[JOINT COMMITTEE PRINT]

# DESCRIPTION OF H.R. 1864 RELATING TO SIMPLIFICATION OF SECTION 89 NONDISCRIMINATION RULES APPLICABLE TO CERTAIN EMPLOYEE BENEFIT PLANS

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON MAY 2, 1989

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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## INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on May 2, 1989, on H.R. 1864, introduced by Chairman Rostenkowski and others on April 13, 1989. The bill replaces the current Internal Revenue Code section 89 nondiscrimination rules for health and other employee benefit plans with a single test. This pamphlet, [1] prepared by the staff of the Joint Committee on Taxation, provides a description of H.R. 1864, and of present-law section 89 rules, and a discussion of related issues.

The first part of the pamphlet is background and a summary of present-law section 89 rules and a summary of H.R. 1864. The second part is a more detailed description of present-law section 89 rules. The third part is a description of the provisions of H.R. 1864, and the fourth part discusses issues related to nondiscrimination rules for employer-provided accident or health plans.

[1] This pamphlet may be cited as follows: *Description of H.R. 1864 Relating to Simplification of Section 89 Nondiscrimination Rules Applicable to Certain Employee Benefit Plans* (JCS-9-89), April 25, 1989.

# I. BACKGROUND

*Purposes of section 89*

Section 89 was enacted as part of the Tax Reform Act of 1986, and became effective generally for plan years beginning after December 31, 1988. The statute imposes nondiscrimination and qualification rules with respect to certain employer-provided fringe benefit plans. Rules similar to those enacted as section 89 were originally included in the tax reform proposals submitted to the Congress by President Reagan in May 1985.[2] After enactment in the Tax Reform Act of 1986, the section was the subject of significant modification under the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).

Section 89 was enacted to limit the tax expenditure related to employer-provided health coverage in certain circumstances. Employer-provided health coverage generally is excludable from the gross income of the employee receiving the coverage. This tax-favored treatment reduces the Federal income tax base and, therefore, reduces Federal budget receipts. The annual cost to the Federal Government of this exclusion is estimated to be $32.6 billion for fiscal year 1990. This cost is projected to increase to $50.8 billion for fiscal year 1994.[3]

In enacting the Tax Reform Act of 1986, the Congress determined that the substantial cost related to employer-provided health insurance coverage is justified only if the tax benefits fulfill important public policy objectives. Increasing health coverage among rank-and-file employees who otherwise would not purchase or could not afford such coverage was identified as a primary policy objective underlying the exclusion for employer-provided health care coverage. Conversely, the Congress believed that the cost to the Federal Government of employer-provided accident and health coverage is not justified if such coverage disproportionately benefits highly compensated employees. In order to achieve this objective, nondiscrimination rules were enacted to permit the full exclusion from income of employer-provided health benefits only if the benefits are provided to required levels of nonhighly compensated employees and the level of benefits provided to highly compensated employees on average does not disproportionately exceed the average benefits provided to rank-and-file employees.

*Present law*

Under present law, section 89 applies nondiscrimination rules to certain types of fringe benefit plans, including employer-provided

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[2] The White House, *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*, May 1985.

[3] See, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1990–1994*, JCS-4-89 (February 28, 1989).

health plans. There are two different methods of testing for nondiscrimination: a 4-part test and a 2-part test. An employer is not required to test under both methods and may elect either method of testing.

Under the first method of testing, four requirements must be satisfied. First, at least half of the employees eligible to participate in the plan must be rank-and-file employees. This test is designed to limit the tax-favored treatment of plans primarily covering highly compensated employees (e.g., executive-only plans).

Second, at least 90 percent of the rank-and-file employees must have available to them coverage that is at least one-half (50 percent) as valuable as the most valuable coverage available to any highly compensated employee. This test is designed to ensure that a significant percentage of rank-and-file employees have a minimum benefit available to them. For example, if the most valuable coverage available to any highly compensated employee is worth $1,000, then to pass this test, 90 percent of the rank-and-file employees must have available coverage of at least $500.

The third requirement is that the value of coverage received by rank-and-file employees must be at least 75 percent of the average value of coverage received by highly compensated employees. This test is designed to ensure that rank-and-file employees actually receive a significant portion of the tax benefits spent for health coverage.

Finally, under the 4-part test, the plan may not contain any provision relating to eligibility to participate that discriminates in favor of highly compensated employees (the nondiscriminatory provisions test).

As an alternative to the 4-part test, an employer may use a 2-part test. This test was designed primarily to provide a less burdensome method of compliance for small employers. Under this test, two requirements must be met. First, at least 80 percent of the employer's rank-and-file employees must be covered by the plan (or a group of aggregated plans). Second, the plan must satisfy the same nondiscriminatory provisions test as is applicable under the 4-part test.

In addition to the nondiscrimination rules, section 89 contains minimum qualification requirements for health plans (and certain other types of plans). These rules require that a plan must be in writing, legally enforceable, maintained for the exclusive benefit of employees, intended to be maintained indefinitely, and that employees be given reasonable notification of plan terms.

### *Summary of the bill*

H.R. 1864, introduced by Chairman Rostenkowski and others on April 13, 1989, replaces the current section 89 nondiscrimination rules for health plans with a single test. In general, an employer's health program passes the test under the bill if at least one plan or a group of plans providing primarily core health coverage is available to at least 90 percent of the employer's nonhighly compensated employees at an employee cost of no more than $10.00 per week ($520 per year) in the case of individual coverage, or $25.00 per week ($1,300 per year) in the case of family coverage. Further, under the bill, the maximum amount of employer-provided coverage that may be excluded from the income of any highly compensated employee cannot exceed 133 percent of the employer-provided coverage made available to 90 percent of the nonhighly compensated employees.

# II. PRESENT LAW

As enacted by the Tax Reform Act of 1986 and amended by the Technical and Miscellaneous Revenue Act of 1988, Code section 89 has two basic sets of requirements: (1) nondiscrimination rules, and (2) plan qualification requirements. In general, the nondiscrimination rules measure the extent to which health benefits (and certain other types of fringe benefits) are made available to rank-and-file employees and the extent to which such employees actually receive those benefits. These rules basically require an employer to compare benefits provided to highly compensated employees with benefits provided to the rank-and-file employees. These rules are designed to limit tax-favored treatment of employee benefits unless a significant portion of such benefits are provided to rank-and-file employees.

The qualification requirements require health plans (and certain other types of fringe benefit plans) to satisfy certain minimum basic requirements, for example, that the plan be in writing and be legally enforceable.

## A. Nondiscrimination Rules

### *Plans subject to the nondiscrimination rules*

In general, health plans and group-term life insurance plans are subject to the section 89 nondiscrimination rules. An employer may also elect to test its dependent care assistance programs under section 89 in lieu of applying the nondiscrimination rules contained in section 129 that otherwise apply to such plans. Disability benefits are subject to the rules to the extent the benefits are excludable from income under section 105 (b) or (c) of the Code. Benefits provided under nonhealth plans may not be taken into account in determining whether the employer's health plans satisfy the nondiscrimination rules.

All employer-provided health coverage is taken into account under section 89. For example, plans providing medical diagnostic procedures or physical examinations are health plans subject to section 89. Health coverage is required to be taken into account under section 89 regardless of the method by which it is provided, for example, through an insurance plan, a self-insured arrangement, or a voluntary employees' beneficiary association (VEBA).

Plans providing for short- and long-term disability benefits, wage continuation benefits, and workers compensation benefits generally are not subject to the section 89 nondiscrimination rules. Similarly, vacation pay plans of the employer are not subject to the section 89 nondiscrimination rules.

The nondiscrimination rules apply to plans maintained by all types of employers, other than plans maintained by churches and certain church-controlled organizations. Thus, section 89 applies to plans of small and large employers, taxable and tax-exempt employers, private and public employers (including the Federal Government), and plans maintained by more than one employer (i.e., multiple employer and multiemployer plans).

*Nondiscrimination tests*

There are two methods by which an employer may test its plans to determine compliance with section 89: (1) a four-part testing method, and (2) an alternative, simplified two-part testing method. The employer may choose either testing method, and only needs to use one method, even if use of the other method might lead to different results under section 89.

*Four-part test*

*In general.*—The four-part testing method consists of three availability tests and one benefits test. The availability tests measure only whether an employee has the opportunity to participate in a plan. The benefits test measures whether, and to what extent, an employee is actually participating in a plan (i.e., has actually enrolled). The three availability tests are generally referred to as follows: the 90-percent/50-percent test, the 50-percent test, and the nondiscriminatory provision test.

