DESCRIPTION OF PRESENT LAW TAX TREATMENT
OF EMPLOYER-PROVIDED HEALTH BENEFITS

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON SAVINGS, PENSIONS
AND INVESTMENT POLICY

of the

COMMITTEE ON FINANCE

on September 9, 1985

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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CONTENTS

INTRODUCTION

The Senate Finance Subcommittee on Savings, Pensions and Investment Policy has scheduled a public hearing on September 9, 1985, on employer funding of retiree health benefits. This Subcommittee hearing was rescheduled from the previous date of July 29, 1985.

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law tax treatment of employer-provided health benefits.

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1 This document may be cited as follows: Joint Committee on Taxation, Description of Present Law Tax Treatment of Employer-Provided Health Benefits (JCX-15-85), September 6, 1985. (This document is an updated reprint of JCX-10-85, prepared for the previously scheduled Subcommittee hearing. There is no substantive changes from JCX-10.)

TAX TREATMENT OF EMPLOYER-PROVIDED HEALTH BENEFITS

A. Overview

Present law provides a number of tax benefits to encourage employers to provide health benefits to their employees. Employer contributions to a plan providing accident or health coverage generally are excludable from gross income. Certain benefits actually paid under such plans are also excludable from the employee's income. Employer contributions to fund medical benefits are deductible, within limits. If such benefits are prefunded through a nondiscriminatory welfare benefit fund or qualified pension plan, employers may claim deductions for additions to qualified reserves. Additional contributions are permitted to be made on a deductible basis to provide post-retirement health benefits for former employees. These deductible reserves are also permitted to accumulate in a trust exempt from income tax and, in part, from the unrelated business income tax.

Gross income, for income tax purposes, includes "all income from whatever source derived" (Code sec. 61(a)). This provision "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" (Comm'r v. Smith, 342 U.S. 177, 181 (1945)).

As a general rule, if an employer-provided fringe benefit program qualifies under a specific statutory provision of Federal 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 costs of benefits that are excluded from the employee's income nonetheless are deductible by the employer, provided that they constitute ordinary and necessary business expenses (sec. 162). The income tax exclusions also generally apply for employment tax purposes.

B. Exclusion for Employer-Provided Medical 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 under accident and health plans generally are includible in the employee's gross income to the extent attributable to employer contributions (sec. 105(a)). 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 (sec. 105(b)). In the case of a self-insured medical reimbursement plan (sec. 105(h)), no exclusion is provided for benefits paid to any employee who is among the five 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.

C. Limits on Employer Deductions to Fund Medical Benefits

In general

Effective for contributions made after December 31, 1985, the amount of the deduction otherwise allowable to an employer for a contribution to a welfare benefit fund for any taxable year is not to exceed the qualified cost of the fund for the year. The qualified cost of a welfare benefit fund for a year is defined as the sum of (1) the qualified direct cost of the fund for the year and (2) the addition (within limits) to reserves under the fund for the year (the qualified asset account), reduced by the after-tax income of the fund.

A fund is defined as any tax-exempt social club, voluntary employees' beneficiary association (VEBA), supplemental unemployment compensation benefit trust (SUB), or group legal services organization; any trust, corporation, or other organization not exempt from income tax; and, to the extent provided by Treasury regulations, any account held for an employer by any person.

Qualified direct cost

The qualified direct cost for a taxable year is the aggregate amount (including administrative expenses) that would have been allowable as a deduction to the employer with respect to the benefits provided by the fund during the taxable year, if the benefits had been provided directly by the employer, and if the employer had used the cash receipts and disbursements method of accounting. For example, in the case of a self-insured medical reimbursement plan, the qualified direct cost equals the actual benefit payments made to employees for the taxable year, plus the administrative costs of providing such benefits.

Qualified asset account

The qualified asset account under a welfare benefit fund consists of the value of assets set aside to provide for the payment of disability benefits, medical benefits, supplemental unemployment compensation benefits (SUB), severance pay benefits, or life insurance (including death) benefits. Present law provides an account limit with respect to the amount in the qualified asset account for any year. Additions to a qualified asset account in excess of the account limit for a year do not increase qualified cost and, therefore, are not deductible for the year.

