Statement of Arthur S. Hoffman, Chairman of the Federal Taxation Executive Committee, Hearing on H.R. 1864, A Bill to Simplify the Nondiscrimination Rules Applicable to Employee Benefit Plans Under Section 89 of the Internal Revenue Code

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STATEMENT OF ARTHUR S. HOFFMAN

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FEDERAL TAXATION EXECUTIVE COMMITTEE

OF THE

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

BEFORE THE WAYS AND MEANS COMMITTEE

OF THE

UNITED STATES HOUSE OF REPRESENTATIVES

HEARING ON

H.R. 1864
A BILL TO SIMPLIFY THE NONDISCRIMINATION RULES
APPLICABLE TO EMPLOYEE BENEFIT PLANS UNDER SECTION 89
OF THE INTERNAL REVENUE CODE

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INTRODUCTION

The American Institute of Certified Public Accountants greatly appreciates this opportunity to offer comments and recommendations prepared by our Federal Tax Division on H.R. 1864, a bill to simplify the nondiscrimination rules applicable to employee benefit plans under section 89 of the Internal Revenue Code.

The AICPA is the national, professional organization of CPAs, with over 280,000 members. Many of our members are tax practitioners who work with millions of American taxpayers, both individuals and businesses. We are deeply concerned with the effect of section 89 upon businesses of all sizes, in all sectors of the economy.

The AICPA applauds the Chairman on a bill that significantly limits compliance costs by focusing on plan availability rather than plan coverage. Given that the cost of compliance was the AICPA's most significant concern with existing IRC section 89, we generally support the proposed legislation with only a few changes, such as the treatment of salary reduction or cafeteria plans and the appropriate indexing of employee contributions for a qualified core health plan. While we will make a number of suggestions for changing the proposed legislation, we want to make it clear that we generally support the approach presented.

We have received hundreds of calls from CPAs requesting assistance in implementing section 89 for their clients. Many of our members report that their clients, both small and large, are finding the statute too complicated to interpret and far too expensive to administer. We believe that the end result of these tests will be relatively minor changes to an individual's Form W-2. This is an instance where the cost of compliance far outweighs any benefit derived from the resulting information, even for the Treasury Department.

In November, we mailed to our 22,000 Tax Division members a copy of our 15-page practice guide which focused on the small business entity which has only one employee plan; thus, it did not encompass most of the complexities of section 89 which are proving to be literally unworkable. Even in the relatively simple situation described in our practice guide, there were many questions which remained unanswered.

Many taxpayers are unable or unwilling to understand the rules. They are seriously considering whether to eliminate some or all of their employee health coverage. Others plan to eliminate the tax preferred health coverage for highly compensated employees (HCE). These are both extreme reactions to tax legislation which requires far too much data collection and manipulation. While the reactions may not be appropriate, they are occurring nonetheless.

The complexity of these rules has resulted in widespread misunderstanding of the provisions and will lead to growing enforcement problems for the Internal Revenue Service. Section 89 is a notable example of the inevitable linkage of complexity and noncompliance.

Large employers incur tremendous costs in complying with section 89. One employer, a Fortune 100 company with 45,000 employees in 2,000 locations, must test approximately 300 "plans" under section 89. As a result of the test, some 1,500 highly compensated employees will recognize additional income of approximately $650,000. To calculate the additional income to be recognized, the employer has incurred additional consulting fees of $260,000 through December 31, 1988. This does not include the additional costs incurred within the corporation in compiling the data. Annual expected cost to this employer for testing and documentation is $250,000. No new or increased health benefits were provided to employees since the cost of the increased benefits far exceeds the tax burden to the highly compensated with respect to this additional section 89 gross income.

Comments on general approach of H.R. 1864

Although we are suggesting a number of changes for the proposed legislation, we want to make it clear that we generally support the approach presented. The testing of discrimination with an availability test is far superior to using a coverage test. We agree with H.R. 1864's change in definition of part-time employees from those working at least 17 1/2 hours to those working 25 hours; however, the proportional allowable increase in employee contributions should be based on a 40-hour week not a 35-hour week. We generally agree with H.R. 1864's reversion (with minor modification) to pre-1986 Tax Reform Act law for the group term life insurance discrimination tests. We also agree with the delay in testing former employees but would suggest a permanent exclusion of these employees from the rules. We agree with the elimination of the rule that requires every employer to have at least one highly compensated employee. This is especially helpful for small tax exempt and governmental employers.

