[JOINT COMMITTEE PRINT]

OVERVIEW OF THE TAX TREATMENT OF FRINGE BENEFITS

SCHEDULED FOR JOINT HEARINGS

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY

AND THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

ON

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PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The Subcommittee on Social Security and the Subcommittee on Select Revenue Measures of the Committee on Ways and Means have scheduled joint public hearings on September 17 and 18, 1984, on the Federal tax treatment of fringe benefits.

In the press release announcing the oversight hearing, Chairman Pickle of the Social Security Subcommittee stated that "the subcommittees do not have a legislative proposal before them and these hearings are not designed to draft any particular legislative proposal. Rather, these hearings are designed to gather information and better inform the Congress and the public about certain aspects of fringe benefits. First of all, the subcommittees are interested in determining the prevalence of fringe benefits in the working population in general and among different types of workers in particular. Secondly, the subcommittees will be exploring the economics of fringe benefits and will be interested in learning how employers and employees consider the tax status of various fringes in devising a total compensation package. The economic effects of these decisions will also be of interest."

Chairman Stark stated that "last year the Select Revenue Measures Subcommittee reported out legislation (now part of P.L. 98-369) that codified long-established nonstatutory fringe benefits, but subjected all benefits not expressly exempted to tax. Now that we have eliminated the distinction between statutory and nonstatutory benefits, it is time to examine on a comprehensive basis all benefits exempted from tax currently in the Code. We need to understand their true cost, both in terms of lost revenue and in terms of higher taxes paid on nonexempt forms of compensation. While no one doubts that fringe benefits serve many useful social purposes, we in the Congress do not have a clear understanding of the true cost of these exemptions."

The first part of the pamphlet is a summary. This is followed by a more detailed overview of the Federal tax treatment of fringe benefits, including qualified pension, profit-sharing, or stock bonus plans, qualified annuity plans, and tax-sheltered annuities. The final part sets forth background information, including revenue implications of the tax treatment of certain fringe benefits and growth in certain fringe benefits.

I. SUMMARY

In general

The Code defines gross income for purposes of the income tax and the tax on self-employment income (SECA) as including "all income from whatever source derived" and specifies that it includes "compensation for services" (sec. 61). Similarly, the social security and unemployment insurance payroll taxes (FICA and FUTA) and income tax withholding generally apply to all remuneration for employment, including noncash remuneration. Any fringe benefit that does not qualify for exclusion under a specific statutory provision is includible in gross income, and subject to employment taxes, at the excess of its fair market value over any amount paid by the employee for the benefit.

Statutory fringe benefit provisions

As a general rule, if an employer-provided fringe benefit program qualifies under a specific statutory provision 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 costs of benefits that are excluded from an employee's income nonetheless are deductible by the employer provided they constitute ordinary and necessary business expenses. The income tax exclusions also generally apply for payroll tax purposes.

The Code provides specific exclusions, among others, 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) group legal services; (8) commuting through use of a van pool; and (9) dependent care assistance.

Miscellaneous fringe benefits

The Economic Recovery Tax Act of 1981 (P.L. 97-34) extended through December 31, 1983, a moratorium on the issuance of Treasury regulations relating to the income tax treatment of nonstatutory fringe benefits. The Treasury Department has announced that the Treasury and the IRS "will not issue any regulations or rulings altering the tax treatment of nonstatutory fringe benefits prior to January 1, 1985," and that "present administrative practice will not be changed during this period" (Ann. 84-5, 1984-4 I.R.B. 31).

Under the Tax Reform Act of 1984 (P.L. 98-369), certain miscellaneous fringe benefits provided by an employer are excluded from the recipient employee's gross income for Federal income tax purposes and from the wage and benefit bases for purposes of social security and other employment taxes. The excluded fringe benefits are those that qualify under one of the following five categories as defined in the Act: (1) a no-additional-cost service, (2) a qualified employee discount, (3) a working condition fringe, (4) a de minimis fringe, or (5) a qualified tuition reduction. Special rules apply with respect to certain parking or eating facilities provided to employees and certain on-premises athletic facilities.

In the case of a no-additional-cost service, a qualified employee discount, a subsidized eating facility, or a qualified tuition reduction, the exclusion applies with respect to benefits provided to officers, owners, or highly compensated employees only if the benefits are also made available to other employees on a nondiscriminatory basis.

The provisions of the Act generally take effect on January 1, 1985, except that the tuition reduction exclusion applies with respect to education furnished after June 30, 1985.[1]

Benefits provided under a cafeteria plan

Under a cafeteria plan, a participant is offered a choice between cash and certain fringe benefits. (Under the law in effect prior to the Tax Reform Act of 1984, a participant in a cafeteria plan could choose among cash, any taxable benefits (such as use of an employer-provided vacation facility), and nontaxable benefits (such as coverage under an accident and health plan). If the plan meets certain conditions generally related to nondiscrimination in favor of highly compensated employees, the participant is not treated as having received cash or a taxable fringe benefit solely because the participant has the opportunity, before the benefit becomes available to the participant, to choose among the taxable and nontaxable benefits offered under the plan.