*90-percent/50-percent test.*—The intent of the 90-percent/50-percent test is to ensure that almost all rank-and-file employees have a reasonably valuable plan available to them relative to the value of benefits available to highly compensated employees. Thus, the rule requires that 90 percent of all rank-and-file employees (i.e., those employees who are not considered highly compensated under the statute) have the opportunity to participate in a plan that is worth at least one-half (50 percent) as much as the plan or plans that provide the greatest value to any highly compensated employee. The value of the coverage to an employee is measured by looking only at the portion of the value that is paid by the employer. Under this test, an employer may look at all health plans to see if the rank-and-file employees have the opportunity to participate in any plan available that meets this requirement. For example, assume that the most valuable health plan available to any highly compensated employee is valued at $1,000. Under the 90-percent/50-percent test, 90 percent of the rank-and-file employees must have the opportunity to participate in a health plan worth at least $500.

*50-percent test.*—The 50-percent test is designed to limit the tax-favored treatment of plans that are only available to highly compensated employees (e.g., executive-only plans). Under this test, 50 percent of those employees eligible to participate in each option under an employer's health program are required to be rank-and-file employees. For example, assume that the dental plan maintained by the employer is available to 20 employees. The 50-percent test is satisfied if at least 10 of those employees are rank-and-file employees.

Plans of comparable value may be grouped together in determining whether the 50-percent test is satisfied. For this purpose, a group of plans are generally considered comparable if the employer-paid value of the lowest-valued plan is at least 95 percent of the employer-paid value of the highest-valued plan in the group. For example, suppose an employer maintains two health plans, one with an employer-provided value of $1,000 and one with an employer-provided value of $950. These plans may be treated as a single plan for purposes of the 50-percent test. Thus, for example, these two plans would satisfy the 50-percent test if the only employees eligible to participate in the $1,000 plan are 15 highly compensated employees and the only employees eligible to participate in the $950 plan are 15 or more rank-and-file employees.

*Nondiscriminatory provision test.*—The third availability test is the nondiscriminatory provision test. Under this test, a plan may not contain any provision relating to eligibility to participate that (by its terms, operation, or otherwise) discriminates in favor of highly compensated employees. This test is subjective in nature and is intended to be applied in those instances in which discrimination is not easily measured under the numerical nondiscrimination tests. For example, assume that the president of a company has an extremely rare condition that is the primary benefit covered by the employer's health plan. This coverage is provided to all employees, not only the company president. The plan may meet the numerical requirements of section 89 because it covers all employees, not just the company president. However, under the facts and circumstances, the nondiscriminatory provision test may not be satisfied because it is unlikely that anyone other than the company president will ever benefit under the coverage in question.

*Benefits test.*—The benefits test, which is often referred to as the 75-percent benefits test, is designed to ensure that rank-and-file employees actually receive a significant portion of the total employer dollars that are spent for health benefits. An employer's health plans pass this test if the average value of all employer-provided health coverage received by the rank-and-file employees is at least 75 percent of the average value of employer-provided health coverage received by highly compensated employees. For example, if the average employer-paid portion of health coverage provided to highly compensated employees is $1,000, the 75-percent benefits test is satisfied only if the average employer-paid portion of health coverage provided to rank-and-file employees is no less than $750.

Treasury regulations contain safe harbors for 1989 and 1990 under which an employer does not have to apply the 75-percent benefits test. Instead, the employer may include as taxable income the value of health coverage received by certain highly compensated employees and satisfy certain other requirements.

*Two-part test*

The alternative method of determining whether an employer's plans are discriminatory is called the two-part test, which consists of the previously discussed nondiscriminatory provision test and an 80-percent coverage test. The 80-percent coverage test was developed for use by small employers with simple benefit programs. An employer passes this test if its plans cover 80 percent of its rank-and-file employees. Thus, for example, if the employer maintains one health plan providing coverage to employees and their families and 80 percent of all rank-and-file employees participate in the plan, then the employer passes the 80-percent coverage test.

Comparable plans may be aggregated for purposes of the 80-percent coverage test. In general, for purposes of the 80-percent test, a group of plans is considered comparable if the employer-paid value of the lowest valued plan is at least 90 percent of the employer-paid value of the highest-valued plan in the group. Thus, for example, a plan with an employer-paid value of $450 and a plan with a similar value of $500 are comparable because $450 is at least 90 percent of $500.

There are several variations on this general comparability rule that compare plans based on employer-provided value. In addition, plans can be aggregated if employees can freely choose among the plans, and the difference in employee cost (i.e., the portion of the cost of coverage that the employee pays) is no more than $100 per year.

*Salary reduction contributions*

Under present law, special rules apply to pre-tax contributions made by an employee to a cafeteria plan (i.e., salary reduction contributions). In general, except for certain purposes, salary reduction contributions are treated as employer contributions. Special rules apply to the treatment of salary reduction contributions for purposes of the 90-percent/50-percent test and for the 50-percent test. These rules are designed to permit an employer to treat salary reduction contributions as employer contributions if doing so does not permit the avoidance of the tests.

In general, an employer may treat available salary reduction contributions as employer contributions under the 90-percent/50-percent test if the ability to make salary reduction contributions is available on the same basis to rank-and-file and highly compensated employees, and the employer does not offer a benefit to its rank-and-file employees primarily on a salary-reduction basis, while offering the same benefit to highly compensated employees on an employer-paid basis.

Notwithstanding these general rules, the Secretary of the Treasury is authorized to establish rules under which salary reduction shall or shall not be taken into account as an employer-provided benefit to prevent avoidance of the nondiscrimination rules. These rules are to take into account the fact that salary reduction contributions provide a tax-benefit to high-paid employees, but represent employee cost for low-paid employees. Consequently, these rules may also permit salary reduction to be characterized differently with respect to highly compensated and rank-and-file employees.

The exclusion of salary reduction contributions of high paid employees may create inappropriate results if such employees can receive a significant portion of their benefits through salary reduction. For example, suppose a highly compensated employee can purchase $5,000 of health benefits through salary reduction. If salary reduction is disregarded, the employee will be treated as receiving no benefit for purposes of the 90-percent/50-percent test. This treatment is inappropriate because the salary reduction contributions are a significant tax-favored benefit.

On the other hand, the inclusion of salary reduction may create inappropriate results if a significant portion of the rank-and-file are required to purchase a significant portion of their benefits through salary reduction because at some level of contribution, salary reduction is not effectively available to the rank-and-file because of its cost.

The Secretary of the Treasury has issued regulations providing that, in computing the largest benefit available to a high-paid employee for purposes of the 90-percent/50-percent test, the health coverage attributable to salary reduction is considered an employer-provided benefit and is taken into account to the extent that the portion of core health coverage attributable to salary reduction exceeds 100 percent of the core health coverage attributable to employer contributions (excluding salary reduction).

The regulations also provide that, in computing the benefit available to a rank-and-file employee, core health coverage attributable to salary reduction is considered an employee contribution and is disregarded to the extent that the portion of core health coverage attributable to salary reduction exceeds 100 percent of the core health coverage attributable to employer contributions. This rule only applies when the employer has elected to consider salary reduction as employer contributions for purposes of the 90-percent/50-percent test.

The Treasury regulations also contain a rule relating to salary reduction for purposes of the 50-percent test. In aggregating plans in order to determine the level of benefit for which a nonhighly compensated employee is eligible, salary reduction relating to noncore health coverage generally is not considered available if it exceeds $2,000 unless the employee actually elects a higher amount.

***Excludable employees; separate lines of business***

In general, all of the employees of the employer, as well as the employees of certain related employers (e.g., subsidiary or affiliate corporations) are required to be taken into account in applying the nondiscrimination tests of section 89. There are, however, several exceptions to this rule.

*Separate lines of business or operating units*

If the employer has separate lines of business or maintains separate operating units, each separate line of business or operating unit may be tested separately by taking into account only those employees in that line of business or operating unit. In general, if a business location of the employer is located more than 35 miles from another location and meets certain other requirements, that location may qualify as a separate operating unit for section 89 purposes.

Under present law, headquarters employees of an employer generally may not be treated as employed in a separate line of business or operating unit. Special rules apply to determine how such employees are to be allocated to other lines of business or operating units of the employer.

*Excludable employees*

Certain employees are disregarded in testing for discrimination under section 89. Generally, employees in the following categories are disregarded: (1) employees who normally work less than six months per year; (2) employees who normally work less than 17.5

hours per week; (3) certain nonresident aliens; (4) employees wh are under 21 years of age; and (5) employees who have less thar one year of service with the employer (or six months with respec to a health plan providing core health coverage).

Some employers have raised the question of whether employee that have been determined to be uninsurable by an insurance com pany may be disregarded. Section 89 does not allow an employer t disregard such individuals. However, section 89 addresses the issu of uninsurable employees by permitting employers to exclude a sig nificant number of individuals from its health plans and still mee the requirements of section 89.