<u>The treatment of salary reduction amounts under the proposed legislation discourages the adoption of cafeteria plans</u>

Amounts funded through salary reduction arrangements are treated as employee contributions for purposes of the eligibility test. Thus, salary reduction amounts may not exceed the $10/$25 limitation on employee contributions for the plan to be a qualified core health plan. This treatment of salary reduction amounts recognizes that salary reduction represents a cost to the employee. Accordingly, the required employee contribution funded through salary reduction is viewed in the same manner as a required employee contribution not funded through salary reduction in determining whether a plan is affordable to nonhighly compensated employees.

For purposes of the benefits test, salary reduction is treated as an employee contribution rather than as an employer provided benefit included in the base amount for applying the 133 percent factor. Consequently, salary reduction made available to or utilized by nonhighly compensated employees (NHCE) does not increase the level of coverage that can be received by the highly compensated employees under the benefits test.

For purposes of determining the taxable benefit of a highly compensated employee, salary reduction amounts are considered employer provided benefits. Thus, to the extent that these amounts, when added to other employer-paid coverage, exceed the 133 percent limitation imposed by the benefits test, the salary reduction is included in the taxable income of the highly compensated employee thereby nullifying his salary reduction.

For example, assume an employer offers a salary reduction plan with three benefits available through salary reduction: core plan II, valued at $2,000, medical reimbursement and a dental plan. All employees are provided, on a nonsalary reduction basis, with core plan I which is valued at $1,000.

	Core Plan I	Core Plan II	Medical Reimbursement	Dental Plan
Annual Plan Value	$1,000	$2,000	$500	$400
Single Employee Annual Salary Reduction Cost	0	900	500	400
Employer Provided Benefit	$1,000	$1,100	$ 0	$ 0
Percent of NHCE's Eligible	90	90	90	90
HCE Taxable Benefit	0	670	500	400

If a highly compensated employee reduces his salary for $900 in order to participate in core plan II, he will realize a taxable benefit of $670 ($2,000 - (1.33 X $1,000)). If a highly compensated employee reduces his salary for core plan II, the medical reimbursement and the dental plan, his taxable benefit would be $1,570 ($2,900 - (1.33 X $1,000)). A highly compensated employee electing only medical reimbursement would have a taxable benefit of $170 ($1,000 + 500 - $ 1,330). It should be noted that in this example, highly compensated employees get no benefit from the salary reduction amount beyond the additional 33 percent of the core health coverage provided. This is the result even though all health plans are equally available and the employer has made an affordable core health plan (core plan I) available to more than 90 percent of nonhighly compensated employees.

We believe that this treatment of salary reduction will discourage the use of cafeteria plans in providing health benefits by eliminating the tax favored status of such contributions with respect to highly compensated employees. The AICPA believes that cafeteria plans which offer employees a choice in designing their benefit package are desirable and that the tax law should not discourage the provision of such programs. Any discrimination tests in this legislation should not favor nonsalary reduction health plan contributions any more or less than salary reduction health plan contributions.

<u>Suggestions for changing the testing with respect to salary reduction amounts</u>

Within the basic framework of H.R. 1864, there are a number of alternatives for testing salary reduction amounts. The legislation could allow for inclusion of salary reduction amounts in the employer provided benefits for purposes of calculating the 133 percent limitation if employees can only receive cash if they have core medical coverage elsewhere, such as through another employer or the employer of the employee's spouse or parents. The treatment of salary reduction amounts should be consistent in calculating the $10/$25 limitation and the 133 percent limit.

Alternatively, the legislation could allow the average salary reduction for all nonhighly compensated employees to be considered an employer provided benefit for purposes of calculating the 133 percent limitation.

More simply, the legislation could increase the 133 percent factor to perhaps 200 percent. With this much allowable disparity, cafeteria plans would not find the tests as onerous.

Another alternative would be to revert to the salary reduction rules of TAMRA (The Technical and Miscellaneous Revenue Act of 1988) as a means of monitoring the abuses with cafeteria plans.

We believe the best alternative is to exclude health benefits provided under cafeteria plans from these discrimination tests. If additional discrimination tests are needed in IRC section 125, a benefits test for all nontaxable benefits elected under the plan might be appropriate.