On February 10, 1984, the IRS issued a news release (IR-84-22) stating that so-called "flexible spending arrangements" offered as part of a cafeteria plan did not provide employees with nontaxable benefits under the Code because, under such arrangements, employees are assured of receiving the benefit of what they would have received had no covered expenses been incurred. In May, 1984, the IRS issued proposed regulations with respect to the cafeteria plan rules and the statutory rules governing the exclusion of benefits from gross income.

The Tax Reform Act of 1984 limits an individual's choices under a cafeteria plan to cash and fringe benefits that are excludable under a specific provision of the Code (other than scholarships or fellowships, van pooling, and those benefits excludable under the miscellaneous fringe benefit provisions of the Act). The Act also amends the cafeteria plan rules to provide that if, for a plan year, more than 25 percent of the total nontaxable benefits are provided to key employees, the key employees are taxed as if they received all available cash and taxable benefits under the plan. The Act imposes certain reporting requirements on employers maintaining cafeteria plans.

[1] Also, the Act imposes a moratorium, with respect to lodging furnished after December 31, 1983, and before January 1, 1986, on the issuance of income tax regulations providing for the inclusion in gross income of qualified campus lodging.

The cafeteria plan provisions of the Act are effective on January 1, 1985. In addition, the Act provides transition relief from the application of some requirements of the proposed regulations up to January 1, 1985, or, in some cases, July 1, 1985.

Welfare benefit plans

The Tax Reform Act of 1984 modified the tax treatment of employers with respect to certain benefits provided to employees under a welfare benefit plan. Under the Act, deductions for contributions to a welfare benefit fund are limited to qualified costs. Qualified costs generally consist of (1) qualified direct costs and (2) additions, within limits, to a qualified asset account. In general, the qualified asset account limit is the amount estimated to be necessary under actuarial assumptions, which are reasonable in the aggregate, to fund the liabilities of the plan for the amount of claims incurred but unpaid to provide certain benefits and the administrative costs of such benefits. In addition, the Act provides that the qualified asset account may include, within limits, amounts reasonably necessary to accumulate reserves on a level annual basis under a welfare benefit plan so that a medical benefit or life insurance benefit (including a death benefit) payable to or on behalf of a retired employee is fully funded upon retirement.

The Act modifies the rules relating to the unrelated business taxable income of certain tax-exempt organizations that provide employee benefits, and establishes new nondiscrimination standards for these organizations.

These provisions of the Act generally are effective for contributions paid or accrued after December 31, 1985. A special effective date is applied to plans maintained pursuant to a collective bargaining agreement in effect on July 1, 1985. In addition, the Act provides certain transition rules with respect to existing reserves. The provisions of the Act relating to nondiscrimination requirements apply to taxable years beginning after December 31, 1984.

Qualified pension, profit-sharing, and stock bonus plans

If a pension, profit-sharing, or stock bonus plan qualifies under the tax law, then (1) a trust under the plan is generally exempt from income tax, (2) employers are generally allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, (3) benefits distributed as a lump sum distribution may be accorded special long-term capital gain treatment or 10-year income averaging treatment, or may be rolled over, tax-free, to an individual retirement account or annuity (IRA) or another qualified plan, and (4) certain partial distributions may be rolled over, tax-free, to an IRA. Special rules are provided for tax-sheltered annuity contracts and simplified employee pensions.

II. DESCRIPTION OF TAX TREATMENT OF FRINGE BENEFITS

A. Statutory Fringe Benefit Provisions

n general

Gross income, for income tax purposes, includes "all income from ᵼhatever source derived" (Code sec. 61(a)). This provision "is broad nough to include in taxable income any economic or financial benfit conferred on the employee as compensation, whatever the form r mode by which it is effected" (*Comm'r* v. *Smith*, 324 U.S. 177, 81 (1945)).

The social security and unemployment insurance payroll taxes FICA and FUTA, respectively) and income tax withholding apply o "wages," defined in the statutes as all remuneration for employnent, including the cash value of all remuneration paid in any nedium other than cash (secs. 3121(a), 3306(b) and 3401(a)). The ailroad retirement tax (RRTA) applies to any form of money renuneration (sec. 3231(e)). Regulations applicable to these statutes pecify that the value of any noncash item is to be determined by he excess of its fair market value over any amount paid by the ecipient for the item (see, e.g., Reg. sec. 31.3121(a)-1(e)).