There is no special definition of what individuals are "employ ees" for purposes of section 89. Issues arise with respect to whethe certain individuals (e.g., prisoners, elected officials, and clients i sheltered workshops) are required to be treated as employees Whether or not a particular individual is an employee is not deter mined by section 89 but by other provisions of the Internal Reve nue Code. Thus, if an individual is considered an employee unde other tax provisions (e.g., employment tax and pension plan rules they will also be considered to be employees for purposes of sectio 89 unless the Secretary determines otherwise.

The Secretary, in the preamble to the Treasury regulation issued with respect to section 89, specifically requested comment on the appropriate treatment under section 89 of leased employees prisoners, clients in sheltered workshops, and similar classes of in dividuals.

*Part-time employees*

Generally, if a part-time employee normally works at least 17. hours a week, then the employee is required to be taken into ac count when an employer tests its plans for discrimination unde section 89. Section 89 contains a number of exceptions to the re quirement that employees who normally work 17.5 hours or mor are required to be taken into account. First, the employer may dis regard any employee if the employee has coverage under anothe employer's health plan (e.g., a spouse's plan). In addition, section 8 contains rules that permit an employer to proportionately reduc the coverage it makes available or provides to its part-time employ ees in relation to the hours worked. Consequently, the employe may still meet the requirements of section 89 even if it does no provide the same level of benefits to its full- and part-time employ ees, for example, because part-time employees are required to pa more for the same total coverage.

Finally, TAMRA added a special rule relating to part-time em ployees that is available to small employers (those with fewer tha 10 employees). For plan years beginning in 1989, such employer may disregard those employees who work less than 35 hours week, and for plan years beginning in 1990, the employer may dis regard those employees who work less than 25 hours a week. Fo subsequent plan years, the 17.5-hour rule applies.

*Employees covered by a collective bargaining agreement*

In general, if any employee covered under a collective bargainin agreement has health coverage, that employee and other employ ees in the same bargaining unit are taken into account for purposes of determining whether an employer meets the section 89 nondiscrimination rules. The effect of this rule is that, in most cases, the employer cannot disregard employees covered by collective bargaining agreements.

*Family coverage*

In enacting section 89, the Congress was concerned that an employer might fail the numerical nondiscrimination tests with respect to health plans covering families simply because those employees with families are disproportionately highly compensated. Therefore, several special rules apply under section 89 with respect to family coverage.

For purposes of the eligibility tests, if the employee has the opportunity to enroll in a plan providing family coverage, such coverage is treated as available to the employee without regard to whether or not the employee actually has a family.

In applying the 75-percent benefits test and the 80-percent coverage test, the employer may test its single coverage and family coverage separately. Thus, if the employee confirms to the employer that he or she does not have a family (e.g., a spouse or dependents), the employer need not consider that employee in testing its family health plans. In addition, if an employee is offered coverage (such as family coverage) at no cost to the employee and the employee declines to participate, that employee may be disregarded for purposes of testing.

*Coverage from another employer*

The Congress concluded in 1986 that an employer should not fail to satisfy the section 89 requirements merely because an employee declines coverage if the employee has health coverage through another employer (for example, through a spouse's employer). Therefore, employees who confirm to an employer that they have other health coverage may be disregarded in applying the nondiscrimination tests of section 89. If the employer treats employees with families separately as discussed above, then the employer may disregard an employee whose family has other coverage.

*Valuation of health coverage*

In order for an employer to compare differing health coverages under section 89, the employer must assign a value to each coverage. The Secretary of the Treasury is to establish tables prescribing the relative values of different types of health coverage. Under TAMRA, these tables are to be effective as of the later of (1) the first testing year beginning after the issuance of the tables, or (2) the date specified by the Secretary.

Until the issuance of valuation rules by the Secretary, an employer may use any reasonable method to value its health coverage. For example, the employer may use the cost of the coverage determined in the same way health coverage cost is determined under the health care continuation rules (sec. 4980B).[4]

There is a special permanent valuation rule for collectively bargained plans maintained by more than one employer (called multiemployer plans). For purposes of section 89, the value of coverage provided by the employer is generally equal to the amount the employer contributes under the collective bargaining agreement on behalf of its employees. Thus, for example, if the contract requires that an employer contribute 55 cents for health coverage for each hour worked by an employee, then the value of the coverage provided to that employee is 55 cents times the number of hours worked.

*Testing procedures*

Under section 89, an employer chooses a testing year on which to base its testing. Within this year the employer selects a day (called the testing date) on which to determine who are its employees and what coverage is available and provided to such employees. In general, testing is based on the facts in existence on that one date. However, the testing day data is required to be adjusted to reflect changes in plan design and changes in elections by highly compensated employees that have occurred during the year. These adjustments are necessary in order to have the limited data available on the testing day reflect what actually occurred during the year.

Treasury regulations relating to section 89 contain a transition rule for 1989 testing years that permits an employer in certain cases to disregard plan design and election changes that occur prior to July 1, 1989.

*Highly compensated employees*

A highly compensated employee is an employee who, during the year or the preceding year (1) was a 5-percent owner of the employer, (2) received compensation in excess of $81,720, (3) was an officer of the employer and received compensation in excess of $45,000, or (4) received compensation in excess of $54,480 and was in the top-paid 20 percent of employees. The dollar limits are indexed for inflation. In lieu of calculating the top-paid 20 percent of employees, the employer may elect to treat all employees with compensation in excess of $54,480 as highly compensated employees. An employer is treated as having at least one officer even if that officer has less than $45,000 of compensation.

*Former employees*

Former employees are taken into account in determining whether an employer meets the requirements of section 89. However, the employer tests former employees separately from active employees. Thus, former employees are not considered when the employer tests its plans relating to active employees. Further, under

[4] In general, the health care continuation rules require that employers provide their employees (and certain other individuals) the opportunity to participate for a specified period in the employer's health plan despite the occurrence of a qualifying event that otherwise would have terminated such participation. Employers are permitted to charge the individual a specified amount for the coverage, based on the employer's cost of providing the coverage.

TAMRA, an employer is generally permitted to disregard employees who separated from service prior to January 1, 1989.

*Sanctions*

If an employer's plan fails to satisfy the section 89 nondiscrimination rules, then the highly compensated employees participating in the plan must include in income the value of the portion of the coverage that is discriminatory (the "discriminatory excess"). The discriminatory excess is determined based on the coverage received that is in excess of the coverage that could be provided if the plan were nondiscriminatory. The amount includible in income is based on the discriminatory excess coverage, that is, the premium paid for the coverage, not on the amount of reimbursements received under the plan. Thus, if the nondiscrimination rules are violated, a highly compensated employee is not required to include a greater amount in income merely because he or she was sick during the year.

The employer is subject to an excise tax if the employer fails to report properly on an employee's W-2 the amount includible in the employee's income due to failure to satisfy the section 89 rules. The excise tax does not apply if the failure to report the proper amount was due to reasonable cause.

## B. Qualification Rules

*In general*

The qualification rules of section 89(k) are designed to ensure that a plan meets certain basic minimum requirements. In general, these rules require that a plan be: (1) in writing; (2) maintained for the exclusive benefit of employees; (3) legally enforceable; and (4) established with the intention that it be maintained for an indefinite period of time (the permanence requirement). In addition, an employer must give its employees reasonable notice of the benefits provided under the plan.

*Plans subject to the qualification requirements*

The qualification rules apply to the following types of benefit plans: (1) health plans; (2) group-term life insurance plans; (3) cafeteria plans; (4) voluntary employees' beneficiary associations (VEBAs); (5) dependent care assistance programs; (6) qualified tuition reduction programs; and (7) fringe benefit programs providing no-additional-cost services, employer-provided eating facilities, and qualified employee discounts.

*Writing requirement*

Treasury regulations provide that a plan will be considered to be in writing if all material terms of the plan are included or referenced in a single document. No particular format is required and several plans can be included in a single document.

Treasury regulations provide a transition rule relating to this requirement for 1989. Under the regulations, the written document requirement is not required to be satisfied by an employer until the first day of the second year that a plan is subject to section 89.

For example, if a plan has a calendar plan year, that plan need not be in writing until January 1, 1990.

*Notice requirement*

An employer satisfies the notice requirement by notifying those employees eligible to enroll in the plan of its existence and nature, the group of employees that may be eligible for the plan, the cost and method of enrolling in the plan, and a statement of how an employee can receive additional information about the plan. Under the Treasury regulations, the employer satisfies this requirement if this information is given to employees by the health care provider (e.g., the HMO or insurance company).

*Exclusive benefit rule*

In general, the exclusive benefit rule requires that the plan is to be maintained for the exclusive benefit of employees and that virtually all individuals participating in the plan are common-law employees of the employer. Self-employed individuals who are treated as employees under the rules relating to qualified retirement plans (sec. 401(c)(1)) are treated as employees for this purpose. Other individuals (i.e., nonemployees) who perform significant services for the employer may participate in the plan, as well as a de minimis number of other individuals, as long as such coverage is provided on an after-tax basis. Under a transition rule, Treasury regulations generally delay the effective date of the exclusive benefit rule for one year, to the first day of the plan year following the first plan year beginning in 1989.

