[JOINT COMMITTEE PRINT]

OVERVIEW OF ADMINISTRATION PROPOSAL TO CAP EXCLUSION FOR EMPLOYER-PROVIDED MEDICAL CARE (S. 640) AND OF TAX TREATMENT OF OTHER FRINGE BENEFITS

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

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PREPARED BY THE STAFF

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on June 22, 1983, on the Federal tax treatment of fringe benefits. In its press release announcing the hearing, the committee stated that the hearing would include (1) the Administration's proposal to cap the amount of employer-provided medical care that may be excluded from an employee's income and (2) the public policy and tax compliance implications of the present law tax treatment of other statutory and nonstatutory fringe benefits and the effect of the moratorium on fringe benefit regulations which is scheduled to expire on December 31, 1983.

The first part of the pamphlet is a summary. This is followed by a more detailed overview of Federal tax treatment of certain statutory and nonstatutory fringe benefits, including the Administration's proposal to cap the exclusion for employer-provided medical care (S. 640). The final part sets forth background information, including revenue implications of the tax treatment of certain statutory fringe benefits, and a brief statement of some of the principal tax issues relating to fringe benefits. This pamphlet does not describe the statutory exclusion for employer contributions to qualified pension, profit-sharing or stock bonus plans, qualified annuity plans, or tax-sheltered annuity plans, or any other income tax items which may be considered fringe benefits.

I. SUMMARY

Administration proposal to cap exclusion for employer-provided medical care (S. 640)

In general, amounts paid by an employer to a health plan for the benefit of an employee are not includible in the employee's income for income tax purposes or in wages for employment tax purposes.

Under S. 640, gross income of an employee would include amounts paid by the employer to a health plan for the employee to the extent the amounts paid exceed specified dollar amounts. These threshold limits would be $175 per month for family coverage and $70 per month for individual coverage. In addition, the amount includible as income would also be subject to social security, railroad retirement, and unemployment payroll taxes.

The effective date of these provisions would be for payroll periods beginning after December 31, 1983. A phase-in period would apply for health plans in which contributions are contractually fixed as of January 31, 1983.

Statutory exclusions for certain other fringe benefits

As a general rule, if an employer-provided fringe benefit program qualifies under certain statutory provisions of the Code, then the benefits provided under the program are excludable (generally, subject to dollar or other limitations) from the employee's gross income for income tax purposes. (The income tax exclusions also generally apply for payroll tax purposes.) Those costs which are excluded from the employee's income nonetheless are deductible by the employer (as are costs not so excluded), provided that they constitute ordinary and necessary business expenses.

The tax statute provides, among others, specific exclusions with respect to employer provision of (1) up to $50,000 of group-term life insurance; (2) up to $5,000 of death benefits; (3) accident or health benefits; (4) parsonage allowances; (5) certain benefits provided to members of the Armed Services; (6) meals and lodging for the convenience of the employer; (7) legal services; (8) commuting through use of a van pool; (9) employee educational assistance; and (10) dependent care assistance.

Tax treatment of nonstatutory fringe benefits

The Internal Revenue Code defines gross income as including "all income from whatever source derived" and specifies that it includes "compensation for services" (sec. 61). The U.S. Supreme Court has held that Code section 61 "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."

In actual practice, however, the economic benefit test has not been rigidly followed in all situations. Thus, where compensation is paid in some form other than cash, issues as to taxability of certain fringe benefits have been resolved by statutory provisions, regulations, and administrative rulings and practices which take account of several different factors.

The Economic Recovery Tax Act of 1981 extended through 1983 the moratorium on issuance of Treasury regulations relating to the income tax treatment of nonstatutory fringe benefits.

II. DESCRIPTION OF ADMINISTRATION PROPOSAL TO CAP EXCLUSION FOR EMPLOYER-PROVIDED MEDICAL CARE (S. 640)

Present Law

Exclusion for income and employment tax purposes

Under present law, amounts paid by an employer to a health plan for compensating an employee (through insurance or otherwise) for personal injuries or sickness are not includible in the employee's gross income for income tax purposes (Code sec. 106) or in the employee's wages for purposes of employer or employee social security (FICA), railroad retirement (RRTA), or unemployment insurance (FUTA) payroll taxes (secs. 3121(a)(2), 3231(e), and 3306(b)(2)).

Also, benefits paid to an employee under an employer health plan are generally excluded from gross income for income tax purposes, and from wages for employment tax purposes, if the benefits are paid directly or indirectly to the employee as reimbursement for expenses incurred by the employee, or the employee's spouse or dependents, for medical care (sec. 105(b)). However, benefits paid under certain self-insured medical reimbursement plans may be includible in the gross income of officers, 10-percent shareholders, and certain highly compensated individuals if the plans discriminate in favor of these individuals (sec. 105(h)).

Deductions for medical care expenses

A deduction generally is allowed to an employer as an ordinary and necessary business expense for employee compensation paid in the form of contributions to a health plan (sec. 162).