As a general rule, if an employer-provided fringe benefit proram qualifies under a specific statutory provision of Federal ncome tax law, then the benefits provided under the program are xcludable (generally, subject to dollar or other limitations) from he employee's gross income for income tax purposes. Similar exclusions also generally apply for employment tax purposes. The osts of benefits that are excluded from the employee's income nonetheless are deductible by the employer, provided they constitute ordinary and necessary business expenses (Code sec. 162).

The social security tax on self-employment income under the Self-Employment Contributions Act (SECA) applies to net earnings from self-employment defined generally as gross income from an individual's trade or business, less the deductions allowed under the income tax which are attributable to the trade or business. Thus, the fringe benefits excluded from income of self-employed individuals under the income tax generally also are excluded from the base of the self-employment tax.

The Internal Revenue Code provides specific income tax exclusions, among others, with respect to employer-provided benefits 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; and (9) dependent care assistance. These fringe benefits have commonly been referred to as statutory fringe benefits.

In addition, the Tax Reform Act of 1984 provided statutory exclusions for certain other fringe benefits (see Miscellaneous Fringe Benefits, below).

Nondiscrimination rules

Under present law, exclusions for most of the statutory fringe benefits are conditioned upon compliance with rules prohibiting discrimination in favor of employees who are owners, officers, shareholders, and highly compensated employees. These nondiscrimination rules generally prohibit discrimination as to eligibility to participate and as to contributions or benefits.

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.

Generally employees covered by a collective bargaining agreement and who are not covered by a plan can be excluded from consideration in applying the nondiscrimination rules if the benefits provided by the plan or program are 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 the 5 highest-paid officers, 10-percent shareholders, or the 25-percent highest-paid employees must also be available to all other plan participants.

Under present law, if a plan is found 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, because such factors depend on the facts and circumstances of individual cases.) 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). The cost of group-term life insurance purchased by an employer for an employee for a taxable year is included in the employee's gross income to the extent that the cost is greater than the sum of the cost of $50,000 of life insurance plus any contribution made by an employee to the cost of the insurance. If a group-term life insurance plan maintained by an employer discriminates in favor of any key employee, the exclusion for the cost of the first $50,000 of this insurance is not available. In that event, the full cost of the group-term life insurance for any key employee is included in the gross income of the employee.

The Tax Reform Act of 1984 made three changes in the treatment of group-term life insurance. First, the $50,000 limitation on the amount of group-term life insurance that may be provided taxfree to employees also applies to retired as well as active employees (but not to disabled employees). Second, the nondiscrimination rules are applied to plans covering former employees, whether retired or disabled. Third, under the Act, if a plan fails to qualify for the exclusion because it is discriminatory, then key employees (whether active or former employees) must include in income the actual cost of their insurance benefit rather than the uniform table cost prescribed by the Treasury. The provisions of the Act are generally applicable to taxable years beginning after December 31, 1983.[2]

Under FICA, the entire amount of any payment on account of death made to, or on behalf of, an employee or dependents under a plan or system for employees generally or for a class or classes of employees is exempt from tax. Any amount paid by an employer for insurance or annuities or into a fund to provide for such a payment also is exempt from FICA (sec. 3121(a)(2)).

Death benefits

Present law generally excludes from a beneficiary's gross income proceeds of death benefits received under a life insurance contract (sec. 101(a)) and provides a limited exclusion for other benefits paid by or on behalf of an employer by reason of an employee's death (sec. 101(b)). As stated above, death benefits are entirely exempt from FICA if paid under a plan or system for employees generally or for a class or classes of employees.

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[2] The new provisions extending the $50,000 limitation and the nondiscrimination rules do not apply to any group-term life insurance plan in existence on January 1, 1984 (or to any comparable successor plan), but only with respect to those individuals who retire under the plan, who were employed during 1983 by the employer maintaining the plan, and who attained age 55 on or before January 1, 1984. Also, these new provisions generally do not apply to any employees who retired before January 1, 1984. However, the new rules will apply to any plan that is discriminatory after December 31, 1986, with respect to any individual retiring after that date.

The income tax exclusion for death benefits for employees not paid under an insurance contract 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 if distribution to the participant had commenced prior to death. Except with respect to certain amounts payable from or under qualified plans, this exclusion generally is not available to self-employed individuals (sole proprietors or partners).

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. 106). No similar exclusion is provided for self-employed individuals (sole proprietors or partners).

Benefits actually paid to employees under accident and health plans generally are includible in the employee's gross income to the extent attributable to employer contributions (sec. 105(a)). Reimbursements for costs incurred for medical expenses (within the meaning of sec. 213) and disability payments which compensate for permanent injury and are computed without reference to the period of absence from work are excluded from gross income (secs. 105(b) and (c)). However, in the case of self-insured medical reimbursement plans (sec. 105(h)), no exclusion is provided for benefits paid to any employee who is among the 5 highest-paid officers, a 10-percent shareholder, or among the 25-percent highest-paid employees if the program discriminates in favor of this group as to either eligibility to participate or the medical benefits actually provided under the plan.