*Permanence requirement*

Treasury regulations provide that the permanence requirement is satisfied if the plan is established and maintained for at least a consecutive 12-month period. Termination or material modification of the plan before the plan has been in effect for 12 months will not violate the permanence requirement if there is a substantial independent business reason for the termination or modification and the termination or modification does not discriminate in favor of highly compensated employees.

*Legally enforceable requirement*

A plan is considered to be legally enforceable if the conditions required for an employee to participate, receive coverage, and obtain a benefit are definitely determinable under the terms of the plan and an employee satisfying such conditions is able to compel such participation, coverage, or benefit. A plan generally is not considered to be legally enforceable if a decision as to whether to grant or deny participation, coverage, or a benefit is discretionary with the employer.

Under a transition rule, Treasury regulations generally delay the effective date of this rule for one year, to the first day of the plan year following the first plan year beginning in 1989.

*Sanction*

If a plan fails to satisfy the qualification requirements, then the employer pays benefits under an ad hoc reimbursement program that attempts to convert fully taxable compensation into nontaxable benefits. Consequently, if such requirements are not met, then all employees participating in the plan are required to include in income the value of benefits (e.g., reimbursements) received under the plan. This sanction may be imposed on all employees whether or not they are highly compensated employees.

Treasury regulations contain several provisions that reduce the sanction for failure to comply with the qualification rules. First, no sanction is imposed if there is a de minimis failure to satisfy the writing or notice requirements, and the failure is corrected within 90 days after the employer has notice of the failure.

Second, the regulations limit the amount includible in income to a percentage of the individual's compensation. In particular, the amount includible for failure to meet the qualification requirements is limited to the sum of (1) 10 percent of the employee's compensation up to the dollar amount used to determine the top-paid 20 percent of highly compensated employees ($54,480 for 1989), (2) 25 percent of the employee's compensation in excess of such dollar amount but not in excess of 200 percent of such dollar amount, (3) 75 percent of the employee's compensation in excess of 200 percent such dollar amount up to and including 300 percent of such dollar amount, and (4) 100 percent of the employee's compensation in excess of 300 percent of such dollar amount. For example, if an employee has $20,000 of compensation and a taxable benefit of $30,000 by reason of a plan's failure to meet the qualification requirements (e.g., the employee had surgery for which the employer paid), the employee would not be required to include in his or her taxable income more than 10 percent of compensation ($2,000).

Third, under the regulations, if a failure to satisfy the qualification requirements is limited to a specific aspect of coverage provided in a plan, then that aspect of coverage may be treated as a separate plan for purposes of determining the amount includible in income. For example, suppose that a benefit is paid to a participant and the benefit exceeds the dollar limitation on benefits described in the written plan. The amount of the benefit in excess of the dollar limitation may, under the circumstances, be treated as a separate plan and, therefore, could be included in the taxable income of the recipient without an adverse impact on the rest of the plan or its participants.

The penalty imposed upon an employer for failure properly to report the amount includible in income on an employee's W-2 applies to failures to report income includible as a result of failure to satisfy the qualification rules of section 89.

### C. Effective Date of Section 89 Rules

In general, the nondiscrimination rules and the qualification requirements of section 89 are effective for plan years beginning on or after January 1, 1989. A delayed effective date applies to plans maintained pursuant to one or more collective bargaining agreements. The effect of this delayed effective date is that in applying the nondiscrimination tests, participants in such collectively bargained plans may be disregarded until the delayed effective date at the employer's election. As described above, Treasury regulations contain transition rules that have the effect of delaying the effective date of certain of the section 89 rules.

## III. DESCRIPTION OF H.R. 1864

### A. Overview

On April 13, 1989, Chairman Rostenkowski and others introduced H.R. 1864, proposing substantial revisions to section 89. The bill is intended to reduce significantly the recordkeeping and data collection requirements of section 89 while retaining the policy objectives of the nondiscrimination rules.[5]

The bill replaces the current section 89 nondiscrimination rules for health plans with a single simplified test. In general, an employer's health plan passes the bill's test if the plan contains no provision that discriminates in favor of highly compensated employees and that satisfies the following requirements:

(1) at least one plan or a group of plans providing primarily core health coverage is available to at least 90 percent of the employer's nonhighly compensated employees at an employee cost of no more than $10.00 per week (i.e., $520 per year) in the case of individual coverage, or $25.00 per week (i.e., $1,300 per year) in the case of family coverage (i.e., coverage of the employee and the employee's family), and

(2) the maximum amount of employer-provided coverage that may be excluded from the income of any highly compensated employee is not more than 133 percent of the employer-provided coverage made available to 90 percent of the nonhighly compensated employees.

The first part of the test is referred to below as the eligibility test, and the second part is referred to as the benefits test.

### B. Eligibility Test

***In general***

Under the bill, the eligibility test is satisfied if affordable core (or primarily core) health coverage is available to at least 90-percent of the nonhighly compensated employees of the employer and the plan does not contain any provision that discriminates in favor of highly compensated employees (the nondiscriminatory provision requirement). The 90-percent test may be met by looking at all plans maintained by the employer that provide health coverage and that meet certain limits on the amount that may be charged to the employee for coverage. This test does not require that the employer only offer health plans meeting the employee contribution requirements. Rather, the employer can offer a full array of plans as long as the eligibility test is met by at least one plan or by a group of

[5] Other bills have been introduced in the House and Senate in the 101st Congress that would repeal or delay the application of the section 89 rules or otherwise modify those rules.

plans when the nonhighly compensated employees eligible under such plans are combined.

If the employer fails to meet the eligibility test, then the value of all health coverage provided to highly compensated employees is includible in the taxable income of the highly compensated employees.

For purposes of what plans may be considered available for the eligibility test, the bill limits mandatory employee contributions to $10.00 per week for employee-only coverage (i.e., $520 per year) and $25.00 per week for coverage for the employee and the employee's family (i.e., $1,300 per year).

The limit on employee cost is intended to ensure that coverage is, in fact, available to rank-and-file employees. Without such a limitation, an expensive plan could meet the eligibility requirements of the bill and yet fail to make coverage meaningfully available because of the unrealistic financial burden electing such coverage would place on nonhighly compensated employees. For purposes of the rule on mandatory employee contributions, amounts paid through salary reduction are treated as an employee contribution because salary reduction generally represents a cost to the employee. See the discussion below of salary reduction.

The dollar limits on mandatory employee contributions are indexed for average wage growth. This indexing permits appropriate increases in the mandatory premium. The dollar limits are indexed to changes in wage growth so that the limits will continue to ensure that employee contributions generally satisfy the principle of affordability. This principle may not be satisfied if increases in the limits are tied to other indices (such as medical cost inflation).

As under present law, core health coverage generally means coverage providing comprehensive major medical and hospitalization benefits. Also, as under present law, coverage for dental or vision care, and health coverage provided under flexible spending arrangements are not considered core health benefits.

In order to pass the eligibility test, the employer is not required to make family coverage available to its employees. The eligibility test is passed if 90 percent of the nonhighly paid have available a plan meeting the contribution limits regardless of whether the plan offers family coverage. However, as described below, failure to pass the eligibility test on the basis of family coverage may have an effect on the application of the benefits test. Under the bill, family coverage means coverage of the employee and coverage of the employee's family.

An issue exists relating to whether the bill as introduced will sufficiently ensure that the premium for the employee-only coverage that satisfies the eligibility test does not exceed the true cost of employee-only coverage because employees with such coverage are expected to subsidize family coverage that is not available to 90 percent of the rank-and-file employees. Of course, if such subsidization is unreasonable, then the plans involved violate the nondiscriminatory provision requirement set forth below and the premium value assigned to such plans may also be an inappropriate measure of the value of the coverages.

*Nondiscriminatory provision requirement*

As under present law, the bill provides that the employer-provided coverage under a plan may be excluded from the taxable income of a highly compensated employee only if the plan does not contain any provision that (by its terms, operation, or otherwise) discriminates in favor of highly compensated employees. The purpose of the nondiscriminatory provision requirement is to preclude executive-only plans and other inherently discriminatory practices. As under present law, the requirement applies to the method and circumstances under which an employer determines whether it meets the requirements of section 89. For example, the requirement applies to the designation of a testing date.

It is generally intended that the Internal Revenue Service will not challenge a plan as an executive-only plan under the nondiscriminatory provision requirement if at least 50 percent of the group of employees eligible to participate in the plan are nonhighly compensated employees and the employer can demonstrate that the plan does not disproportionately benefit highly compensated employees even if the nonhighly compensated employees actually elected to participate in the plan. It is also intended that a plan providing accidental death and dismemberment coverage will not fail the nondiscriminatory provision requirement merely because the death benefits under such plan bear a uniform relationship to compensation.