We believe, as is reflected in H.R. 1864, that salary reduction amounts are inherently different from traditional employer provided health benefits and thus should be subject to different discrimination tests. We also believe that the tests should include all benefits available within the cafeteria plan so that employees are not penalized by the choice of a specific benefit.

The 90 percent eligibility test should be modified

We believe that the 90 percent eligibility test, which represents a good approach, also results in inequities for employers who are slightly below the 90 percent cutoff. We suggest that this could be alleviated in any of several ways:

- lower the percentage;
- include a graduated penalty schedule;
- eliminate leased employees from this calculation; or
- provide a grace period for employers who substantially meet the eligibility rules.

A lower required eligibility percentage would increase the number of employers with qualified core health plans. It is unclear why health plans are subject to more restrictive rules than the 70 percent rule of pension plans.

A phase-in of the penalty for failing the eligibility test, such that a smaller taxable benefit accrues to employees of an employer who covers more than 70 percent of nonhighly compensated employees than one who covers less than 70 percent of nonhighly compensated employees, would be more equitable. While this would involve additional complexity in the legislation, we believe such complexity may be warranted so that highly compensated employees are not unduly burdened where a plan does not satisfy the 90 percent test by a small margin.

Elimination of leased employees from the testing would also help employers satisfy the 90 percent eligibility test. While we are aware that such employees can be disregarded where the lessor makes qualified core health coverage available, we are doubtful that a lessor's coverage can easily be considered by the lessee in its testing.

A grace period could be provided for employers who fall below the required 90 percent eligibility standard by a certain margin. It is possible for an employer who has met the 90 percent test in prior years to fall slightly below that level due to such things as mergers or unexpected rapid growth in employment. These employers could avoid all penalties for the first year such eligibility test was not met, giving them time to comply. For 1989, the grace period could apply to all employers.

Alternatives to $10/$25 limits would be a better measure of affordability

The $10 and $25 limits are not properly adjusted for cost of living increases. In the very near future more and more employers will fail to satisfy the $10/$25 affordability standard because medical costs are increasing at a much greater rate than wages. Many small employers with higher health insurance costs because of their relatively small groups already find these rates inadequate. As the cost of health premiums increase, employers will be forced to pay a higher percentage of the cost, offer a plan which no longer qualifies as a qualified core health plan or lower the value of the qualified core health plan offered.

While we understand that an affordability test should be related more to wages than to medical costs, we believe that the law must recognize that employers also have limited resources to put into health plans. If employees cannot share future increases in medical premiums, it is quite likely that coverage will be reduced or plans discontinued. A limit on increasing the employee cost for a qualified health plan will decrease the incentive for providing health coverage in the near future.

We believe that using a percentage of total premium costs to determine an affordable plan, perhaps not to exceed a certain percentage of an individual's wages, would add needed flexibility to the affordable plan defined in the proposed statute and put the small employer more at parity with the large employer. Tying the allowable employee cost to a percentage of the employer's total premium cost would ensure that it would keep pace with medical inflation and with that particular employer's cost for group coverage. Adding the percentage of compensation cap would ensure that non-highly compensated employees do not pay too great a portion of their wages for health benefits.

For example, assume the maximum employee contribution is the lesser of 40 percent of premium or 5 percent of wages. Assume wages increase 2 percent per year and medical premiums increase 25 percent per year.

	Year 1	Year 5
Premium	$1,000	$3,050
40 percent of premium	400	1,220

Employee A		
Wages	$10,000	$11,040
5 percent of wages	500	552
Maximum contribution	400	552
Employee B		
Wages	$30,000	$33,122
5% of wages	1,500	1,656
Maximum contribution	400	1,220

As this indicates, the very low paid employee is protected by the 5 percent wage cap, while the $30,000 employee would continue to contribute the 40 percent of premium. The additional premium for the $10,000 employee would be absorbed by the employer. However, with other employees sharing the increased costs, this arrangement will encourage employers to maintain reasonable health plans.

Defining the affordable plan as a percentage of the health premium will not penalize the employer who wants to offer a very generous plan with a required employee contribution of more than the $10 or $25. One of the inappropriate results of the proposed legislation is that the highly compensated employees have a taxable benefit for all health coverage which is not available through an "affordable" plan. This results even if the employer makes available an affordable plan and a more expensive plan on an equal basis.

For example, assume an employer offers to all employees on a nonsalary reduction basis, two core health plans, (core plans I and II), a dental plan and a vision plan with the following annual required employee contributions.