Under FICA, payment of medical or hospitalization expenses in connection with sickness or accident disability made to, or on behalf of, an employee or dependents under a plan or system for employees generally, or for a class or classes of employees, are exempt from social security tax. Any amount paid by an employer for insurance or annuities or into a fund to provide for such a payment also is exempt from FICA (sec. 3121(a)(2)).

Also, any payments to or on behalf of an employee on account of sickness or accident disability, or medical or hospitalization expenses in connection with such disability, are exempt from FICA after the expiration of six calendar months following the last calendar month in which the employee worked for the employer (sec. 3121(a)(4)). In addition, FICA exempts payments to employees on account of retirement for disability under a plan which makes provision for employees generally or a class or classes of employees (sec. 3121(a)(12)). Finally, any payment to an employee while the employee is entitled to disability insurance benefits under section 223(a) of the Social Security Act is exempt from FICA if the entitlement commenced prior to the calendar year in which the payment is made and if the employee did not perform any services for the employer during the period for which the payment is made (sec. 3121(a)(15)).

Parsonage allowances

Present law permits a minister of the gospel to exclude from gross income the rental value of a home provided as 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.[3]

For social security tax purposes, ministers generally are treated as self-employed individuals subject to SECA (rather than as employees subject to FICA). SECA liability is computed without regard to the income tax exclusion for the rental value of parsonages (sec. 1402(a)(8)).

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. 1.61-1(b)). A similar exclusion is provided for FICA (sec. 3121(i)(2)).

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.

FICA exempts the value of any meals or lodging furnished by or on behalf of the employer if it is reasonable to believe that the employee will be able to exclude such items from income under section 119 (sec. 3121(a)(19)). For social security tax purposes, minis-

[3] In 1983, the IRS ruled that ministers may not take deductions for mortgage interest and real estate taxes on their residences to the extent that such expenditures are allocable to tax-free housing allowances provided for ministers (Rev. Rul. 83-3, 1983-1 C.B. 72). The new deduction disallowance rule generally applied beginning July 1, 1983. Under a transitional rule, in the case of a minister who owned and occupied a home before January 3, 1983 (or had a contract to purchase a home before that date), the deduction disallowance rule generally will not apply until January 1, 1985. The 1984 Act extends this transitional rule date to January 1, 1986.

ters generally are treated as self-employed individuals subject to SECA (rather than as employees subject to FICA). SECA liability is computed without regard to the income tax exclusion for meals and lodging furnished for the convenience of the employer (sec. 1402(a)(8)).

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.

FICA excludes any contribution, payment or service provided by an employer which may be excluded from gross income under section 120.

Van pooling

Present law excludes from an employee's gross income the value of certain employer-provided transportation ("van pooling") 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 vanpooling 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).

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

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 employee 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) that are incurred to enable the taxpayer to be gainfully employed; (3) no exclusion is available for amounts paid for qualifying services rendered by the employee's dependent or child of the employee who is under the age of 19; (4) no exclusion is available 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 available 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).

FICA excludes any payment made or benefit furnished if it is reasonable to believe that employee will be able to exclude the payment or benefit from income under section 129 (sec. 3121(a)(18)).

B. Miscellaneous Fringe Benefits

Background

A moratorium first enacted in 1978 prohibited issuance of Treasury regulations relating to the income tax treatment of nonstatutory fringe benefits. The legislative moratorium expired on December 31, 1983. The Treasury Department has announced that Treasury and the IRS "will not issue any regulations or rulings altering the tax treatment of nonstatutory fringe benefits prior to January 1, 1985," and that "present administrative practice will not be changed during this period" (Ann. 84-5, 1984-4 I.R.B. 31).

General rule

The Tax Reform Act of 1984 provides a statutory exclusion from income and FICA and other employment taxes for (1) no-additional-cost services; (2) qualified employee discounts; (3) working condition fringes; (4) de minimis fringes; and (5) qualified tuition reductions. No fringe benefit (other than a de minimis fringe) is excluded under the Act if another section of the Code provides rules for the tax treatment of that general type of benefit.

Under the Act, any fringe benefit that does not qualify for a statutory exclusion is expressly includible in gross income, and subject to employment taxes, at the excess of its fair market value over any amount paid by the employee for the benefit.

The rules of the Act do not make any change in existing statutory or regulatory exclusions for benefits for military personnel.

