on their company's experience complying with the Section 125 requirement, including how they educated themselves about their responsibilities, how they managed the compliance process, how they outreached to employees, and the nature of the ongoing administration of their Section 125 plans. While individual companies' experiences and reflections varied, a number of common themes emerged.

The interviews revealed that the early adoption period of Section 125 plans was the most labor-intensive component of complying with the new requirement and that there was some initial difficulty in finding adequate information about how to comply with the law, set up a plan, and figure out how to effectively outreach to employees. Developing a methodology around payroll deductions and how to deal with potential problems (e.g., premium shortages, lag time between payroll deduction and effective date of coverage) presented challenges for some employers, as well. Once these initial operational challenges were addressed, however, most employers found that the process became largely self-automated and came to impose fewer demands on HR professionals. Employers indicated that they might have benefited from more materials and support from the Connector in the form of regular communications and plain-spoken information about Section 125 plans, including "roadmaps," checklists, Q & A, and assigned account managers.

Please see the Case Study Appendix for individual employer profiles. All profiled companies and company representatives have been made anonymous to encourage candid feedback.

	Size	Industry
Employer A	Very small	Multi-media
Employer B	Small	Museum
Employer C	Medium	Television station
Employer D	Medium	State agency
Employer E	Large	Retail
Employer F	Very large	Retail

Recommendations

Based on feedback from employers via the surveys and case studies, we offer the following recommendations for states considering Section 125 requirements:

Initial Implementation Period

- Target employers and/or industries that tend not to offer ESI.
- Target individuals purchasing coverage in the non-group market who do not pay their premiums on a pre-tax basis.
- Provide employers with information about ways in which they may contribute to non-benefits-eligible employees' health insurance premiums (e.g., health reimbursement accounts or other ways for an employer to make a defined contribution).
- Ensure that there is an easily accessible "go-to" place for employers to get information and answers to Section 125-related questions.
- Stress the importance of and find ways to influence employers to take a proactive position towards employee outreach; provide suggestions and "best practices" on effective communications strategies and in-person assistance, if needed.
- Reduce use of technical jargon in communications regarding Section 125 plans both for employers and employees. Recognize that this is not business-as-usual for most employers, and is certainly new to employees, who may struggle to understand the benefits of a Section 125 plan.
- Develop an "Employer Roadmap" that visually delineates the steps an employer needs to take in order to achieve compliance with the Section 125 requirement, as well as ongoing administration.
- Supplement materials provided to employers with easy-to-understand template letters that can be sent to employees about Section 125 plans and how to obtain coverage.
- Maintain open lines of communication with brokers and consultants, given their significant involvement in employers' compliance strategies.
- Develop an information packet that can be sent directly from the Connector or the relevant administrator to Section 125-eligible employees and obtain mailing/e-mail distribution information from employers.

Ongoing Administration

- Establish regular communications with employers via e-mail or a newsletter to provide information on regulatory or administrative changes -- including reminders about properly administering a Section 125 plan -so that employers do not need to monitor a website or otherwise find information third-hand about changes to plan offerings or other notable updates.
- Provide a Q & A for employers with information on how to respond to various issues from employees and/or the Connector that may arise during on-going administration of a Section 125 plan.
- Consider establishing direct communication with employees to enhance communication and educational responsibilities commonly borne by the employer.

Key Lessons Learned

- Low level of uninsured in Massachusetts -- which is due to high rate of ESI and relatively generous public insurance programs -- is likely a major reason for relatively low take-up rate, to date, of Section 125 plans by purchasers of individual coverage;
- Affordability remains a significant barrier for employees to purchase health insurance, even when they have access to a Section 125 plan;
- Part-time worker population can be difficult for employers to outreach to, as a result of staggered and irregular work schedules, language barriers, and difficulty in understanding complicated information about benefits, taxes and insurance;
- Employers' active engagement, armed with the right information that's easily understood, can positively influence employees' take-up rates; and
- Consistent and correct information is crucial to employers' satisfaction.

Our findings indicate a wide range of employer responses to the new Section 125 plan requirement, ranging from the many who took only the minimal steps to comply with the law to those who committed considerable time and effort to engage in extensive employee outreach, making sure employees understood their options, and encouraging sign-up among their otherwise uninsured non-benefits-eligible employees. Among employers who put in greater effort and engaged in "hand-to-hand combat," greater take-up among employees was found. Some level of confusion among employers regarding details about Section 125 plans and insurance in general was pervasive. The perceived technical complexity of how a Section 125 plan works and how to explain the benefit to employees in layman's terms was likely exacerbated by information gaps and by confusing insurance and legal jargon. In instances in which the lines of accurate

communication broke down, employer frustration and confusion was likely to occur, leading to low levels of investment in educating employees and facilitating enrollment. Conversely, for employers who felt well-informed and supported in their handling of Section 125 plan set-up, administration, and employeeoutreach, the requirement has been relatively easy and take-up rates have been better.

Section 125 plans are a powerful tool in helping to reduce the cost of health insurance for otherwise uninsured members of the work force and for currently insured workers purchasing insurance without the benefit of a Section 125 plan. For Massachusetts and for other states considering a similar requirement, it is important to recognize how crucial it is to ensure that the employer community is supported, well-informed, and aware of how the magnitude of its outreach efforts will shape the true accessibility of Section 125 plans and the purchase of health insurance by employees.