REPORT #625

TAX SECTION

New York State Bar Association

Report On The Sanction Imposed by the Section 89 Qualification Rules

by the Committee on Insurance Companies

September 11, 1989

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TAX SECTION

New York State Bar Association

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September 12, 1989

The Honorable Dan Rostenkowski
Chairman
House Ways & Means Committee
211 Rayburn Office Building
Washington, D.C. 20515

Dear Congressman Rostenkowski:

Enclosed is a Report by our Committee on Insurance Companies on the Sanction Imposed by the Section 89 Qualification Rules. The draftsmen of this report are Hugh T. McCormick and Norman C. Bensley.

The Report recommends that the present sanctions for failure to meet the requirements of Section 89(k) be repealed. It supports current efforts to substitute imposition of an excise tax of up to 34% of the employer's cost of the relevant plan, as contained in Senate Bill 5.5 (or alternatively in House Bill 315), in place of the taxation of actual benefits paid to employees.

Sincerely,

Wm. L. Burke

WLB/JAPP
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Enclosure

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cc (w/ encl.): Robert J. Leonard, Esq.
Chief Counsel, Staff Director
House Ways & Means Committee
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Washington, D.C. 20510

Identical Letter and Report Sent to the Following:

The Honorable Bill Archer
The Honorable Lloyd Bentsen
The Honorable Bob Packwood
The Honorable Ronald A. Pearlman
The Honorable Kenneth Gideon

September 11, 1989

Tax Report #625

New York State Bar Association -- Tax Section

Report On The Sanction Imposed by
the Section 89 Qualification Rules

by the Committee on
Insurance Companies[1]

The merits of section 89 of the Internal Revenue Code of 1986, as amended (the "Code"), have been widely discussed, and the Insurance Companies Committee has little to add to the overall subject at this time. The Committee believes, however, that with virtually all the attention devoted to the section 89 non-discrimination rules, an important tax policy issue may not have received proper attention.

Our concern is focused on the sanction for non-compliance with the so-called qualification rules set out by section 89(k) as it is now in force. Under these rules, the sanction for an employer's failure to observe statutory requirements as to the formalities for certain types of employee benefit plans is primarily visited upon the employee. or the beneficiary of a deceased employee. Moreover, unlike the sanction under the general nondiscrimination rules of section 89, in the case of life insurance and health insurance plans the section 89(k) sanction is not the taxation of the value of an otherwise untaxed in-kind benefit in the hands of highly-compensated

[1] This report was prepared by Hugh T. McCormick and Norman C. Bensley, Committee Co-Chairs. Helpful comments were received from William L. Burke, John A. Corry, William M. Colby, Sherman F. Levey and Robert J. Levinsohn.

employees; rather, all employees, or their beneficiaries, lose the benefit of income exclusions for death benefits or medical reimbursement payments (exclusions that are not forfeitable by a taxpayer in virtually any other circumstance).[2]

We believe that this rule is misguided in its aim and unjustifiably draconian in its effect, and thus represents unwise tax policy. We commend the efforts made in the recently proposed section 89 regulations (the "Proposed Regulations") to ameliorate the potentially harsh effects of the section 89 (k) sanction. The Proposed Regulations, however, do not and cannot correct the problem of the basic statutory approach. We believe that the concept of imposing sanctions on employees for the employer's error is, as a general proposition, wrong. Thus, we support current efforts to amend section 89, so that the employer, and not employees, would suffer any sanction for noncompliance with qualification rules. Furthermore, to the extent that it is deemed appropriate to tax employees in this context, for an insured plan the value of coverage, not the value of benefits, is the proper measure for any sanction. We finally suggest that Congress should consider whether or not the adoption of the current

[2] When a qualified plan becomes disqualified as a result of an employer's actions, the employee loses the benefits of tax deferral. Otherwise excludible benefits, such as life insurance death benefits, would not, however, become taxable in such instance. Circumstances in which statutory exclusions from income are forfeited as a result of the actions of another are relatively rare. For example, a statutory exclusion can be lost as a result of violations of the arbitrage rules under section 103, and under the section 7702 definition of life insurance, when an insurer fails certain actuarial tests.

section 89 (k) sanction represents an aberration, or is reflective of some new, stricter (and, we believe, unwarranted) view as to sanctions for taxpayer noncompliance.