Individuals (whether or not employees) who itemize deductions may claim a deduction for their expenses for medical care, including premiums for health insurance, paid during the year to the extent that such expenses exceed five percent of the individual's adjusted gross income and are not reimbursed by insurance (sec. 213). The five-percent floor replaces the prior-law three-percent floor for taxable years beginning after 1982.

Medical care means amounts paid for (1) the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body; (2) transportation primarily for and essential to such medical care; and (3) insurance premiums to the extent that such insurance covers expenses of medical care (sec. 213(d)(1)). Under Treasury regulations, the itemized deduction is limited to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness. An expenditure which is merely beneficial to the general health of an individual or for the alleviation of physical or mental discomfort

which is not related to some particular disease or defect is not an expenditure for medical care.[1]

Explanation of Provisions

In general

The bill would establish a maximum exclusion for employer contributions to an employee health plan providing for medical care. The maximum would apply for income tax purposes and for purposes of the employer's and employee's FICA and RRTA liability, the employer's FUTA liability, and income tax withholding.

The maximum would be $175 per month for family coverage for calendar year 1984. A correspondingly lower limit on the exclusion ($70 per month) would apply for "employee-only" coverage for 1984.[2] These exclusion limits would be indexed each year thereafter by the average of the Consumer Price Index for All Urban Consumers for the 12-month period ending on the June 30 prior to the calendar year in which the limits apply.

The amount of an employer contribution to a health plan with respect to coverage of an employee would be the cost of the coverage of the employee reduced by any contributions made by the employee for such coverage. Any cost of providing coverage under a plan allocable to worker's compensation or for a purpose other than the providing of medical care would not be considered as employer contributions to an employee health plan.

Under the bill, the amount of employer contribution exceeding the relevant dollar cap for a month (the "excess employer contribution") would be prorated according to the length of the payroll period. The excess employer contribution for a payroll period would be treated as compensation paid to the employee in cash on the earliest date on which any other compensation for such payroll period is paid to the employee or included in the employee's gross income.

Health plan definition

Health plans would be defined by the bill to include employer plans that provide (through insurance, reimbursement, or otherwise) to employees and their families the types of medical care that would be deductible if purchased by the individual employee. However, the bill would not apply to benefits under a plan for providing medical care for individuals in active service in the Armed Forces of the United States or for the families of such individuals.

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[1] See Regs, sec. 1.213-1(e)(1)(ii). For example, the Internal Revenue Service has held that payments for weight reduction or smoking prevention programs do not qualify as expenses for medical care under section 213 where participation in such programs was not for the purpose of curing any specific ailment or disease (Rev. Rul. 79-151, 1979-1 C.B. 116; Rev. Rul. 79-162, 1979-1 C.B. 117). However, in a subsequent letter ruling, the Revenue Service treated the costs of a weight reduction program as medical care expenses deductible under section 213 where two physicians had expressly prescribed such a program for purposes of treating and curing the taxpayer's hypertension, obesity, and hearing problems which were directly related to the taxpayer's excessive weight (IRS Ltr. Rul. 8004111, Oct. 31, 1979).

[2] In any case where an employee has coverage other than individual coverage, and the employee has no spouse or dependent who is actually covered by reason of the employee's coverage, the employee would have to notify the employer of such fact. For purposes of the bill, such an employee would be treated as having individual coverage.

The bill would prescribe rules for computing the cost of a health plan and of the employer contribution to a health plan. If a group of employees is offered a choice of coverage which differs from that offered to a second group of employees, each group would be treated as covered by a separate plan. Individuals whose primary health insurance coverage is under Medicare (title XVIII of the Social Security Act) would be treated as receiving different coverage from individuals whose primary health insurance coverage is not under Medicare.

Cost determination

The cost of coverage under a plan for a payroll period would be determined prior to the beginning of a payroll period and would be redetermined at least every 12 months. The cost of coverage would be redetermined whenever there were significant changes in coverage or in the composition of the group of employees covered. Under the bill, the employer would determine the cost of coverage separately for individual coverage and family coverage under each of the employer's plans.

The cost of coverage for a payroll period would be the aggregate annual cost for all employees covered under the plan divided by the number of such employees and further divided by the number of payroll periods in the year. The annual cost of providing coverage under a plan would be the cost to the employer of insurance for any insured coverage, plus all costs incurred by the employer with respect to noninsured coverage. Noninsured coverage means any coverage the risk of which is not shifted from the employer to a third party. Therefore, the liability incurred for benefit payments (those not covered by a third party) plus all other costs, including administrative costs, incurred with respect to the plan is considered a noninsured cost. In lieu of determining the actual amount of other costs, an employer could treat an amount equal to seven percent of the liability incurred for benefit payments which are not covered by a third party as equal to such other costs. If the cost to the employer of insurance reflects the employer's prior experience under the plan, an average cost of insurance based on premiums for the three immediately preceding years could be used.