Exclusion provisions

No-additional-cost service.—A service provided to an employee is excluded if—

(1) the employer incurs no substantial cost (including foregone revenue) in providing the service;

(2) the service is provided by the employer or another business with whom the employer has a written reciprocal agreement, and is of the same type ordinarily sold to the public in the line of business in which the employee works;

(3) the service is provided to a current or retired employee, or a spouse or dependent child of either, or a widow(er) or dependent children of a deceased employee; and

(4) for certain highly compensated employees, nondiscrimination requirements are met (see below).

Qualified employee discount.—A discount on merchandise provided to an employee is excluded to the extent it does not exceed the employer's gross profit percentage (in the relevant line of business). The exclusion does not apply to discounts on real property or to discounts on personal property of a kind commonly held for investment.

A discount on services provided to an employee is excluded to the extent it does not exceed 20 percent of the selling price of the services to nonemployee customers (with no gross profit percentage restriction).

The following conditions generally must be satisfied for the exclusion to apply:

(1) the property or service is provided by the employee and is of the same type ordinarily sold to the public in the line of business in which the employee works;

(2) the property or service is provided to a current or retired employee, a spouse or dependent child of either, or to a widow(er) or dependent children of a deceased employee; and

(3) for certain highly compensated employees, nondiscrimination requirements are met (see below).

Working condition fringe.—Property or services provided to an employee are excluded to the extent that they would be deductible as ordinary and necessary business expenses (under Code secs. 162 or 167) if the employee had paid for them.

The Act excludes, as a working condition fringe, the value of free or reduced-cost parking provided to employees on or near the employer's business premises.

De minimis fringe.—Property or services not otherwise tax-free are excluded if their fair market value is so small, taking into account the frequency with which similar fringe benefits (otherwise excludable as de minimis fringes) are provided and other relevant factors, as to make accounting for the benefits unreasonable or administratively impracticable. For example, benefits that generally are excluded as de minimis fringes include the typing of a personal letter by a company secretary, occasional personal use of the company copying machine, monthly transit passes provided at a discount not exceeding $15, occasional company cocktail parties or picnics for employees, occasional supper money or taxi fare for employees because of overtime work, and certain holiday gifts of property with a low fair market value.

Subsidized eating facilities operated by the employer also are excluded as a de minimis fringe if located on or near the employer's business premises, if revenue equals or exceeds direct operating costs, and if (for certain highly compensated employees) nondiscrimination requirements are met (see below).

Athletic facilities.—An exclusion is allowed for the value of on-premises athletic facilities provided and operated by an employer for use of its employees. Under Code section 274, the employer is not allowed a deduction for the costs of an athletic facility if the facility is not primarily for the benefit of employees (other than employees who are officers, shareholders or other owners, or highly compensated employees).

Qualified tuition reduction.—The Act provides that a reduction in tuition provided to an employee of an educational institution is excluded for income and employment tax purposes if (1) the tuition is for education below the graduate level provided by the employer or by another educational institution; (2) the education is provided to a current or retired employee, a spouse or dependent child of either, or to a widow(er) or dependent children of a deceased employee; and (3) certain nondiscrimination requirements are met (see above).

Nondiscrimination requirements.—The exclusions for no-additional-cost services, qualified employee discounts, subsidized eating facilities, and qualified tuition reductions are available to officers, owners, or highly compensated employees only if the property or service is provided on substantially the same terms to each member of a group of employees defined under a reasonable classification, set up by the employer, which does not discriminate in favor of employees who are officers, owners, or highly compensated employees.

Effective dates.—Under the Act, the provisions generally are effective beginning January 1, 1985. The provisions of the Act relating to qualified tuition reductions are effective for education furnished after June 30, 1985.

C. Benefits Provided Under a Cafeteria Plan

In general

Under a cafeteria plan, a participant is offered a choice between cash and one or more fringe benefits. The mere availability of cash or certain taxable benefits under a cafeteria plan does not cause an employee to be treated as having received the available cash or taxable benefits for income tax purposes if certain conditions are met (sec. 125). Thus, a participant in such a cafeteria plan is required to include in gross income only those taxable benefits actually received.

A highly compensated participant is treated as having received available cash and taxable benefits 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 five-percent shareholder, a highly compensated individual, or a spouse or dependent of any of the preceding individuals.

The cafeteria plan rules generally do not affect whether any particular benefit offered under the plan is a taxable or nontaxable benefit. Thus, a benefit that is excludable under the Code when offered separately is an excludable benefit under a cafeteria plan only if the rules providing for the exclusion of the benefit from gross income continue to be satisfied when the benefit is provided under the cafeteria plan.

IRS release, regulations

On February 10, 1984, the Internal Revenue Service issued a news release (IR-84-22), stating that so-called "flexible spending arrangements" offered as part of cafeteria plans do not provide employees with nontaxable benefits under the Code because employees are assured of receiving the amounts available under the arrangement without regard to whether covered expenses are incurred.