*Examples illustrating the 90-percent eligibility test and the nondiscriminatory provision requirement*

*Example 1.*—An employer maintains several health plans for its employees. One of the plans provides core health coverage that is available to all nonhighly compensated employees at a cost of $8.00 per week ($416 per year) for employee-only coverage and $15.00 per week ($780 per year) for coverage of the employee and the employee's family. This plan is a qualified core health plan and, therefore, the employer meets the 90-percent eligibility test without regard to the characteristics or employee contribution requirements of the other plans maintained by the employer.

*Example 2.*—An employer maintains two plans providing core health coverage. One plan is an indemnity plan and is available to employees at a cost of $5.00 per week ($260 per year) for employee-only coverage, and $20.00 per week ($1,040 per year) for coverage of the employee and the employee's family. This plan is available to 40 percent of the nonhighly compensated employees of the employer. The other plan is an HMO requiring no employee contribution that is available to 70 percent of the employer's nonhighly compensated employees. When considered together, 90 percent of the nonhighly compensated employees are eligible for one or both of the plans. Both plans are qualified core health plans and may be considered for the eligibility test because the cost to employees under both plans is within the mandatory contribution range and both plans primarily provide core health coverage. Because 90 percent of the nonhighly compensated employees can participate in one of the two plans, the employer meets the 90-percent eligibility test.

*Example 3.*—An employer maintains two core health plans. One plan provides employee-only coverage at a cost to the employee of $800 per year. The other plan provides spousal and dependent coverage for an additional $400 per year, for a total annual employee-paid premium of $1,200 for family coverage. These plans are available to all employees. While the family plan meets the employee premium requirements of the bill ($1,300 for family coverage), the single coverage does not meet the limits on employee contributions for single coverage ($520 per year). Therefore, the employer's health program does not meet the availability test. The same result would obtain if the family coverage were the only coverage available (i.e., if single coverage could not be purchased separately) and the cost of such coverage exceeded the limitation on employee contributions for employee-only coverage.

*Example 4.*—An employer maintains two health plans, an indemnity plan that is available to all employees at no cost to the employees and a plan providing coverage for physical examinations that is available only to certain highly compensated employees. The plan providing coverage for physical examinations fails the nondiscriminatory provision requirement because it is available only to highly compensated employees. The employer-provided coverage of the plan for physical examinations must be included in the income of those employees covered by the plan. However, the eligibility test is met with respect to the indemnity plan and, therefore, the employer-provided coverage relating to that plan retains its tax-favored status for all participating employees provided the benefits test described below is also satisfied.

## C. Benefits Test

*In general*

The purpose of the benefits test is to ensure that highly compensated employees do not receive a disproportionately higher level of nontaxable employer-provided coverage than the level of employer-provided coverage that is available to the nonhighly compensated employees. The benefits test does not limit the amount of coverage that can be provided to highly compensated employees as long as the value of the coverage in excess of certain limits is included in the employees' income.

Under the bill, the maximum coverage that a highly compensated employee may exclude from income generally is 133 percent of the value of the employer-provided employee-only coverage that is taken into account in satisfying the 90-percent test. However, if a highly compensated employee elects family core coverage, and if the employer maintains a plan that provides family coverage that meets the requirements under the bill for the 90-percent test, then the maximum tax-favored coverage is increased. The maximum coverage for such an employee is 133 percent of the value of the employer-provided benefit relating to family coverage that would otherwise satisfy the 90-percent test if family coverage were separately tested. The employer-provided benefit available to nonhighly compensated employees for spouse and dependent coverage may not be taken in account in determining the limitation on the benefit that may be received by a highly compensated employee not electing family core health coverage. In addition, for purposes of this rule, an election relating to a flexible spending account is not considered an election of family coverage.

Any employer-provided coverage received by a highly compensated employee in excess of the level of employer-provided coverage that meets the benefits test is includible in the taxable income of such employee.

For purposes of the benefits test, an employer may aggregate certain plans in determining the employer-provided benefit available to 90 percent of the nonhighly compensated employees. Because these rules are permissive, an employer is not required to aggregate plans and may designate any level of employer-provided benefit to be multiplied by 133 percent, as long as that benefit satisfies the 90-percent eligibility test. Thus, an employer is likely to use the highest level of employer-provided benefit that satisifes the 90-percent test in calculating the benefit to be multiplied by 133 percent.

Under the aggregation rule, the employer may increase the level of benefit available to the nonhighly compensated employees by aggregating two or more plans if such plans are available to the same group of employees and, when combined, such aggregated plans constitute a qualified core health plan (i.e., are primarily composed of an employer-provided benefit relating to core health coverage and continue to meet the maximum employee contribution limitation on an aggregate basis).

For example, if a dental plan with an employer-provided benefit of $499 and a core health plan with an employer-provided benefit of $501 are available to the same employees and the two plans meet the maximum contribution limitation when considered together, then such plans may be treated as one qualified core health plan with an annual employer-provided benefit of $1,000. If 90 percent of the nonhighly compensated employees are eligible for this plan or for other qualified core health plans with at least the same employer-provided benefit, the benefits test would be met if no highly compensated employee received an employer-provided benefit in excess of $1,330 (133 percent of $1,000). Of course, for purposes of the aggregation rules, overlapping coverage under the plans may not be considered more than once in determining the employer-provided benefit under the combined plans.

For purposes of determining the value of the employer-provided benefit received by highly compensated employees under the benefits test, the bill treats salary reduction as employer contributions. See the discussion below relating to salary reduction.

In determining the value of the employer-provided benefit under a plan for purposes of the benefits test, the bill retains present law, including the rules enacted as part of TAMRA. Thus, for example, as under present law, an employer may use premium cost as determined under the health care continuation rules, or can use any reasonable valuation method in lieu of employer premiums until the issuance of valuation rules by the Secretary. In addition, the special rule for valuation of benefits under multiemployer plans applies.

*Examples illustrating the benefits test*

*Example 1.*—An employer maintains only two health plans: an indemnity plan and an HMO. Both plans are available at no cost to over 90 percent of the nonhighly compensated employees. An employee may choose either plan. Under this example, there can be no failure of the benefits test because the highly compensated employees can only receive an employer-paid value of coverage equal to the employer-paid value of coverage available to nonhighly compensated employees.

*Example 2.*—An employer maintains two health plans: an indemnity plan providing core health coverage that is available to all employees, and a dental plan available only to a limited class of employees (including both highly and nonhighly compensated employees). Neither plan requires employee contributions. The employer-paid cost for the indemnity plan is $1,400, as determined under the health care continuation coverage rules. The employer cost for the dental plan is $500. In this example, the dental plan and the indemnity plan may not be aggregated because the plans are not available to the same employees. Therefore, the limitation on the excludable premium that may be received by any highly compensated employee is $1,862 ($1,400 x 1.33). If a highly compensated employee participates under both plans, then the portion of the premium includable in such employee's taxable income is $38 ($1,400 plus $500 less $1,862).

*Example 3.*—An employer maintains several health plans. Three plans are core health plans. Each core plan is available to over 90 percent of the nonhighly compensated employees. The required employee contributions for each plan are less than the maximum premium allowed in the 90-percent test. The employer cost of each of the three core plans is $500, $1,000 and $1,500 respectively. The employer may designate the $1,500 plan as the plan available to 90 percent of the nonhighly compensated employees. Therefore, the maximum excludable benefit that may be received by any highly compensated employee is $1,995 ($1,500 x 1.33), and any highly compensated employee would have taxable income to the extent that the employee receives coverage in excess of this amount.

*Example 4.*—An employer maintains two core health plans and two dental plans. All employees may elect one or both of the core plans, but only 75 percent of the nonhighly compensated employees are eligible for the dental plans. One of the core health plans provides employee-only coverage with an employer-provided benefit of $1,000 per year and requires an employee premium of $400 per year. The second core health plan provides coverage for a spouse and dependents (but not for the employee), has an employer-provided benefit of $2,500 per year, and requires an employee premium of $800 per year. Thus, the total annual premium for family coverage is $1,200 ($800 plus $400) and the total employer-provided benefit for family coverage is $3,500 ($2,500 plus $1,000). One of the dental plans has an employer-provided benefit of $300 per year for single coverage. The second dental plan has an employer-provided benefit of $600 per year for family coverage.

The core health plans in this example are both qualified core health plans. Thus, any highly compensated employee who elects employee-only coverage is limited to $1,333 in coverage under the benefits test ($1,000 x 1.33). The dental coverage cannot be taken into account in determining the maximum exludable amount because it is not available to 90 percent of the nonhighly compensated employees. However, if a highly compensated employee elects employee-only dental coverage and employee-only core health coverage, that coverage will not be included in his or her taxable income because the resulting total employer-provided benefit received is $1,300, which does not exceed the benefit limitation of $1,330.