If actual costs of coverage cannot be determined in advance, the cost of coverage would be based on a reasonable estimate. If such estimates are determined not to be reasonable and are lower than the actual cost of coverage, then the employer or multiemployer plan to which an employer makes contributions would be liable for the taxes that would have been imposed, computed using the actual cost of coverage. In this case, the taxes would be computed by assuming that the excess employer contribution had been included, for the calendar year in which the payroll period begins, in the taxable income of each employee. The computations would be based on the assumptions that the (1) employee is subject to the maximum rate of tax imposed upon individuals, (2) the individual's remuneration (including such excess) had not reached the maximum wage base for purposes of FICA taxes, and (3) the individual's remuneration for employment (including such excess) for the calendar year exceeded $6,000.

Multiemployer plans

The bill provides special rules for computing the employer's payroll tax and withholding tax liability with respect to employer contributions to a multiemployer health plan.[3] With respect to an employee for a payroll period, the excess employer contribution in this case would be equal to a fraction of each contribution made to the plan. The numerator of this fraction would be the excess employer contribution for one month (as determined by the multiemployer plan) and the denominator would be the total employer contributions for one month, both determined with respect to coverage of all employees under the plan. For this purpose only, the excess employer contribution could be determined on the basis of a single cost of coverage and a single dollar limit for both individual and family coverage. Such cost and limit each would be based on an average of the separate cost of coverage or the separate limit for each type of coverage (family or individual), with the average weighted to take into account the percentage of employees having each type of coverage.

For purposes of determining the employee's income and payroll tax liability, the amount of excess employer contributions would be determined by the multiemployer plan in the same manner as if the plan were the employer. That is, this liability would be based on a separate determination by the plan of the amount by which the cost of providing individual or family coverage exceeds the applicable limit. The bill would provide that each multiemployer plan which includes an employee health plan for which there are excess employer contributions for a calendar year must provide an information report to each employee with respect to whom such contributions to the plan were made during the calendar year. The report would have to be furnished by February 1 of the succeeding year and would have to include the amount of the excess employer contributions with respect to the employee for the calendar year and the amount of employer contributions that were treated by employers as excess employer contributions included in the gross income of the employee.

Employment tax amendments

If the taxes imposed on an employee by FICA or RRTA with respect to excess employer contributions which constitute wages exceed the portion of such tax which can be collected by the employer from the wages of the employee, then the employee would pay the excess. Income tax withholding liability on excess employer contributions would apply only to the extent that the amount can be deducted by the employer.

Effective Date

The provisions of the bill generally would apply to payroll periods beginning after December 31, 1983, in taxable years ending after such date.

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[3] A multiemployer plan is an employee welfare benefit plan (within the meaning of section 3(1) of the Employee Retirement Income Security Act of 1974) to which more than one employer is required to contribute and which is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer.

In health plans in which employer contributions are fixed by terms of a legally binding contract in effect on January 31, 1983, the provisions of the bill would apply to the earliest of January 31, 1986, or the first date on which the amounts of the employer contributions are no longer fixed by the terms of the contract, or the first date on which the contract is or could be extended, renegotiated, or reopened or altered.

Revenue Effect

The bill is estimated to increase fiscal year budget receipts as follows:

[In billions of dollars]

	1984	1985	1986	1987	1988
Income tax	1.5	3.0	4.0	4.9	6.1
Payroll tax	.6	1.1	1.4	1.7	2.2
Total	2.1	4.1	5.4	6.6	8.3

III. OVERVIEW OF TAX TREATMENT OF CERTAIN STATUTORY FRINGE BENEFITS

In general

As a general rule, if an employer-provided fringe benefit program qualifies under certain statutory provisions of the income tax law, then the benefits provided under the program are excludable (generally, subject to dollar or other limitations) from the employee's gross income for income tax purposes. (The income tax exclusions also generally apply for payroll tax purposes.) Those costs which are excluded from the employee's income nonetheless are deductible by the employer (as are costs not so excluded), provided that they constitute ordinary and necessary business expenses (sec. 162).

The tax statute provides, among others, specific exclusions with respect to employer provision of (1) up to $50,000 of group-term life insurance; (2) up to $5,000 of death benefits; (3) accident or health benefits; (4) parsonage allowances; (5) certain benefits provided to members of the Armed Services; (6) meals and lodging for the convenience of the employer; (7) legal services; (8) commuting through use of a van pool; (9) employee educational assistance; and (10) dependent care assistance.

Nondiscrimination rules

Under present law, rules prohibiting discrimination in favor of owners, officers, shareholders and highly compensated employees are provided for many of different statutory fringe benefits. These rules generally prohibit discrimination as to eligibility to participate. A plan or program generally is required to meet the eligibility requirement by covering a classification of employees determined by the Internal Revenue Service not to result in prohibited discrimination. A self-insured medical reimbursement plan or group-term life insurance plan may also satisfy the requirement by covering a stated percentage of the employer's employees.

The eligibility rules generally permit employees covered by a collective bargaining agreement to be excluded from consideration if the benefits provided by the plan or program were the subject of good faith bargaining between the employer and employee representatives. The eligibility rules for self-insured medical reimbursement plans also provide that employees need not be taken into account if they have not completed three years of service, have not attained age 25, or are part-time or seasonal employees.