In May, 1984, the Internal Revenue Service issued proposed regulations with respect to the cafeteria plan rules and the statutory rules governing the exclusion of benefits from gross income. These proposed regulations provide that an otherwise nontaxable benefit will be nontaxable if offered in a cafeteria plan only if it continues to satisfy the provisions governing exclusion of the benefit from gross income. Accordingly, the proposed regulations provide that employer contributions with respect to an accident or health plan, a qualified group legal services plan, or a dependent care assistance program are not excluded from a participant's gross income under the Code to the extent that the participant is assured of receiving benefits under the plan without regard to whether the participant incurs covered expenses.

Provisions of the Tax Reform Act of 1984

The Tax Reform Act of 1984 provides that under a cafeteria plan, an employee generally can choose only among cash and fringe benefits that are excludable from gross income under a specific section of the Code (other than scholarships or fellowships, van pooling, and those benefits excludable under the miscellaneous fringe benefit provisions of the 1984 Act).

Also, the Act amends the cafeteria plan rules to provide that if, for a plan year, more than 25 percent of the total excludable benefits are provided to employees who are key employees with respect to the plan for such year (as determined under the rules of sec. 416(i)(1)), then the key employees will be taxed as though they received all available taxable benefits under the plan. Generally, in determining the portion of the total excludable benefits that is provided to key employees, coverage under a plan (e.g., an accident or health plan) and not actual expense reimbursements are to be counted.

Under the Act, certain reporting requirements are applied with respect to cafeteria plans. The Act provides both general and special transition relief through January 1, 1985, or, in certain cases, July 1, 1985, with respect to the proposed Treasury regulations on cafeteria plans, for cafeteria plans and "flexible spending arrangements" in existence on February 10, 1984. Finally, the Act provides that the Secretary of Health and Human Services, in cooperation with the Secretary of the Treasury, is to submit a report by April 1, 1985, to the House Committee on Ways and Means and the Senate Committee on Finance on the effect of cafeteria plans on the containment of health costs.

D. Welfare Benefit Plans

Deductions for contributions to funded benefit plans

The Tax Reform Act of 1984 modified the tax treatment of employers with respect to welfare benefits provided to employees. Under the Act, deductions for contributions to a welfare benefit fund are limited to qualified costs, generally defined as the sum of

(1) qualified direct costs and (2) additions, within limits, to a qualified asset account.

Limitations on qualified asset account.—The Act provides rules relating to the limitation on additions to a qualified asset account. Such an account consists of assets set aside for the payment of disability benefits, medical benefits, supplemental unemployment compensation or severance pay benefits, and life insurance or death benefits. To the extent the qualified asset account exceeds the account limit, additions to the account are not currently deductible.

In general, the account limit is the amount estimated to be necessary, under actuarial assumptions that are reasonable in the aggregate, to fund the liabilities of the plan for the amount of claims incurred but unpaid, for benefits described in the previous paragraph, and administrative costs of providing those benefits, as of the close of the taxable year. Claims are incurred only when an event entitling the employee to benefits, such as a medical expense, a separation, a disability, or a death, actually occurs. The allowable reserve includes amounts for claims estimated to have been incurred but which have not yet been reported, as well as those claims which have been reported but have not yet been paid.

Child care facilities and other capital expenditures.—Under the Act, in determining qualified direct costs with respect to a child care facility held by a fund, the adjusted basis of the facility is treated as deductible ratably over a period of 60 months. A child care facility is tangible property of a character subject to depreciation and located in the United States, and must be a child care center primarily for children of the employees of the employer. Qualified direct costs with respect to other capital expenditures are those that would be allowed under the usual Code rules which would be applied if the employer owned the asset.

Prefunding of life insurance, death benefits, or medical benefits for retirees.—The qualified asset account limit includes amounts reasonably necessary, within limits, to accumulate reserves under a welfare benefit plan for the medical benefit or life insurance (including death benefit) payable to a retired employee during retirement. These amounts may be accumulated no more rapidly than on a level basis over the working life of the employee with the employer, subject to certain additional limitations.

Safe harbor.—The Act provides that an actuarial certification by a qualified actuary (determined under Treasury regulations) justifying the taxpayer's reserve computations is not necessary if the amount in the qualified asset account does not exceed a prescribed safe harbor level equal to the sum of separate safe-harbor amounts computed with respect to each benefit for which a safe harbor is provided.

Certain collectively bargained plans.—The Act provides that before July 1, 1985, the Treasury Department is to publish final regulations establishing special reserve limit principles with respect to welfare benefit funds maintained pursuant to certain collective bargaining agreements.