If a highly compensated employee elects single core coverage and family dental coverage, then $270 of the total employer-provided benefit is includible in the taxable income of such employee ($1,600 less $1,330). If a highly compensated employee elects family coverage, then the limitation on benefits received by that employee is $4,655 ($3,500 x 1.33).

If the family plan that is maintained by the employer is not a qualified core health plan (e.g., has an annual required employee premium of $1,500) then the tax-favored coverage permitted to be received by any highly compensated employee is limited to 133 percent of the value of the single coverage ($1,330).

***Salary reduction arrangements***

Under the bill, 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 limitation on employee contributions if a plan is to be considered in determining whether an employer meets the 90-percent eligibility test. This treatment of salary reduction amounts recognizes that salary reduction represents a cost to the employee. Consequently, the level of the minimum required employee contribution funded through salary reduction determines whether a plan is affordable to nonhighly compensated employees in the same manner as a required employee contribution not funded through salary reduction.

For purposes of the benefits test, salary reduction is treated as an employee contribution in setting the base amount that is multiplied by 133 percent to obtain the limitation on benefits received by the highly compensated employees. Consequently, salary reduction made available to nonhighly compensated employees 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 amount actually received by a highly compensated employee, salary reduction amounts are considered employer contributions. 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 employee.

Without such a rule, an employer could simply provide all health coverage to highly compensated employees in excess of the 133-percent limitation through a salary reduction arrangement. For example, assume that an employer maintains one core health plan providing employee-only coverage that is available to all nonhighly compensated employees. The plan is provided at a premium of $10 per week and has an employer-provided benefit of $500. The employer also maintains a cafeteria plan by which employees may purchase additional coverage through salary reduction. The cafeteria plan contains several core health plans (including family coverage) that are more valuable than the core plan outside the cafeteria plan. In this example, if salary reduction were not considered to be employer-provided, there would be no limit on the amount of tax-favored coverage that could be received by highly compensated employees.

## D. Other Changes to Present-Law Rules

*Election not to test*

Under the bill, an employer may elect to forego testing and instead include the employer-provided benefit for health coverage as taxable income on the W-2 of highly compensated employees.

*Part-time employees*

Under the bill, employees who normally work less than 25 hours a week are disregarded for purposes of the nondiscrimination tests (compared with 17.5 hours under present law). Mandatory employee premiums may be proportionately increased with respect to those employees that normally work less than 30 hours per week. Thus, for example, the maximum premium limitation with regard to an employee is increased to $14 per week for single coverage ((35/25) x $10) and $35 per week for family coverage ((35/25) x $25). In such a case, for purposes of the benefits test, the part-time employee is considered as eligible for the same employer-provided coverage as a full-time employee (even though the value of the employer-provided coverage is reduced because the employee pays more for the coverage). The allowable increase in the employee premium is calculated using a 35 hour numerator so as not to disadvantage employees who work in industries with a 35-hour work week.

*Leased employees*

The bill creates a safe-harbor that allows an employer to disregard leased employees if certain requirements are met. The rule is similar to the leased employee rules applicable to qualified pension plans. Under the bill, an employer may disregard a leased employee if the leasing company certifies to the employer that such employee has available a core health plan meeting the limitations on mandatory employee contributions contained in the eligibility test. This rule, like the rule in the pension plan area, is only available if leased employees do not constitute more than 20 percent of the employer's nonhighly compensated workforce. Of course, the employer will fail the nondiscriminatory provision requirement with regard to all health coverage if the employer has knowledge that the core health plan of the leasing organization is not meaningful.

*Employees covered by a collective bargaining agreement*

The bill provides that plans maintained pursuant to collective bargaining agreements are tested separately. The rule is to be applied on a bargaining unit by bargaining unit basis. Thus, when testing benefits provided to employees covered by a collective bargaining agreement, an employer may not consider other employees. Similarly, an employer may not consider employees covered under a collective bargaining agreement, when testing benefits provided to its other employees.

*Former employees*

As under present law, the nondiscrimination tests are applied separately to former employees of the employer. The bill delays the application of section 89 to former employees for one year, to 1990. In addition, generally no employee that separates from service prior to January 1, 1990, is to be considered in determining whether the employer meets section 89 with respect to its former employees.

*Definition of highly compensated employees*

The bill amends the definition of who constitutes a highly compensated employee for purposes of section 89. Under present law, an employer will always have at least one highly compensated officer regardless of that officer's compensation. Under the bill, only officers with compensation in excess of $45,000 must be considered highly compensated employees. This rule will benefit employers who, but for the present-law rule, would have no highly compensated employees. These employers include many municipalities and tax-exempt organizations.

*Plans other than health plans*

Under present law, group-term life insurance plans are subject to the section 89 rules. To further simplify section 89, the bill generally provides that the nondiscrimination rules in effect prior to the Tax Reform Act of 1986 apply to group-term life insurance. The nondiscrimination rules contained in section 129 as amended by the Tax Reform Act of 1986 apply to dependent care assistance programs.

*Failure to comply with qualification rules—excise tax on employer*

An employer's fringe benefit plans are required to meet certain minimum standards, for example, that the plan be in writing, that employees be notified of plan provisions, and that the plan be maintained for the exclusive benefit of employees. Under present law, if an employer's plan does not satisfy these requirements, then all employees must include in income the value of benefits (e.g., reimbursements for health care) received under the plan.

The bill replaces the present-law sanction with an excise tax on the employer. The excise tax is equal to 34 percent of the cost to the employer relating to the coverage that failed the qualification requirements. Generally, the cost to the employer is the applicable premium calculated under the health care continuation rules relating to all coverage under the failed plan. It is intended that certain rules under the section 89 proposed Treasury regulations, including those relating to severable coverage and correction shall apply in determining the amount of the tax under this provision.

## E. Effective Date

The bill is effective for plan years beginning in 1990. However, the employer may use either present law or the new rules for 1989. In addition, for 1989 it is intended that the employer may use the new rules relating to part-time, leased, former, highly compensated, and union employees without regard to whether the employer chooses to test its plans under the new tests. The rule relating to the sanction under the qualification rules and the rule allowing an employer to forego testing are effective for plan years beginning after December 31, 1988.

## IV. ISSUES

The major issues raised to date under section 89 deal with the ules as applied to health plans. Thus, the following discussion reıtes only to health care coverage.

### *'omplexity; recordkeeping requirements*

Many employers argue that the present-law section 89 nondiscimination rules are overly complex and impose burdensome recrdkeeping requirements. For example, if an employer elects to ıst family coverage separately from individual coverage and to disıgard individuals with other coverage, under present law, the emloyer is required to obtain sworn statements from its employees ttesting to the employee's family status and to whether the emloyee (and his or her family) is covered under a plan of another nployer (e.g., a spouse's plan). In addition, regardless of the emoyer's testing method, the employer has to determine what indiduals have elected to participate in each plan of the employer. ome employers do not currently obtain and maintain such inforation, or do not do so in the systematic manner required to demıstrate compliance with section 89.

Some employers, particularly small employers, argue that the alrnatives available in applying the nondiscrimination rules only rve to make the rules more complex.

On the other hand, much of the complexity of the present-law ıles is the direct result of the desire of the Congress to allow emoyers greater flexibility in designing their benefit plans. Because e benefit plans of employers differ greatly in design, various opons and elections that employers may use to demonstrate compliıce with section 89 are arguably necessary to account for such sign differences. Many of the present-law rules, e.g., the rules rmitting the separate testing of family coverage and the provions added in the TAMRA, were the direct result of input from nployers and health-care providers who argued that such rules sed the burdens of section 89.

Also, some of the rules adding to the perceived complexity of secon 89 are elective on the part of an employer. For example, an ıployer is not required to test its plans under all possible meths, but may test under any one of the available methods. Thus, e employer may choose to limit the amount of testing to which it subject under present law.

Some employers have also argued that the lack of a permanent le for valuing health benefits makes the rules more difficult to ply. Thus, some employers have argued that the temporary valuion rule added by TAMRA should be made the permanent valuion rule.

***Responses to nondiscrimination requirements***

Some have argued that the overall effect of the section 89 nondi crimination rules will be to decrease health insurance coverage individuals, rather than to promote the expansion of such coverag to those employees who need the coverage the most. Under th theory, for some employers, the costs of compliance with section 8 outweigh the benefits of maintaining employer-provided accider and health plans and, therefore, it is most economical for such en ployers to eliminate the coverage rather than to comply with th nondiscrimination requirements.

This argument is countered by those who point out that an en ployer's decision whether or not to maintain a health plan is ofte driven by the demands of the labor market from which the emplo er draws. This effect of the labor market is particularly apparer in the case of medium- and large-sized employers who must pa competitive wages and benefits in order to maintain an adequa workforce.

Further, some point out that the response of an employer to no discrimination requirements is likely to depend upon the degree which the employer's plans fail to satisfy the requirements. If th failure to satisfy the nondiscrimination requirements occurs b cause of the failure to provide an accident and health plan to a re atively small number of employees, an employer may be willing extend coverage to those employees, thereby satisfying the polic goal of expanded coverage.