The present-law nondiscrimination rules applicable to certain types of fringe benefit plans and programs also prohibit discrimination as to contributions or benefits. With respect to self-insured medical reimbursement plans, present law specifically requires that all benefits available to officers, 10-percent shareholders, or

highly compensated individuals must also be available to all other plan participants.

Under present law, if a plan is determined to discriminate in favor of employees who are officers, shareholders, or highly compensated, the otherwise applicable income exclusion generally is denied for all benefits provided under the plan, including those benefits provided for rank-and-file employees. (The nondiscrimination rules generally do not provide express guidance as to when an employee is considered highly compensated, or the extent of stock ownership required before an employee is considered a shareholder.) However, under a discriminatory self-insured medical reimbursement plan or group term life insurance plan, only those employees with respect to whom discrimination is prohibited are required to include amounts in gross income. Other employees retain the benefit of the income exclusion.

Group term life insurance

Under present law (sec. 79), the income exclusion for the cost of employer-provided group term life insurance is subject to several limitations: (1) the exclusion is limited to the cost of the first $50,000 of such insurance on the employee's life, computed pursuant to tables prescribed by the Treasury Department; (2) no exclusion is provided for any "key employee" (officers, five-percent owners, one-percent owners with compensation in excess of $150,000, and certain employee-owners) if the program discriminates in favor of key employees as to either eligibility to participate or the life insurance benefits actually provided under the plan; and (3) no exclusion is provided for self-employed individuals (sole proprietors or partners).

Death benefits

Present law generally excludes from a beneficiary's gross income certain benefits paid by or on behalf of an employer by reason of an employee's death (sec. 101(b)). This exclusion is subject to several limitations: (1) only the first $5,000 of benefits attributable to any one employee is eligible for the exclusion; (2) amounts which are income in respect of a decedent (e.g., uncollected salary or unused vacation pay) are not eligible for the exclusion; (3) no exclusion is provided for amounts with respect to which the employee had a nonforfeitable right to receive the benefits, unless the source of payment is a qualified pension, profit-sharing, or stock bonus plan or certain annuity plans; and (4) no exclusion is provided for amounts received under certain joint and survivor annuities where distribution to the participant had commenced prior to death. The exclusion generally is not available to self-employed individuals.

Accident and health benefits

Under present law, an employer's contributions to a plan providing accident or health benefits are excludable from the employee's income (sec. 105). No exclusion is provided for self-employed individuals.

Benefits actually paid under accident and health plans generally are includible in gross income to the extent attributable to employer contributions. However, payments unrelated to absence from

work and reimbursements for costs incurred for medical expenses (within the meaning of sec. 213) are excluded from gross income. In the case of self-insured medical reimbursement plans (sec. 105(h)), no exclusion is provided for benefits paid to any employee who is an officer, 10-percent shareholder, or highly compensated if the program discriminates in favor of this group as to either eligibility to participate or the medical benefits actually provided under the plan.

Parsonage allowances

Present law permits a minister of the gospel to exclude from gross income the rental value of a home provided as a part of compensation, or a rental allowance paid as compensation to the extent used to rent or provide a home (sec. 107). The exclusion is subject to several restrictions: (1) the amount of the exclusion is limited to the rental value of the home or actual amounts paid to rent or provide a home; (2) the exclusion is available only if the home or rental allowance is paid as remuneration for services; and (3) the exclusion for rental allowance is available only if the employer designates such payment as a rental allowance in advance of payment.

Benefits provided to members of the Armed Forces

Present law permits military personnel to exclude a variety of in-kind benefits and cash payments from gross income. Specific exclusions apply to certain disability pensions (sec. 104(a)(4)); qualifying combat pay (sec. 112); mustering-out payments (sec. 113); and subsistence, housing, and uniform allowances, as well as the value of quarters or subsistence provided in kind (Regs. sec. 1.61-2(b)).

Meals and lodging for the employer's convenience

Present law excludes from gross income the value of certain meals or lodging furnished to an employee (or to the employee's spouse or dependents) by or on behalf of the employer for the convenience of the employer (sec. 119).

The exclusion for meals is available only if the meals are furnished (1) on the employer's business premises and (2) for the convenience of the employer.

The exclusion for lodging is available only if (1) the lodging is furnished on the employer's business premises; (2) the lodging is furnished for the convenience of the employer; and (3) the employee is required, as a condition of employment, to accept such lodging.

Legal services

Present law excludes from gross income employer contributions to a qualified prepaid legal services plan, as well as the value of any legal services received by, or amounts paid as reimbursement for legal services for, the employee, or the employee's spouse or dependents (sec. 120). Also, the exclusion is available to self-employed individuals covered by qualified prepaid legal services plans.

This exclusion is subject to several limitations: (1) the program may provide only for personal (i.e., nonbusiness) legal services; (2) no exclusion is available if the program discriminates in favor of employees who are officers, shareholders, or highly compensated,

as to either eligibility to participate or the benefits provided under the plan; and (3) no more than 25 percent of the employer contributions to the plan may be attributable to the group consisting of employees (and their spouses and dependents) who own more than five percent of the stock or of the capital or profits interest in the employer.