The account limit for a qualified asset account for a taxable year is generally the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for benefits with respect to which the account is maintained and the administrative costs incurred with respect to those claims. Claims incurred but unpaid include claims incurred but unreported as well as claims reported but unpaid.

Unless there is an actuarial certification of the account limit for a taxable year, the account limit for the year is not to exceed the sum of the safe harbor limits for the year. Accordingly, an actuarial certification by a qualified actuary (determined under Treasury regulations) justifying the taxpayer's reserve computations is necessary if the amount in the qualified asset account is above a prescribed safe harbor level equal to the sum of the separate safe harbor amounts computed with respect to each benefit.

For medical benefits (including post-retirement medical benefits), the safe harbor limit for a taxable year is 35 percent of the qualified direct cost (including administrative costs) of providing the benefit for the immediately preceding taxable year.

Post-retirement medical benefits

Special account limits are provided for post-retirement medical benefits. Those limits allow amounts reasonably necessary to accumulate reserves under a welfare benefit plan so that funding of post-retirement medical benefits with respect to an employee can be completed upon the employee's retirement. These amounts may be accumulated no more rapidly than on a level basis over the working life of an employee with the employer of that employee. Funding is considered level if it is determined under an acceptable funding method so that future post-retirement benefits and administrative costs will be systematically allocated ratably to future pre-retirement years.

Each year's computation of contributions with respect to retiree medical benefits is to be made under the assumption that the medical benefits provided to retirees will have the same cost as medical benefits currently provided to retirees. Because the reserve is to be computed on the basis of current medical costs, future inflation is not to be taken into account and it is to be assumed that the level of utilization will not increase in the future. Accordingly, future experience is not to be assumed to be less favorable than past experience.

No deduction for advance funding is allowed with regard to a plan which provides medical benefits exclusively for retirees, because such a plan would be considered a plan of deferred compensation rather than a welfare benefit plan. If a plan maintained for retirees is merely a continuation of a plan maintained currently or in the past for active employees, then the retiree plan would not be considered a plan of deferred compensation because medical benefits would have been provided without the necessity of retirement or other separation from service.

In addition, no reserve is to be taken into account in computing the account limit with respect to post-retirement medical benefits under a plan that does not meet the nondiscrimination rules applicable to such benefit.

Separate accounts for certain post-retirement benefits

Present law provides an overall limit with respect to pre-retirement deductions for the retirement benefits of employees to insure that the effect of any prefunding of these benefits is nondiscriminatory. Under this limit, separate accounting is required with respect to amounts attributable to contributions made to a welfare benefit fund under the provisions for additional reserves for post-retirement benefits. Separate accounting is required for contributions, under the post-retirement reserve provisions, to provide medical benefits to an individual who is, or ever has been, a key employee.

The amount of medical benefits provided under the plan after retirement to an employee with respect to whom these requirements are in effect is limited to the balance in the employee's separate account. Present law also provides for the coordination of net contributions for post-retirement medical benefits with the overall limits on contributions and benefits under section 415(c) and (e); any such amount allocated to a separate account is to be treated as an annual addition to a defined contribution plan.

D. Tax on Unrelated Business Income

Tax-exempt organizations generally are subject to income taxes on income from an unrelated trade or business. In the case of a voluntary employees' beneficiary association (VEBA) (sec. 501(c)(9)), income of the organization generally is not subject to the tax on unrelated business income to the extent that the income is exempt function income consisting of certain member contributions and amounts set aside to provide permissible benefits.

A specific annual limit applies to the amount of income of a tax-exempt VEBA, or supplemental unemployment compensation benefit trust (SUB) (described in sec. 501(c)(9) or (17), respectively) that may be considered a permissible set aside. The amount of such an organization's income for a year that may be considered set aside as exempt function income is generally not to increase the total amount that is set aside to an amount in excess of the account limit for the taxable year determined under the deduction limits.