On the other hand, if an employer's failure to satisfy the nondi crimination requirements occurs because of a particularly genero plan provided primarily to its highly compensated employees, th employer may not be willing to eliminate the coverage to satis the section 89 rules. In such a case, the employer will include th value of the discriminatory coverage as taxable income on th W–2s of its highly compensated employees and may decide to increa such employees' salaries by the additional tax the employees w pay on the discriminatory benefits. The policy objectives of th nondiscrimination rules are also being satisfied in such a case b cause the Federal Government is no longer subsidizing health be efits that are disproportionately provided to highly compensat employees.

In the case of small employers, some argue that the demands the labor market will not be as significant because such employe often draw workers who are not highly skilled or organized. Fu ther, the costs of compliance may be larger as a percentage of tot costs of wages and benefits than they would be for larger emplo ers. In such cases, an employer may view the cost of complyi with the nondiscrimination requirements as a significant deterre to the continued maintenance of a health plan.

On the other hand, some argue that, even for small employe there are advantages to maintaining a health plan at least on after-tax basis for the benefit of group insurance rates, employ morale, and recruitment and retention of skilled highly compens ed employees.

*Part-time employees*

Many employers argue that the present-law definition of part-time employee (employees who normally work more than 17.5 hours per week) is unduly restrictive, and does not conform to normal business practices in certain industries. They argue that it is unrealistic to expect employers to expand coverage to employees whose health benefits constitute a significant percentage of their overall wages. Moreover, some employers contend that it is currently difficult to obtain insurance for part-time employees.

Because of these problems, some employers have argued that the 17.5-hour standard should be increased, or that the requirement that part-time employees be taken into account should be phased-in over time.

Others argue that part-time employees should be taken into account under the nondiscrimination tests because such employees constitute a significant portion of the individuals without any available health care coverage. They point out that section 89 does not require that an employer provide coverage to part-time employees. Rather, if such an employee does not have coverage (from the employer or another employer, such as under the plan of a spouse), the fact that the employee cannot be ignored reduces the likelihood that the employer can pass the nondiscrimination tests. This result is consistent with one of the general purposes of section 89, which is to reduce the tax subsidy of employer-provided health coverage if an employer has a significant number of nonhighly compensated employees without health coverage (whether from the employer or from another employer).

Further, some argue that one reason that the nondiscrimination requirements do not require an employer to make health plans available to all of its employees is to permit the employer flexibility in determining the classes of employees who are excluded from eligibility for the employer's health plans beyond those classes of employees that are automatically excluded from consideration. Under this argument, the nondiscrimination requirements already take into account the problems employers face with respect to providing health benefits to rank-and-file employees by allowing the employer to offer coverage to less than 100 percent of its workforce and still satisfy the nondiscrimination requirements.

*Employees covered by collective bargaining agreements*

Under present law, most employers are required to take employees covered by collective bargaining agreements into account in applying the nondiscrimination tests. This requirement can help an employer pass the nondiscrimination tests if the union has bargained for benefits that are generous relative to the benefits provided to the employer's other nonhighly compensated employees. On the other hand, this requirement can make it more difficult for an employer to pass the tests if a significant portion of the employer's employees are covered under a collective bargaining agreement that provides less generous benefits than those generally provided to the employer's other employees.

Some have argued that the collective bargaining process should not affect the employer's other employees and that the benefits provided outside the bargaining agreement should not affect the employees covered by the agreement. For example, under present law, a highly compensated union employee may be required to include the value of health coverage in income because the employer provides lower benefits to its rank-and-file nonunion employees, even though all union employees receive the same benefits. Some people believe that present law may give a union inappropriate leverage in the negotiation of a collective bargaining agreement if the employer cannot satisfy the nondiscrimination requirements because of the benefits provided to collectively bargained employees. Thus, some people argue that plans maintained pursuant to a collective bargaining agreement should be tested separately from other plans of the employer. Such a rule would be more consistent with the treatment of union employees under the rules applicable to qualified pension plans.

Others argue for the present-law rule relating to the treatment of collectively bargained employees. Some employers prefer the present-law rule because it aids them in meeting the requirements of section 89. Some argue that the leverage the present-law rule may give the union is appropriate. Requiring union employees to be taken into account may serve to increase the level of coverage of such employees, which is consistent with the general purposes of section 89.

The present-law rule may reduce the level of discrimination in some cases. For example, if an employer's nonunion employees are all highly compensated, then present law would generally prevent the employer from providing a disproportionately high level of benefits to the highly compensated employees. If the union employees are tested separately, however, then there is no limit on the tax-favored benefits that can be provided to the highly compensated employees.

Some also argue that benefits provided pursuant to collective bargaining agreements should not be subject to the nondiscrimination rules. Proponents of this view argue that the operation of the collective bargaining process is sufficient to deal with the policy purposes of section 89 and that the nondiscrimination rules should not be allowed to influence the collective bargaining process. They argue that an exemption is particularly appropriate in the case of multiemployer plans (i.e., plans maintained by more than one employer). Under this view, recordkeeping presents particular problems in the case of such plans, because the employer may not know what the benefits are under the plan, or whether an employee is eligible to participate in the plan. However, many of the recordkeeping problems under present law were addressed in TAMRA.

Opponents of an exemption argue that there is no policy justification for exempting collectively bargained plans from nondiscrimination rules. At the very least, tax benefits should be limited if the benefits under the agreement discriminate in favor of high-paid collectively bargained employees if the collectively bargained plan is tested separately.

*Leased employees*

Under present law, in applying the nondiscrimination tests, an employer is required to take into account certain individuals who perform services for the employer, other than the common-law employees of the employer. These individuals, called leased employees, are generally defined as individuals who perform services for the employer of the type normally performed by an employee on a substantially full-time basis, even though the individual is nominally employed by another employer. Leased employees must be taken into account by an employer for purposes of the nondiscrimination rules applicable to qualified retirement plans as well as the section 89 rules.

The leased employee rules are designed to prevent circumvention of the nondiscrimination rules. For example, suppose a doctor maintains a health plan for himself, but does not cover his nurses or his office administrative staff (e.g., a secretary). Instead of directly employing his nurses and administrative staff, he leases them from a leasing organization. Without the leasing rules, the doctor would be able to exclude his nurses and staff from the doctor's benefit plans, and provide generous benefits to himself, even though the nurses and staff work only for him and work on a substantially full-time basis.

Many employers argue that taking their leased employees into account under section 89 creates significant administrative problems. Their main concern is that it is difficult to identify leased employees because the statute and Treasury regulations contain a broad definition of who constitutes a leased employee. They argue that leased employees should be ignored in applying the nondiscrimination rules.

Others argue that disregarding leased employees would permit employers to avoid the nondiscrimination rules. Moreover, many leased employees have no health coverage. Thus, disregarding leased employees could undermine one of the policy objectives of section 89.

Some alternative modifications to section 89 have been suggested that would deal with employer concerns without undermining section 89's policy objectives, including (1) delaying the effective date of the section 89 rules to leased employees to give the Treasury Department time to develop alternative rules for leased employees, (2) modifying the definition of a leased employee, and (3) providing that leased employees do not have to be taken into account if they are covered by a safe harbor health plan of the leasing organization. The last alternative is similar to the approach under the rules applicable to qualified retirement plans.

*Former employees*

Some employers do not have the information necessary to apply the nondiscrimination rules to employees who have already separated from service, and thus argue for a delay in applying the nondiscrimination rules to former employees.

Opponents of delay of the rules to former employees argue that recordkeeping requirements for former employees were adequately addressed in TAMRA. Under TAMRA, employees who separated from service prior to January 1, 1989, can generally be ignored for purposes of the nondiscrimination rules. However, employees who separated from service prior to January 1, 1989, may not be disregarded if their benefits are changed; this restriction may reduce significantly the former employees who may be disregarded because benefit changes are not uncommon.

In addition, some employers argue that it is difficult to maintain records for any former employees and that section 89 will require them to maintain records for all terminated employees. Thus, they argue that the nondiscrimination rules of section 89 should not be applied to former employees.

Those opposed to this view argue that it is appropriate to apply nondiscrimination rules to former employees for the same reasons that nondiscrimination rules are applied to benefits of active employees. For example, without nondiscrimination rules, an employer could provide retiree health benefits only to its retired key executives. Moreover, it is argued that present law permits an employer to impose reasonable age and service requirements on the receipt of benefits by former employees (e.g., attainment of age 55 with 10 years of service). Thus, the employer will not be required to track all of its former employees in order to apply the tests.