DISCUSSION

Under section 89 of the Code as it now reads, an employer maintaining certain types of "employee benefit plans" is subject to the "qualification rules" of section 89(k). The relevant plans include a "statutory employee benefit plan" as defined in section 89(i), which specifically covers group term life insurance programs within the meaning of section 79, and accident or health plans within the meaning of Code section 105(e)[3]. With respect to any covered plan, section 89(k)(l) provides that:

> Notwithstanding any provision of Part III of this subchapter, gross income of an employee shall include an amount equal to such employee's employer-provided benefit for the taxable year under an employee benefit plan to which this subsection applies unless, except to the extent provided in regulations -
>
> (A) such plan is in writing,
>
> (B) the employees' rights under such plan are legally enforceable,

[3] Section 89(k) also applies to tuition reduction programs within the meaning of section 117(d), cafeteria plans covered by section 125, certain fringe benefit programs described in section 132, and a plan to which section 505 is applicable.

(C) employees are provided reasonable notification of benefits available in the plan,

(D) such plan is maintained for the exclusive benefit of employees, and

(E) such plan was established with the intention of being maintained for an indefinite period of time.[4]

Section 89(k)(l) makes it clear that in the case of life insurance benefits paid under a “section 79 plan,” the benefit paid by the insurer is taxable in the hands of the employee's beneficiary. Section 89(k)(3) states that for purposes of the section 89(k)(l) rule of inclusion, the employer- provided benefit is the value of benefits provided to the employee.

Thus, under these rules, if an employer's group-term life insurance plan fails the qualification test of section 89(k), the entire death benefit becomes taxable in the hands of the recipient, without regard to the normal rule of exclusion under section 101(a). This applies even though the true "employer-provided benefit" is the premium value of the coverage, not the death benefit payments and even though this clearly would have been the result if the employer had provided the benefit to the employee other than pursuant to a "plan" or had simply paid the premium to the employee in cash for the employee to purchase the insurance. Similarly, in the case of a non-qualifying

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[4] Part III of subchapter B pertains to items excluded from gross income.

insured accident or health plan, the employee would be taxed not on the value of the premiums paid for the coverage, but on the medical reimbursement benefits that would otherwise be excludible under section 105(b).

It seems clear that the result of taxing the employee on value of benefits, and not just on cost of premiums, is not inadvertent. Section 89(g)(3) differentiates clearly between the value of coverage and the value of benefits. Also, section 89(k)(1) was amended by section 1011B(a)(29) of the Technical and Miscellaneous Revenue Act of 1988 to clarify that death benefits are includible in the income of the employee's beneficiary.[5]

The untoward result of this rule is easily illustrated. Consider a situation in which an employee incurred many thousands of dollars of reimbursed medical expenses, and the reimbursement payments are now subject to tax.[6] It seems at least doubtful

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[5] See also H. Rep. 100-795, 100th Cong., 2d Sess. 515 (July 26, 1988), which states, "in the case of an insurance-type plan, an employee's employer-provided benefit is the value of the benefits, not the coverage, attributable to employer contributions."

[6] Code section 213(a) allows a deduction for medical expenses "not compensated for by insurance or otherwise." Clearly, the employee referred to above would have received compensation; the fact that the compensation is includible in income under a special rule would seem to have no bearing on the question of deductibility under section 213. Although it can be argued that there should be complete symmetry between section 213 and section 105(b) (the exclusion provision that is overridden by section 89), the Code provides no method to accomplish that goal; the excludibility of medical reimbursement payments under section 105(b) is to some extent governed by the amount of covered expenses that are deductible under section 213, but the deductibility of amounts under section 213 is not governed in any way by section 105.

Moreover, even if expenses are deductible, the 7.5% floor on the medical expense deduction would reduce the value of the deduction.

that the employee would be allowed a deduction for the related medical expenses, and even if the employee were allowed to take into account the expenses, there would not be full relief.

As another case, assume a small employer who provides employees with $50,000 of group-term life insurance coverage under a basic "section 79 plan," but who is not in compliance with the requirements of section 89(k)(1). For the bulk of the employees there would be no sanction, as the value of the annual premium would not be brought into income. If an employee dies, however, the $50,000 death benefit paid to a surviving spouse would be subject to tax.

We do not believe this harsh result is justified by any tax policy or employee protection considerations. The apparent rationale of the tax treatment imposed by section 89(k) is that if a plan fails to satisfy the qualification requirements, then the employer pays benefits under an ad hoc reimbursement program that attempts to convert fully taxable compensation into nontaxable benefits.[7] We question the wisdom of imposing sanctions on

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[7] See Staff of Joint Committee on Taxation, Description of H.R. 1864 Relating to Simplification of Section 89 Nondiscrimination Rules Applicable to Certain Employee Benefit Plans 14, JCS-9-89 (April 25, 1989) (the "Joint Committee Pamphlet").

all employees, at least many of whom frequently will be ill-positioned and ill-equipped to discern and protect themselves against the penal consequences and potential financial hardship that could be involved, when effective sanctions can be imposed more directly and predictably against the employer (who necessarily must be a consenting party to any of the practices stated to be of concern). Moreover, although it may be possible to support the result provided in section 89(k) as a strictly technical matter when the employer makes direct reimbursement payments, there is no support for such an approach when payments are made under an insured plan. At best, the separately enforceable rights employees get against a third party (the insurance company) makes the section 89(k) approach fly directly in the teeth of the basic tax rules concerning economic benefit and constructive receipt (which would effectively result in the employee being treated as the owner of the policy with additional income equal to the necessary premiums).