For purposes of determining the limit on the set aside, the account limit generally is not to include any amount with respect to reserves to provide post-retirement medical benefits. However, the limit on the amount which may be set aside for purposes of the unrelated business income tax does not apply to income attributable to certain existing reserves for post-retirement medical benefits. This exclusion applies only to income attributable to the amount of assets set aside, as of the close of the last plan year ending before July 18, 1984, for purposes of providing such benefits.

E. Excise Tax on Disqualified Benefits

If a welfare benefit fund provides a disqualified benefit during a taxable year, then an excise tax is imposed for that year on each employer who maintains the fund. The tax is equal to 100 percent of the disqualified benefit.

A disqualified benefit is (1) any post-retirement medical or life insurance benefit provided by a welfare benefit fund with respect to a key employee other than through a separate account for that employee, (2) any post-retirement medical or life insurance benefit provided to highly compensated employees under a plan of which the welfare benefit fund is a part that does not meet nondiscrimination requirements with respect to the benefit, or (3) any portion of the fund that reverts to the benefit of the employer (whether or not all liabilities of the fund have been previously satisfied).

F. Medical Benefits Provided by Qualified Plans

Present law also permits an employer to pre-fund post-retirement medical benefits through a tax-qualified pension or annuity plan provided certain additional qualification requirements are met with respect to the post-retirement medical benefits. First, the medical benefit, when added to any life insurance protection provided under the plan, must be subordinate to the retirement benefits provided by the plan.

Second, a separate account must be maintained with respect to contributions to fund such benefits. This separate accounting is determined on an aggregate, rather than a per participant basis, and is solely for recordkeeping purposes. Third, the employer's contributions to a separate account must be reasonable and ascertainable. Fourth, the plan must preclude the application of amounts in the separate account, at any time prior to the satisfaction of all liabilities with respect to post-retirement benefits, to any other benefits. Upon the satisfaction of all plan liabilities to provide post-retirement medical benefits, the remaining assets must revert to the employer and cannot be distributed to the retired employees. Similarly, if an individual's right to medical benefits is forfeited, the forfeiture must be applied to reduce the employer's future contributions for post-retirement medical benefits.

In addition, for years beginning after March 31, 1984, if the requirements with respect to post-retirement medical benefits are met, employer contributions to fund these benefits are deductible under the general rules relating to deductions for contributions to qualified plans. The deduction for such contributions is in addition to the deductions provided for contributions for retirement benefits. The amount deductible may not exceed the total cost of providing the medical benefits, determined in accordance with any generally accepted actuarial method that is reasonable in view of the provisions and coverage of the plan, the funding medium, and any other relevant considerations. In addition, for years beginning after March 31, 1984, any pension plan that provides such benefits is required to create and maintain an individual medical benefit account similar to that required in a welfare benefit fund for any participant who is a 5 percent owner and to treat contributions allocated to such accounts as annual additions for purposes of the overall limits on contributions and benefits.

G. Study of Employee Benefit Plans

In enacting provisions designed to limit the extent to which welfare benefits (including post-retirement medical benefits) were prefunded, Congress noted that the minimum standards of the Employee Retirement Income Security Act of 1974 (ERISA) and of the Code relating to employee participation, vesting, accrual, and funding applicable to pension plans do not apply to welfare benefit plans. Congress was concerned that, in the absence of minimum standards, the reasonable expectations of employees and their dependents under welfare benefit plans could be unreasonably disappointed. Congress was also concerned that the imposition of minimum standards could have undesirable results if the standards are unnecessary or improperly designed.

The Deficit Reduction Act of 1984 directed the Secretary of the Treasury to study the possible means of providing minimum standards for employee participation, vesting, accrual, and funding under welfare benefit plans for current and retired employees (including separated employees). The study is to include a review of whether the funding of welfare benefits is adequate, inadequate, or excessive. The Secretary was required to report to Congress with respect to the study by February 1, 1985. The Congress expected that the Secretary will provide suggestions for minimum standards where appropriate.

The Secretary has not yet reported the Department's findings to Congress.