*Salary reduction arrangements*

Many employers maintain plans that permit an employee the choice between receiving cash or purchasing nontaxable benefits, such as health coverage. These plans are generally referred to as cafeteria plans or salary reduction arrangements, and the contributions made by employees to purchase benefits are generally called salary reduction contributions. Salary reduction contributions generally are not included in the taxable income of the employee.

Many employers have adopted cafeteria plans in order to take advantage of the flexibility and tax benefits such arrangements provide to employees. For example, some employers permit employees to pay the mandatory employee premium for health coverage on a salary reduction basis.

A medical reimbursement account (or flexible spending arrangement) is a type of salary reduction arrangement. Under a flexible spending arrangement, the employee can elect the amount contributed to the account, and then use such amounts to purchase health coverage for benefits not otherwise covered by insurance (e.g., to pay deductibles under the health insurance plan or to pay for items that might not be covered by insurance, such as orthodontia expenses). These expenses, if reimbursed through coverage under a flexible spending arrangement, are not included in the taxable income of the employee, notwithstanding the fact that identical expenses paid with after-tax dollars may not have the same tax-favored treatment because medical expenses of individuals are not deductible unless they exceed 7.5 percent of the individual's adjusted gross income.

Some employers and employees like the flexibility of a cafeteria plan because it lets each employee tailor the nontaxable benefits the employee receives to his or her own needs. Further, some employers consider salary reduction arrangements an essential method by which they can shift a portion of the ever increasing cost of health coverage to the employee. These employers argue that they could no longer afford to provide health coverage to their employees without the cost savings they realize through these salary reduction arrangements. Implicit in this argument is the asımption that the employees are willing to bear a cost of benefits ı a pre-tax basis that they are unwilling to bear on an after-tax asis.

On the other hand, some argue that, although salary reduction rrangements permit cost shifting, they do not contribute to overll health cost containment. Such arrangements and, in particular, exible spending arrangements may serve to increase health costs y subsidizing overutilization of health care services, particularly if ıey permit employees to pay for first-dollar coverage (e.g., coverge below the deductible limit in the insurance policy) on a tax-prerred basis.

In applying nondiscrimination rules to salary reduction contribuons, the key issue is whether such amounts should be considered s employee or as employer contributions to an employee benefit an.

Some argue that the primary impact of salary reduction contriıtions on an employee depends on whether one is evaluating the fordability of health care for purposes of an eligibility test or is ılculating the value of tax-favored benefits an employee actually ceives for purposes of a benefits test. Proponents of this view gue that salary reduction contributions affect whether a rankıd-file employee can afford to participate in a plan. They argue at, aside from certain administrative costs, there is little or no st to the employer in making salary reduction available to emoyees. In addition, such contributions reduce the cash available the employee just as employee after-tax contributions do. Moreer, any eligibility rule that looks to whether coverage is meangfully available to rank-and-file employees could be easily avoid if salary reduction is not taken into account as an employee conibution. Therefore, these individuals argue that salary reduction properly considered an employee cost for rank-and-file employees r purposes of an eligibility test.

Proponents of this view also argue that it is the highly compented who can afford to reduce their salaries and take advantage of e tax benefits of a salary reduction arrangement. Further, salary duction represents significant tax-savings for highly compensated ıployees. Failure to treat salary reduction as an employer contrition for purposes of a benefits test could lead to abuse of any ndiscrimination rule, because an employer could simply provide health coverage to highly compensated employees through lary reduction at no additional cost to the employer or employee.

As an illustration of this point, assume that an employer pays a ghly compensated employee a salary of $5,000 a month and a alth benefit worth $300 a month, $200 of which exceeds the alth benefit that could be provided on a nondiscriminatory basis. e employee's overall monthly comnpensation is $5,300, $5,200 of ıich would be taxable under the nondiscrimination test. If salary luction is not treated as an employer-provided benefit, the emyer could make $200 of salary reduction available to the employ- and reduce the employer-provided health benefit from $300 to )0. Thus, the employee would have $5,200 of salary, but $200 uld not be taxable because the employee would elect $200 of ary reduction to pay for his health benefit. The employee's over- compensation would still be $5,300, $5,000 of which would be taxable, the employer's total compensation costs would be un changed, and the nondiscrimination requirements would be sati fied. Thus, the nondiscrimination rules would have no effect salary reduction contributions are not treated as employer-provide benefits.

There are several alternative methods that might be used to dea with the issues relating to the treatment of salary reduction unde any health coverage nondiscrimination rule. One approach woul be to treat salary reduction amounts as attributable solely to em ployee contributions or employer contributions. However, as di cussed above, such a rule could effectively undermine any nondi crimination rule.

Alternatively, an approach similar to the approach unde present law could be used. (See the discussion of present la above.) This would allow the treatment to vary depending upon th amount of salary reduction available to an individual and th terms under which it is made available. A similar approach migh treat all or a portion of salary reduction available to the rank-an file employees as employer-provided when calculating the amoun actually received by the high paid. On the other hand, such an a proach might be said to defeat the principle of making available a fordable health care coverage.

Another approach would be to recognize as employer-provide the tax savings to the employee achieved through the use of salar reduction. This approach could apply with respect to whether co erage is available to, or received by, an employee. For exampl each dollar of salary reduction available to a nonhighly compensa ed employee could be considered 15-percent employer-provided an 85 percent employee-provided (assuming a 15-percent tax rate wit respect to such employee).

Alternatively, salary reduction could be treated solely or part as employee contributions for purposes of section 89 and the rul relating to cafeteria plans under section 125 of the Code could b tightened in order to ameliorate discrimination concerns under ca eteria plans.

*State and local governmental plans*

Some argue that the nondiscrimination rules of section present special problems for State and local government employer For example, such employers generally have large numbers of em ployees and may not have centralized recordkeeping, making da collection more burdensome. In addition, in some cases it is dif cult to identify who the employer is (e.g., the State government a local government) and thus difficult to determine the proper em ployee group on which to apply the tests.

Because of these issues, some argue for special rules for Sta and local governmental plans. Some also argue that such pla should be exempted from the rules. They argue that, because ben fits under such plans are often determined pursuant to collecti bargaining or State or local law, the benefits are already subject sufficient scrutiny to ensure that they are nondiscriminatory.

Opponents of an exemption for State and local government pla argue that there is no policy justification for exempting such plan

Benefits provided under such plans represent a tax expenditure in the same way that benefits provided under plans of private employers do, i.e., the benefits are excludable from income. Thus, nondiscrimination rules should apply to such plans for the same reason these rules should apply to plans of private employers—to limit the tax expenditure unless the benefits are provided on a nondiscriminatory basis. Moreover, it may be more difficult to justify application of the rules to plans maintained by private employers if governmental plans are exempted.

Such individuals argue that, to the extent public employers have specific concerns with the nondiscrimination requirements, such concerns should be directly addressed. For example, if collectively bargained plans are an issue, then any modification of the treatment of such plans in general should also apply to collectively bargained plans maintained by State and local governments.

*Qualification rules*

The main issue that has been raised with respect to the qualification rules is the sanction for failure to satisfy the rules. Under present law, if a plan fails the qualification rules, then all employees are taxed on the benefits received (e.g., reimbursements for health care) under the plan. This sanction has received considerable attention because of the possibility that a rank-and-file employee could have a large income inclusion if the employee is sick during the year and is covered by a plan that fails the qualification rules. The sanction has been criticized as unfair because it may penalize employees who have no control over, or responsibility for, the failure of the employer to satisfy the rules.

Several alternatives to the present-law sanction have been suggested, including (1) applying the sanction only to highly compensated employees, (2) limiting the amount the of income inclusion (e.g., to a percentage of compensation), (3) limiting the inclusion to the value of coverage in the case of benefits provided through a third-party insurer, and (4) applying the sanction to the employer rather than the employees. An employer sanction could take the form of an excise tax, or the denial of the deduction for the benefits. An excise tax has the advantage that it applies to all employers, not only those that pay taxes.

***Repeal or delay of section 89***

Some have argued that section 89 should be repealed or delayed in order to give employers more time to adjust to the rules, and the Congress more time to modify the rules. Opponents of repeal or delay argue that the nondiscrimination rules serve to fulfill important policy objectives, and that such objectives should not be abandoned. They argue that it is more appropriate to modify the rules to make them less complex without compromising the basic policy objectives. In addition, repeal or delay would have revenue implications that the Congress would be required to address.

***Other issues***

Some employer groups have suggested alternatives to the present-law rules other than repeal or delay. Some employers have advocated a design-based nondiscrimination test. A design-based test is one that an employer can satisfy by designing its benefit program in a certain way. Passage of a design-based test is not dependent on individual employee elections as to coverage so that such a test reduces required recordkeeping.

Some employers have also argued that they should be able to avoid testing simply by including the value of coverage in the income of highly compensated employees. It is not clear under present law whether such an approach is permissible.

Some employers have already incurred significant expense to modify their benefit plans to comply with present law. They argue that they should not be disadvantaged by any changes to section 89.

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