Transitional rule.—Under the Act, in the case of a plan that was in existence on June 22, 1984, special rules are provided for the de-termination of the deduction limit for each of the first four years to which the provision applies.

10-or-more-employer plans.—For a plan year in which no employer (or employers related to an employer) is required to contribute more than 10 percent of the total contributions, the Act provides that the deduction limits do not apply.

Effective date.—These provisions generally apply to contributions paid or accrued after December 31, 1985. However, in the case of a plan maintained pursuant to a collective bargaining agreement in effect on July 1, 1985, or ratified before that date, the provisions do not apply until the termination of the contract, determined without regard to any contract extension agreed to after that date.[4]

Excise taxes on funded benefit plans

Under the Act, an excise tax is imposed on the employer equal to 100 percent of the disqualified benefits provided by a fund under a welfare benefit plan.

The Act defines a disqualified benefit as (1) any medical benefit or life insurance benefit provided with respect to a retired key employee (sec. 416(i)) other than from a separate account established for that employee under the new rules relating to deductions under funded welfare benefit plans (sec. 419A(d)); (2) any medical or life insurance benefit provided with respect to a retired employee unless the benefit is provided from a fund that meets the additional requirements for tax-exempt status provided by the Act (sec. 505(b)(1)); and (3) any portion of a welfare benefit fund reverting to the benefit of the employer.

These excise tax provisions generally apply to contributions paid or accrued after December 31, 1985. However, in the case of a plan maintained pursuant to a collective bargaining agreement in effect on July 1, 1985, or ratified before that date, the provisions do not apply until the termination of the contract, determined without regard to any contract extension agreed to after that date.

Tax treatment of exempt benefit organizations

Unrelated business income.—Under the Act, the special rules applicable to voluntary employees' beneficiary associations (VEBAs) and social clubs for purposes of the tax on unrelated business taxable income are extended to supplemental unemployment compensation benefit trusts (SUBs) and group legal service organizations (GLSOs). In addition, more specific limits are provided with respect to the amount that may be set aside for exempt purposes by such an organization without incurring unrelated business income tax; these limits generally are the same as those applicable for purposes of limitations on deductions for plan contributions.

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[4] In addition, the Act generally applies to any contribution of a facility to a welfare benefit fund after June 22, 1984. Under the Act, deductions with respect to such a contribution are to be determined under the usual Code rules applicable to recovery of the cost of assets (but taking account of the special rule for child care facilities described above). Further, these rules apply to other contributions, such as cash, made after that date which are to be used to acquire a facility, so that later acquisition of a facility with the use of such funds will limit the deduction for the original contribution. This rule does not apply for any facility acquired by the fund under a binding contract in effect on and at all times after that date, or any facility under construction by or for the fund before June 22, 1984.

The Act also provides for a tax on an employer who maintains a welfare benefit fund that is not exempt from income tax. Under the Act, in the case of any welfare benefit fund, such as a retired life reserve account, that is not exempt from income tax as a social club, VEBA, SUB, or GLSO, the employer who maintains the fund is to include in gross income for the taxable year an amount equal to the fund's deemed unrelated income. Deemed unrelated income is the amount of income which would have been subject to the unrelated business income tax if the fund were a tax-exempt organization.

Discrimination.—The Act establishes new nondiscrimination standards for a tax-exempt VEBA or GLSO. With respect to the nondiscrimination rules, certain employees who are not covered by a plan may be excluded from consideration in applying the nondiscrimination standards. These employees are employees who have not attained the age of 21, employees who have not completed 3 years of service with the employer, less than half-time employees, employees who are included in certain collective bargaining units, and certain nonresident aliens.

Effective date.—These provisions generally apply after December 31, 1985. However, in the case of a plan maintained pursuant to a collective bargaining agreement in effect on July 1, 1985, or ratified before that date, the provisions do not apply until the termination of the contract, determined without regard to any contract extension agreed to after that date.

The nondiscrimination provisions apply to taxable years beginning after December 31, 1984.

E. Qualified Pension, Profit-Sharing, and Stock Bonus Plans

If a pension, profit-sharing, or stock bonus plan qualifies under the tax law (sec. 401(a) or 403(a)), then (1) a trust under the plan is generally exempt from income tax, (2) employers are generally allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, (3) benefits distributed as a lump sum distribution may be accorded special long-term capital gain treatment or 10-year income averaging treatment, or may be rolled over, tax-free, to an individual retirement account or annuity (IRA) or another qualified plan, and (4) certain partial distributions may be rolled over, tax-free, to an IRA.

Qualified plans are generally subject to minimum standards (including standards relating to employee participation, vesting, forms of benefits, and fiduciary conduct) and to limits on contributions or benefits. These plans are prohibited from discriminating in favor of employees who are officers, shareholders, or highly compensated. Pension plans are generally subject to a minimum funding standard. In addition, benefits under a defined benefit pension plan are generally guaranteed (within limits) by the Pension Benefit Guaranty Corporation.