As noted above, we believe the Service's efforts to soften the impact of the qualification rule sanction are commendable.[8] Nonetheless, we believe that a statutory provision that imposes a penalty that results in the inclusion of, for

[8] The Joint Committee Pamphlet, at 15, describes the rule as follows: [T]he regulations limit amount includible in income to a percentage of the individual's compensation. In particular, the amount includible for failure to meet the qualification requirements is limited to the sum of (1) 10 percent of the employee's compensation up to the dollar amount used to determine the top-paid 20 percent of highly compensated employees ($54,480 for 1989), (2) 25 percent of the employee's compensation in excess of such dollar amount but not in excess of 200 percent of such dollar amount, (3) 75 percent of the employee's compensation in excess of 200 percent of such dollar amount, and up to and including 300 percent of such dollar amount, and (4) 100 percent of the employee's compensation in excess of 300 percent of such dollar amount. For example, if an employee has $20,000 of compensation and a taxable benefit of $30,000 by reason of a plan's failure to meet the qualification requirements, (e.g., the employee had surgery for which the employer paid), the employee would not be required to include in his or her taxable income more than 10 percent of compensation ($2,000).

example, as much as $2,000 in the income of an employee at the $20,000 per year compensation level, as would occur in a situation covered by the Proposed Regulations, is wrong in its very conception.[9]

We believe that the sanction provisions contained in S. 5 (as passed by the Senate on June 23, 1989) represent a significant improvement. S. 5 would apply to the employer an excise tax of up to 34% of the cost to the employer of "specified employee benefit plans" (which are generally the type of plans now covered by section 89, including accident and health plans, group term life insurance plans, and other plans listed in note 3). It should be noted that the excise tax covers employers that might not otherwise be subject to tax in the relevant year, whereas a deduction disallowance mechanism might be a toothless sanction. The employer's cost ("amounts paid or incurred during the taxable year") would be determined by reference to actual costs, including the premiums paid for insurance coverage. Finally, by focusing on the employer, this provision generally would eliminate the override of sections 101(a) and 105(b) for insured plans that exists under the current law.

[9] In contrast, it is worth noting that the annual income inclusion for a 40-year old employee with life insurance coverage to the extent of two times salary at $20,000 per year would be $81.60 under the section 79 tables, or $176.80 under "P.S. 58" rates.

The Senate bill would apply to multi-employer plans (by taxing the plan, rather than the employer), and would provide certain relief provisions in the case of good faith errors. The tax rate would be subject to a phase-in: 10% in the first six months of taxable non-compliance, 20% for the second six months, and 34% thereafter. The taxable period (the "correction period") would begin at such time as the failure to comply with the qualification rules first becomes known (or should become known to a person exercising due diligence). It would also minimize the qualification rules for certain small employers utilizing plans issued by a third-party insurer.

Additionally, on July 12, 1989 the House Ways and Means Committee approved a measure that would also impose an excise tax of 34% on non-compliant employers. This approach, first suggested by Chairman Rostenkowski as part of H.R. 1864, which was introduced on April 13, 1989, has now been introduced as section 11302(b)(1) of H.R. 3150 ("Revenue Reconciliation Bill of 1989"). Although the Ways and Means provision would not phase in imposition of the tax, it is intended to achieve an overall result similar to that of S.5; i.e., it would provide a six-month correction period, and allows the Secretary of the Treasury to waive the tax in appropriate circumstances. It would also allow an employer the opportunity to correct any inadvertent failures under the qualification rules.

The effect of the excise tax is to penalize directly the party responsible for the non-compliance. It is the view of this Committee that this approach is preferable to that set out in present law, even as softened by the Proposed Regulations. We thus support the enactment of the qualification rule amendments set out in either S. 5 or in the House Ways and Means Committee proposal.

Finally, we believe that respect for the tax laws, and thus compliance, is harmed by the imposition of poorly targeted penalties and sanctions. The need to revise the section 89(k) sanctions serves as a good occasion to renew the attention and sensitivity to those concerns in formulating appropriate controls.