

Can Our Company Require Employees Who Elect Health Coverage to Pay Their Share of the Premiums With Pre-Tax Salary Reductions?

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QUESTION: Our company wants to establish a premium-only cafeteria plan to allow employees who elect coverage under our company's health plan to pay their share of the premiums with pre-tax salary reductions. I know that some employers offer their employees the option of paying for health coverage on an after-tax basis, but we would rather not do that. Can we require employees who elect health coverage to pay their share of the premiums with pre-tax salary reductions?

ANSWER: Yes. Your company can establish an arrangement under which employees can receive health coverage only if they pay for it with pre-tax salary reductions. You don't mention why your company prefers this design, but one possible reason is to streamline plan administration. (Payroll and computer-programming practices are simplified when all payroll deductions are taken on the same pre-tax basis.) Some employers may also choose this approach to maximize employer FICA savings. The IRS has confirmed that the approach you describe is permissible. Specifically, the 2007 proposed cafeteria plan regulations (which can be relied on, even though they have not yet been finalized) provide that a cafeteria plan "is permitted to require employees to elect to pay the employees' share of any qualified benefit through salary reduction and not with after-tax employee contributions."

Although it is legally permissible to require employees who want health coverage to pay their share of the premiums on a pre-tax basis, this design may create hardships for your employees who want benefits but are concerned about the impact of pre-tax salary reductions. For example, participating in the cafeteria plan could restrict their ability to make midyear election changes, decrease their Social Security benefits, and adversely affect benefits under programs that do not treat salary reductions as compensation for benefit calculation purposes. If your company decides to offer an after-tax option after all, employees could make an election under the cafeteria plan to receive their full salaries in cash. Then, outside of the cafeteria plan, they could enroll in the health plan and pay their share of the premiums on an after-tax basis.

For more information, see EBIA's Cafeteria Plans manual at Sections III.D ("Advantages and Disadvantages of Cafeteria Plans for Employees"), XIII.C ("Can Participants Be Required to Elect Benefits on a Pre-Tax Basis? (The Need for Choice)"), and XVI.L ("Forced Participation in a Cafeteria Plan").

Contributing Editors: EBIA Staff.