	Core Plan I	Core Plan II	Dental Plan	Vision Plan
Annual Plan Value	$ 950	$2,000	$350	$400
Single Employee After Tax Annual Cost	450	900	150	300
Employer Provided Benefit	$ 500	$1,100	$200	$100

An employee can participate in one of the core plans and the dental and vision plans. If a highly compensated employee participates in core plan I, the dental plan and the vision plan, a total employer provided benefit of $800 ($500 + $200 + 100) will be received, of which $135 ($800 - (1.33 X 500)) would be taxable. This is because the dental and vision plans cannot be aggregated with either core plan I or II and still have such plans treated as qualified core health plans. If participating in core plan I, the highly compensated employee can receive a tax-preferred benefit of $665 (1.33 x 500). If participating in core plan II only, which is not a qualified core health plan, the taxable benefit for a highly compensated employee is $435 ($1,100 - $665). Participation in either the dental or vision plan by a highly compensated employee who participates in core plan II, cannot be on a tax-favored basis, even though the benefits are available to all employees on a similar basis. Accordingly, a highly compensated employee participating in core plan II, the dental plan and the vision plan would have a total employer provided benefit of $1,400 ($1,100 + $200 + $100) of which $735 ($1,400 - $665) would be taxable.

<u>The excludable employees should not be affected by plan coverage</u>

In determining whether 90 percent of employees are eligible for coverage, it is important that the employer accurately count his total employee population. Certain categories of employees can be excludable, but only if no employee in that category is included in the health plan. This complicates the testing process and penalizes employers for allowing certain employees to participate. For example, assume an employer offered health benefits to employees working 10 hours or more in prior years. When this employer changed health benefit eligibility to employees working more than 25 hours per week, the continuing employees working fewer than 25 hours and more than 10 hours were allowed to remain in the plan. These employers are now penalized by being required, in calculating the 90 percent test, to include in the employee group all employees working more than 10 hours per week.

Another situation with inappropriate results occurs when the employer provides immediate coverage for all employees or for some part-time employees, perhaps because they are classified as permanent. For example, an employer may offer health coverage to all employees at the beginning of employment. The employee is classified as part-time or full-time based on actual hours worked during the first three months of employment. If the employee is a part-time employee, coverage is eliminated. This employer is penalized because all employees are included in the employee population. The exclusion for part-time employees is not available since part-time employees are provided benefits for three months. Here, an employer who offers more health benefit coverage than required is being penalized by expansion of the group of employees tested.

Under existing rules, IRC section 89(h)(5) allows the employer to separately test employees receiving benefits who otherwise were excludable employees. This has been eliminated in the proposed legislation. If the excludable employees can be tested separately, the plans would be nondiscriminatory. This separate testing rule mitigates the harsh effect of requiring such employees to be included in the employee group.

The AICPA favors elimination of the rules which require adjustment of the excludable group based on plan coverage. At a minimum, inclusion of the separate testing rule in the legislation is needed.

Good faith compliance with separate line of business rules

The bill allows these rules to be applied on a separate line of business or operating unit basis. We recommend that the legislation make it clear that a good faith attempt to comply with such rules is sufficient until after the publication of final regulations. Final regulations should only be effective after issuance.

Existing law modifications should conform

Under the bill, employers who use existing section 89 for 1989 testing may not use any of the bill's improvements, such as the 25-hour rule for determining part-time employees. This is an especially harsh result for those employers. If an employer uses the new rules, he has the advantage of being able to use the more liberal part-time employee rules. However, the employer who uses the old rules is at a disadvantage. These employers should be given the same advantage as the employer who uses the new rules.

Valuation rules need clarification

The bill provides that the value of coverage provided by any health plan should be determined under procedures prescribed by the Secretary. TAMRA provides special transitional rules for testing years beginning before the later of January 1, 1991 or the date one year after the Secretary of the Treasury first issues such valuation rules as are necessary to apply the provisions of section 89. The bill should include the special transitional relief available in TAMRA.

Discriminatory terms test adversely affects accidental death and dismemberment

Accidental death and dismemberment insurance plans and business travel accident insurance plans will most likely fail the discriminatory terms test. The benefits payable under such plans are generally based on an employee's compensation. These plans should be excluded from testing under section 89. The value of such plans is de minimis in relation to the effort to properly include such amounts on an employee's W-2. Alternatively, the legislation could provide that such plans are not in violation of the discriminatory terms test if benefits vary as a uniform percentage of compensation.