This exclusion is scheduled to terminate for taxable years ending after 1984.

Van pooling

Present law excludes from an employee's gross income the value of certain employer-provided transportation between an employee's residence and place of employment (sec. 124).

This exclusion is subject to several limitations: (1) the exclusion is available only for transportation furnished through use of a commuter van; (2) no exclusion is provided if the van-pooling arrangement discriminates in favor of employees who are officers, shareholders, or highly compensated; and (3) no exclusion is permitted for self-employed individuals (sole proprietors and partners).

The exclusion for van pooling is scheduled to terminate for van pooling provided in taxable years beginning after 1985.

Employee educational assistance

Present law excludes from an employee's gross income amounts paid for employer-provided educational assistance pursuant to a qualifying educational assistance program (sec. 127). Also, the exclusion is available to self-employed individuals (sole proprietors or partners).

The exclusion is subject to several limitations: (1) qualifying educational benefits are limited to the cost of tuition, fees, and similar payments as well as the cost of books, supplies, and equipment (i.e., no exclusion is provided for the costs of meals, lodging, or transportation); (2) no exclusion is provided for educational assistance furnished for courses involving sports, games, or hobbies; (3) no exclusion is provided for educational assistance furnished to an employee's spouse or dependents; (4) no exclusion is provided if the program discriminates in favor of employees who are officers, shareholders, or highly compensated; (5) no exclusion is provided if more than five percent of the total benefits paid is for the group consisting of employees who own more than five percent of the stock or of the capital or profits interest in the employer (or their spouses or dependents); and (6) the educational assistance program may not be part of a cafeteria plan.

This exclusion is scheduled to terminate for taxable years beginning after 1983.

Dependent care assistance

Present law excludes from an employee's gross income amounts paid or incurred by an employer for dependent care assistance provided under a qualified dependent care assistance program (sec. 129). Also, the exclusion is available to self-employed individuals (sole proprietors or partners).

This exclusion is subject to several limitations: (1) the amount excluded may not exceed the employee's earned income (or, if the em-

ployee is married, the lower of the earned income of the employee or the employee's spouse); (2) the exclusion is only provided for expenses for household services or care of qualifying individuals (dependents under the age of 15 or physically or mentally incapacitated dependents or spouses) which are incurred to enable the taxpayer to be gainfully employed; (3) no exclusion is provided for amounts paid for qualifying services rendered by the employee's dependent or any child of the employee who is under the age of 19; (4) no exclusion is provided if the dependent care assistance program discriminates in favor of employees who are officers, owners, or highly compensated individuals (or their dependents); and (5) no exclusion is provided if more than 25 percent of the total benefits paid are for the group consisting of employees who own more than five percent of the stock or of the capital or profits interest in the employer (or their spouses or dependents).

Cafeteria plans

Under a cafeteria plan, an employee may choose from a package of employer-provided fringe benefits, some of which are taxable (e.g., group-term life insurance in excess of $50,000) and some of which are nontaxable (e.g., health and accident insurance). Under present law, the mere availability of cash or taxable benefits under a cafeteria plan will not cause an employee to forfeit an otherwise applicable income exclusion (sec. 125). Thus, benefits generally are excluded to the extent that nontaxable benefits are elected.

No exclusion is permitted, however, if the cafeteria plan discriminates in favor of highly compensated individuals as to eligibility or as to benefits or contributions. A highly compensated individual includes an officer, a 5 percent shareholder, a highly compensated individual, or a spouse or dependent of any of the preceding individuals.

Voluntary employees' beneficiary associations

Under present law, the income of a voluntary employees' beneficiary association (VEBA) is exempt from Federal income tax provided that (1) the VEBA provides for the payment of life, sick, accident, or other benefits to members and dependents; (2) substantially all of the operations are to provide such benefits; and (3) no part of the VEBA's net earnings inure (other than through such payments) to the benefit of any private shareholder or individual (sec. 501(c)(9)).

Benefits which may be provided by a VEBA include life, sick, or accident benefits and other similar benefits intended to safeguard or improve the health of a member or member's dependents or to protect against a contingency that interrupts or impairs a member's earning power. For example, such benefits include vacation benefits, vacation facilities, subsidized recreational activities, child care facilities, and job adjustment allowances. (Reg. sec. 1.501(c)(9)-3(e)).

Under Treasury regulations, a VEBA may not discriminate as to eligibility or as to benefits in favor of officers, shareholders, or highly compensated individuals. (Reg. sec. 1.501(c)(9)-2(a)).

Present law permits an employee receiving cash or noncash benefits from a VEBA to exclude the value of the benefit from

gross income to the extent otherwise permitted by specific Code provisions granting income exclusions. (Reg. sec. 1.501(c)(9)-6).

Similar rules apply to trusts for the payment of supplemental unemployment benefits (sec. 501(c)(17)).