Certain qualified plans may include a qualified cash-or-deferred arrangement (sec. 401(k)). Under a qualified cash or deferred arrangement, an employee may elect to receive compensation from the employer currently or to have the compensation deferred. Amounts deferred under a qualified cash or deferred arrangement are taken into account in computing social security and unemployment compensation benefits and taxes.

No minimum standards or special limits apply to an unfunded plan of deferred compensation. Generally, under ERISA, these plans may not be provided for rank-and-file employees.

Under a tax-sheltered annuity program, amounts paid by an educational institution or by an eligible tax-exempt organization to purchase an annuity contract for an employee are excluded from the employee's income, subject to certain limits (sec. 403(b)). Excludable contributions to custodial accounts investing in stock of a regulated investment company (e.g., a mutual fund) are also permitted. No nondiscrimination standard applies in the case of a tax-sheltered annuity program. Amounts distributed or made available under tax-sheltered annuities or custodial accounts generally are includible in gross income. However, certain distributions may be rolled over, tax-free, to another such annuity contract or to an IRA.

If an IRA qualifies as a simplified employee pension (SEP), the annual IRA deduction (generally, the lesser of $2,000 or 100 percent of compensation) is increased by the lesser of $30,000 or 15 percent of compensation. The increase in the deduction limit applies only to employer contributions (sec. 219). Except in the case of certain correcting distributions, all distributions from SEPs are includible in gross income unless rolled over to another IRA.

FICA generally excludes payments under or to a qualified pension, profit-sharing, or stock bonus plan, a SEP, a tax-sheltered annuity, an exempt governmental deferred compensation plan, or a plan to provide cost-of-living adjustments in benefits under these provisions. However, FICA applies to contributions under a qualified cash-or-deferred arrangement or to contributions under a tax-sheltered annuity made by reason of a salary reduction agreement (sec. 3121(a)(5)).

III. BACKGROUND DATA RELATING TO TAX TREATMENT OF CERTAIN FRINGE BENEFITS

A. Revenue Implications

Table 1 below shows the estimated increases in revenues that would result from terminating the present-law exclusions for those benefits described in Part II A and E of this pamphlet.

Each entry in the table has two lines. The first represents the estimated increase in income tax receipts that would result if the benefit were included in gross income. The second line shows the estimated increases in social security tax receipts that would result if the benefit were included in the FICA tax base.

In terms of revenue effect, qualified pension plans are the largest fringe benefit shown in this table, followed by health insurance. Each of the other fringe benefits shown in this table have less revenue impact.

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

[In billions of dollars]

Item	1984	1985	1986	1987	1988	1989
1. Employer contributions for medical insurance:						
Income tax	17.6	20.2	23.0	26.2	29.9	34.1
FICA	6.7	7.7	8.8	10.1	11.9	13.7
2. Premiums on group term life insurance:						
Income tax	2.2	2.4	2.6	2.9	3.2	3.5
FICA	.5	.8	.9	.9	1.0	1.1
3. Contributions to prepaid legal services plans:						
Income tax	(1)	(1)				
FICA	(1)	(1)				
4. Employer provided child care:						
Income tax	(1)	.1	.1	.1	.2	.2
FICA	(1)	(1)	(1)	(1)	.1	.1
5. Employee meals and lodging (other than military):						
Income tax	.7	.8	.9	.9	1.0	1.1
FICA	.2	.2	.3	.3	.3	.3

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

[In billions of dollars]

Item	1984	1985	1986	1987	1988	1989
6. Benefits and allowances to Armed Forces personnel:						
Income tax	1.9	2.0	2.2	2.3	2.4	2.6
FICA	(2)	(2)	(2)	(2)	(2)	(2)
7. Net exclusion for pension contributions and earnings						
Income tax	47.3	52.7	59.0	66.0	73.9	82.9
FICA	(2)	(2)	(2)	(2)	(2)	(2)

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

B. Growth in Certain 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 wages and salaries. Group health insurance grew from 0.5 percent of wages in 1950 to 3.8 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 5.5 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 term 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 0.3 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, 1950–1981

[In percent]

	Group Health	Group Life
1950	0.5	0.2
1955	0.8	0.3
1960	1.3	0.4
1965	1.6	0.5
1970	2.2	0.5
1975	3.0	0.5
1980	3.7	0.5
1981	3.8	0.4

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, 1950–1981

[In percent]

	Group Health	Group Life
1950–55	1.5	0.5
1955–60	2.8	0.9
1960–65	2.7	0.6
1965–70	3.3	0.7
1970–75	4.7	0.6
1975–80	4.5	0.3
1980–81	5.5	0.3

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

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