Dependent care assistance discrimination test is too harsh

Existing law allows dependent care assistance to pass a 55 percent benefits test or be included in the section 89 test with health benefits. The proposed legislation would eliminate the ability to test dependent care assistance with health benefits. The separate line of business rules also do not apply to these tests. We recommend that the dependent care assistance rules be reviewed. Inclusion of a separate benefits test for all nontaxable benefits in a cafeteria plan may satisfy this concern because most dependent care assistance, other than employer owned facilities, is offered on a salary reduction basis.

The exclusive benefit rule should allow nonemployees in an employer's plan

We believe that section 89(k)(1)(D) should be amended to allow a de minimis number of individuals with no service nexus with the employer to participate in a plan without violating the exclusive benefit rule.

According to the legislative history of section 89, Congress believed that the cost of allowing an employer deduction for health benefits was justified if the important social policy objective of increasing health insurance coverage was met. Thus, section 89(k) was designed to broaden, not restrict, coverage. According to the General Explanation of the Tax Reform Act of 1986 prepared by the staff of the Joint Committee on Taxation, "Congress did not intend that a plan fail to satisfy the exclusive benefit rule merely because benefits are provided under the plan to non-employees on a basis that is not tax favored." The intent in implementing the exclusive benefit provision of section 89(k)(1)(D) was not to restrict coverage of non-employee plan participants to only those who perform significant services. However, this is required in the proposed regulations.

The floor statement to this proposed legislation addressed the exclusive benefit requirement of current law by providing that, "this exclusive benefit requirement is satisfied if the number of individuals with no service nexus to the employer who participate in the plan is de minimis." We believe H.R. 1864 should make the rule clear for all future years. We understand that proposed regulations generally do not become effective until 1990.

Allowing individuals with no service nexus into an employer's plan on a non tax-favored basis does not violate the social policy behind section 89. Including such individuals will actually increase health insurance coverage. The only problems caused by including such individuals could be with adverse selection against insurance companies. Thus, the ability for an employer to include such individuals should be regulated by the insurance industry and their contracts with an employer, not through the tax law.

Qualification rules in general

The purpose of the qualification rules is to ensure that employees receiving a tax preference for certain benefits are actually receiving those benefits and not cash. We believe that these rules should conform with existing ERISA rules to ease administration for the employer.

The effective date of existing law should be delayed

While we are aware that the proposed regulations offer a number of transitional rules and delayed effective dates, we believe that these should be incorporated in H.R. 1864. Depending on the timing of legislative action on IRC section 89, a further delay may be necessary. Such delay should be statutory.

CONCLUSION

In view of the burdens placed on practitioners and businesses by section 89, legislative relief is needed. Given that the cost of compliance was the AICPA's most significant concern, we congratulate the Chairman on a proposal which saves compliance dollars by focusing on plan availability rather than coverage. The AICPA will be pleased to continue working with the committee to accomplish its objectives.

SUMMARY

The AICPA applauds the Chairman and the entire committee on undertaking the important task of providing meaningful relief from the myriad of complex rules contained in section 89. We strongly recommend that the new legislation adopt a design-based approach, focusing on plan availability rather than plan coverage.

As part of the design-based approach, the excludable part-time work force should be those employees working less than 25 hours per week. Leased employees should be excluded from the test until the definition of a leased employee becomes more clear. While several categories of workers should be excluded, such exclusion should not be impaired if the employer allows some of those workers into a health plan.

In a design-based approach, some type of affordability test is necessary. We recommend that the employee's maximum contribution be defined as a percentage of the employer's health care cost, with a ceiling based on an employee's wages. This will reflect an employer's actual cost, the difference in regional health care costs, and the difference in costs for different group sizes.

We believe the definition of highly compensated employees should be simplified. Many employers do not need to use the detailed rules of IRC section 414(q) and would welcome a simplified system.

We do not believe it is necessarily good tax policy to design one set of qualification and testing rules for all types of plans, employers, and groups of employees. Cafeteria plans and group term life insurance plans should be governed by sections 125 and 79 respectively, and not included in the design-based test for health coverage.

The penalty for failing the qualification rules should be borne by the employer, rather than employees, perhaps through an excise tax. This tax should be calculated on the cost of the coverage, rather than amounts paid or incurred.