IV. OVERVIEW OF TAX TREATMENT OF NONSTATUTORY FRINGE BENEFITS

Background

The Internal Revenue Code defines gross income as including "all income from whatever source derived," and specifies that it includes "compensation for services" (sec. 61). Treasury regulations provide that gross income includes compensation for services paid other than in money (Reg. sec. 1.61-1(a)). Further, the U.S. Supreme Court has stated that Code section 61 "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."[4]

In actual practice, however, the "economic benefit" test has not been rigidly followed in all situations. Thus, where compensation is paid in a form other than cash, issues as to the taxability of certain fringe benefits have been resolved by statutory provisions, regulations, and administrative rulings and practices which take account of several different factors.

As described in Parts II and III of this pamphlet, some fringe benefits, such as the providing of medical care by an employer for its employees, are expressly excluded from gross income, generally within certain limitations, by particular provisions of the Code. In addition, exclusions for other fringe benefits have been based on judicial authority or on administrative practice. For example, some economic or financial benefits furnished as compensation have been treated as excluded from income on the basis of *de minimis* principles; that is, accounting for some occasional benefits of small value may be viewed as unreasonably burdensome or administratively impractical. Other items have been treated as excluded in light of a combination of valuation difficulties and widely held perceptions that the particular items should not be taxed as income.

1975 Treasury discussion draft

In 1975, the Treasury Department issued a discussion draft of proposed regulations[5] which contained a number of rules for determining whether various fringe benefits constitute taxable compensation. The discussion draft was withdrawn by the Treasury Department on December 28, 1976.[6] Thus, the question of whether, and what, employee fringe benefits result in taxable income gener-

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[4] *Commissioner* v. *Smith*, 324 U.S. 177, 181 (1945). *See also Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 429-30 (1955) ("Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature. And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted.")

[5] 40 Fed. Reg. 4118 (Sept. 5, 1975).

[6] 41 Fed. Reg. 5634 (Dec. 28, 1976).

ally continued to depend on the facts and circumstances in each individual case.

The 1975 discussion draft proposed a "safe harbor" (i.e., nontaxable treatment) for fringe benefits meeting all of three tests: (1) the goods or services provided to the employee were owned or provided by the employer in connection with a regular trade or business; (2) the employer incurred no substantial incremental costs in furnishing the goods or services to the employee; and (3) the goods or services were made available to employees on a nondiscriminatory basis. Fringe benefits not qualifying under the safe harbor would have been evaluated in terms of a nine-part facts and circumstances test, with no single factor deemed to be controlling. In addition, the discussion draft provided a *de minimis* rule exempting from taxation fringe benefits of little value.

If an item was required to be taken into income under the 1975 discussion draft, the amount includible in gross income constituted the amount the employee would have had to pay for the goods or services on an arm's-length basis (i.e., fair market value).

Ways and Means Task Force discussion draft bill

On January 22, 1979, the Task Force on Employee Fringe Benefits of the House Committee on Ways and Means issued a discussion draft report and bill on fringe benefits.[7] No further action was taken by the Ways and Means Committee on the Task Force Report. The Task Force discussion draft bill would have excluded from gross income certain fringe benefits that qualified under either (1) a safe harbor test, (2) a convenience of the employer test, (3) a *de minimis* test, or (4) regulations issued by the Treasury. Any other fringe benefits received by an employee would be includible in gross income at fair market value (less any amount paid by the employee for the benefits).

Under the safe harbor test in the Task Force bill, a fringe benefit would be excluded from gross income if: (1) it is made available to employees generally or to a reasonable classification of employees, (2) the employer incurs no substantial incremental cost in providing the fringe benefit, and (3) the total value of all fringe benefits received during the taxable year by the employee is not substantial, either in absolute terms or relative to the amount of compensation of the employee.

The convenience of the employer test would exclude from gross income fringe benefits made available primarily for the purpose of facilitating the employee's performance of services for the employer.

Under the *de minimis* rule in the Task Force bill, a fringe benefit would be excluded from gross income if its value is so small as to make accounting for it unreasonable or administratively impractical.

1981 Treasury discussion draft

On January 15, 1981, the Treasury forwarded to the House Committee on Ways and Means a revised "discussion draft" of proposed

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[7] House Committee on Ways and Means, Discussion Draft Bill and Report on Employee Fringe Benefits (Comm. Print 1979).

regulations on the tax treatment of fringe benefits.[8] This discussion draft was not reviewed by the Secretary of the Treasury and was not published in the Federal Register.

Under the 1981 discussion draft, the value of property, services, or facilities furnished by an employer in connection with the performance of services by an employee generally would be included in the employee's gross income. The value of any fringe benefit included in gross income would be the amount by which the fair market value of the item or its use exceeds any amount paid by the employee for the item or its use.

Certain exceptions to the general rule would have been provided. Fringe benefits consisting of items furnished by an employer with the specific intent either to enable or facilitate the performance of employment services by the recipient would be excluded from gross income. In addition, certain items would be excluded from gross income for reasons of administrative convenience, which would be determined on the basis of the facts and circumstances.

Finally, the 1981 discussion draft would exclude from gross income nondiscriminatory free or discount parking provided to employees, and occasional noncash gifts of up to $25 in value per gift.

Moratorium on issuance of regulations

Public Law 95-427, enacted in 1978, prohibited the Treasury Department from issuing prior to 1980 final regulations relating to the income tax treatment of fringe benefits. That statute further provided that no regulations relating to the treatment of fringe benefits were to be proposed that would be effective prior to 1980. Public Law 96-167, enacted in 1979, extended the moratorium on issuance of fringe benefit regulations through May 31, 1981. Public Law 97-34 (the Economic Recovery Tax Act of 1981) extended the moratorium through December 31, 1983.

[8] The January 15, 1981 discussion draft was reprinted in various publications, including Bureau of National Affairs, Daily Executive Report (Jan. 16, 1981), at p. J-14.

V. BACKGROUND DATA AND ISSUES RELATING TO TAX TREATMENT OF CERTAIN FRINGE BENEFITS

A. Revenue Implications

Table 1 below shows the increased revenues which would result from terminating the present-law exclusions for the principal statutory fringe benefits described in the previous portion of this pamphlet.[9] This table does not contain information on nonstatutory fringe benefits, although the tax treatment of these items may have substantial revenue implications.

Each entry in the table has two lines. The first represents the gain in income tax revenue which would result if the benefit were included in gross income; these figures are taken from the 1983 tax expenditure pamphlet published by the Joint Committee on Taxation.[10] The second line shows the implications for social security tax receipts of the employment tax treatment of these items.

In terms of revenue effect, health insurance is the largest fringe benefit shown in this table, followed by group term life insurance. Each of the other fringe benefits shown in this table have less revenue impact.

Table 1.—Effects of Including Certain Statutory Fringe Benefits in the Federal Income Tax Base and the FICA Tax Base

[In billions of dollars]

Item	1983	1984	1985	1986	1987	1988
1. Employer contributions for medical insurance:						
Income tax	18.6	21.3	24.3	27.7	31.6	36.0
FICA	6.1	7.6	8.8	10.0	11.3	13.3
2. Premiums on group term life insurance:						
Income tax	2.1	2.2	2.5	2.7	3.0	3.3
FICA	.3	.5	.8	.9	.9	1.0
3. Contributions to prepaid legal services plans:						
Income tax	(1)	(1)	(1)			
FICA	(1)	(1)	(1)			

[9] This pamphlet does not describe the statutory exclusion for employer contributions to qualified pension, profit-sharing or stock bonus plans, qualified annuity plans, or tax-sheltered annuity plans, or any other income tax items which may be considered fringe benefits.

[10] Staff of the Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 1983-1988", (JCS-4-83), Comm. Print (March 7, 1983).

Table 1.—Effects of Including Certain Statutory Fringe Benefits in the Federal Income Tax Base and the FICA Tax Base—Continued

[In billions of dollars]

Item	1983	1984	1985	1986	1987	1988
4. Employer educational assistance:						
Income tax	(1)	(1)				
FICA	(1)	(1)				
5. Employer provided child care:						
Income tax	(1)	(1)	.1	.1	.1	.2
FICA	(1)	(1)	(1)	(1)	(1)	.1
6. Employee meals and lodging (other than military):						
Income tax	.7	.7	.8	.9	.9	1.0
FICA	.2	.2	.2	.3	.3	.3
7. Benefits and allowances to Armed Forces personnel:						
Income tax	2.2	2.2	2.4	2.5	2.7	2.8
FICA	(2)	(2)	(2)	(2)	(2)	(2)

[1] Less than $50 million.
[2] Not available.

B. Growth in Fringe Benefits

Tables 2 and 3 present data from the national income accounts on the growth between 1950 and 1981 of employer contributions to group health insurance and group life insurance, the two largest generally available statutory fringe benefits which are shown in table 1, measured in terms of revenue effect.

Table 2 shows that during this period, these two benefits have grown considerably faster than wage and salaries. Group health insurance grew from 0.5 percent of wages in 1950 to 3.7 percent of wages in 1981, and group life insurance contributions increased from 0.2 percent of wages in 1950 to 0.4 percent of wages in 1981.

Group health insurance has grown at a much faster rate than group life insurance. Group health insurance has continued to grow throughout the period, while group life has been approximately the same percentage of wages since 1965. Although many factors have influenced the growth of these two fringe benefits, it should be noted that the tax treatment of group term life insurance changed in 1964, when a limit was placed on the amount of employer contribution which could be excluded from gross income for income tax purposes.

Table 3 shows another way of examining the growth in employer contributions to health and life insurance during this period. These figures compare the increase in wages to the increase in the fringe benefit during this period.

Between 1950 and 1955, for example, health contributions increased 1.5 cents for every dollar of increase in aggregate wages. By the end of the period, health benefit contributions increased approximately 4.7 cents for each dollar of increase in wages. Thus, there was a significant acceleration in the growth of health benefits relative to wages over the 1950 to 1981 period, although this trend stabilized during the 1970s.

In contrast, increases in group term life insurance as percentage of wage increases declined over the 1950-1981 period. During the first five years, group life insurance contributions increased 0.5 cents for every dollar of wage increase. This figure reached a peak during the last part of the 1950s. Since that time, however, the increase in life insurance as a percentage of wage increases declined significantly, so that by 1981 these contributions increased by only 0.2 cents for every dollar of wage increases.

Table 2.—Employer Contributions to Group Health and Life Insurance as Percentage of Wages and Salaries, United States, 1950–81

[In percent]

	Group health	Group life
1950	0.5	0.2
1955	.8	.3
1960	1.3	.4
1965	1.6	.5
1970	2.2	.5
1975	3.0	.5
1980	3.6	.5
1981	3.7	.4

Source: Computed from U.S. Department of Commerce data.

Table 3.—Increase in Total Employer Insurance Contributions as Percentage of Total Increase in Wages, United States, 1950–81

[In percent]

	Group health	Group life
1950–55	1.5	0.5
1955–60	2.8	.9
1960–65	2.7	.6
1965–70	3.3	.7
1970–75	4.7	.6
1975–80	4.5	.5
1980–81	4.7	.2

Source: Computed from U.S. Department of Commerce data.

C. Issues Related to Tax Treatment of Fringe Benefits

In general

1. Present law imposes a higher tax liability on an individual who receives no employer fringe benefits (whether or not the purchases the item individually) than on another individual with the same amount of income partially received in the form of tax-free fringe benefits. Some have argued that this is inequitable.

2. By excluding certain fringe benefits from taxation, present law may encourage greater consumption of the benefit than would occur in the absence of a tax system and higher marginal tax rates on the income which remains taxable. Some argue that this causes an inefficient distortion in the ability of consumers to obtain maximum satisfaction from available resources and interferes with incentives to work, save, and invest; others argue that the greater consumption of certain items should be encouraged because this provides a significant benefit to society which individuals do not take into account when making their consumption decisions.

3. By excluding certain fringe benefits from taxation, present law avoids administrative difficulties which could be encountered in valuing noncash forms of compensation.

4. Some argue that rules which prohibit discrimination in favor of owners and highly compensated employees in the provision of tax-free fringe benefits are sufficient to prevent abuse. Others argue that these rules do little to limit the amount of income excluded from tax, and, thus, the revenue loss and inequity resulting from this treatment.

Administration proposal to cap exclusion for employer-provided medical care

1. Some argue that the present unlimited exclusion for employer health plan contributions encourages inefficient expansion of coverage that encourages consumers to treat medical care as if it were free. This, in turn, increases the use of medical services which may have little or no value to the consumer or are more expensive than necessary. Even with a limit on the exclusion, employers will provide services which enable them to reduce the cost of their health plans, but there is little evidence that unlimited health care spending *per se,* as encouraged by present law, improves health status. Others argue that any limit on the exclusion would discourage coverage among low-income employees who are least able to afford it, would discourage the use of relatively new services which could reduce health costs significantly in the long run, and would increase out-of-pocket medical expenses for those who become sick.

2. Some argue that a limit which is uniform across all employers is unfair because it does not recognize significant variations by region, age, and health status in the cost of providing health services. Thus, employees who belong to high-cost groups would pay higher taxes than other employees receiving the same coverage and belonging to low-cost groups. Others argue that a uniform limit is consistent with other important features of the tax statute, such as the brackets and the personal exemption, which are not adjusted for differences in costs of purchasing goods and services, and that high costs in certain regions may simply result from an exces-

sive amount of insurance coverage in those areas, rather than from differences in the prices of medical supplies and in wages paid to health care workers.

3. Some argue that significant administrative difficulties are presented by the taxation of benefits provided by multiemployer plans and self-insured plans. Others argue that exempting multiemployer or self-insured plans would result in inequitable administration of the tax laws and, thus, these administrative difficulties are justified.

4. Some argue that the effective date of any proposal to tax employer health plan contributions should give special treatment to those whose benefits are determined under a collective bargaining contract, while others argue that this would be unfair to other affected workers.

Moratorium on fringe benefit regulations

Some argue that the moratorium on the issuance of fringe benefit regulations should be extended at least for another two-year period. In light of disagreements as to the proper tax treatment of certain nonstatutory fringe benefits, it is argued that there should be additional time to consider the issue of subjecting to taxation benefits which are widely available to many workers, which many taxpayers simply do not view as either equivalent to cash or taxable compensation, and for which there would be substantial valuation and recordkeeping problems for employers and employees alike.

Others argue that the moratorium should not be extended beyond 1983, and that the Congress either should enact guidelines for the exclusion or taxability of particular types of common nonstatutory employee fringe benefits (e.g., discounts on employer-produced goods or services, free transportation provided to employees in the transportation industry, subsidized or free parking and cafeterias, etc.), or should permit the Treasury to continue its efforts to develop such rules by regulation. It is argued that extending the moratorium would encourage increased use of such benefits in lieu of cash compensation, with corresponding loss in revenue and inequality of treatment between employees of industries which can provide such benefits at little or no cost and employees of industries, for example, whose products are not consumer goods. Also, questions as to the applicability of the moratorium to the taxation of particular fringe benefits have caused confusion and uncertainty for taxpayers and the Internal Revenue Service, as well as the lack of uniform treatment among similarly situated taxpayers.

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