

SUMMARY OF LETTER TO PEARLMAN
AND COMMENTS ON THE PENDING TECHNICAL CORRECTIONS BILLS
(H.R. 4333 and S. 2238)

The cover letter to Ronald Pearlman, Chief of Staff, Joint Committee on Taxation, points out that employers and others who are required to comply with the new Code section 89 welfare plan nondiscrimination rules have not been provided with timely, adequate guidance on how to comply. We urge that, even if broader, more adequate solutions cannot be provided with respect to section 89, at a minimum, employers should be permitted to follow a reasonable, good faith interpretation of section 89 until at least the beginning of the first testing period that begins at least six months after relevant Treasury regulations are issued. We also urge the support of more workable mechanisms in connection with future legislation. We plan to submit identical letters to Congressman Rostenkowski, Senator Bentsen, and O. Donaldson Chapoton, Assistant Secretary of the Treasury for Tax Policy.

Our specific comments address a number of technical issues we have identified with respect to the pending technical corrections bills. We plan to submit them to Ronald Pearlman, Robert Leonard, Chief Tax Counsel to the Ways and Means Committee; Janice Mays, Majority Tax Counsel to the Ways and Means Committee; Randy Hardock, Majority Tax Counsel to the Senate Finance Committee; Gwen Gampel, House Ways and Means Committee Staff; Rosina Barker, Professional Assistant to the Ways and Means Committee; Lindy Paul, Minority Deputy Chief of Staff to the Senate Finance Committee; Carolyn Smith, Legislation Attorney to the Joint Committee on Taxation; Mary Levonton, Legislation Counsel to the Joint Committee on Taxation; Kent Mason, Legislation Attorney, Joint Committee on Taxation; Harry Conaway, Associate Tax Legislative Counsel at Treasury; and Paul Strella, in the Tax Legislative Counsel's Office at Treasury.

We have made specific suggestions to make interim compliance procedures more workable. We have suggested that more lead time be provided to comply with new guidance. We have made suggestions to clarify and simplify the rules relating to the timing and methods of testing for compliance. We have suggested clarifications of the aggregation rules, rules permitting exclusions of certain employees covered by other plans, special multiemployer plan rules, and certain rules relating to employer sanctions and elections to treat group legal, educational assistance, or dependent care plans as covered by section 89.

[Taxation Section Letterhead]

Draft
September 19, 1988

Mr. Ronald A. Pearlman
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

Re: Comments on Technical Corrections
to Code Section 89 by Individual
Members of the Welfare Plan Issues
Working Group, Employee Benefits
Committee of the Taxation Section
of the District of Columbia Bar

Dear Mr. Pearlman:

We enclose specific comments on the pending technical corrections to the welfare plan nondiscrimination rules of section 89, for consideration in the ongoing legislative process. These comments reflect the individual views of the members of the Welfare Plan Issues Working Group¹ of the Employee Benefits Committee of the Section of Taxation of the D.C. Bar and have been approved by the Steering Committee of the Section of Taxation.² In addition, we would like to bring to your attention a more general and very important concern of both the Welfare Plan Issues

¹ The members include: Vivian H. Berzinski, Esq., (Chair), Edward B. Cohen, Esq., Richard H. Fay, Esq., David D. Green, Esq., Evan Miller, Esq., Janelle Straszheim, Esq., Anne Moran, Esq., Daniel L. Morgan, Esq., Steven A. Weiss, Esq., and John A. Wilhelm, Esq.

² The views expressed herein represent only those of the Section of Taxation of the District of Columbia Bar and not ~~the District of Columbia Bar~~ those of the District of Columbia Bar or of its Board of Governors. The Section of Taxation is comprised of approximately 1,200 members.

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Working Group and the Steering Committee of the Section of Taxation.

We do not question the need for nondiscrimination rules for welfare plans. However, we are deeply concerned about the process through which section 89 has been enacted and is being interpreted and implemented.

1. There Has Been a Failure To Provide Timely, Adequate Guidance Under Section 89

Less than four months remain before most employers will have to begin complying with the section 89 rules. Nevertheless, the legislative history remains the only guidance currently available to employers. As yet, there is no adequate guidance on several basic concepts on which section 89 compliance depends.

For example, valuation issues, which are central to the application of section 89, have not been resolved, although the technical corrections bill (if passed) provides some interim guidance. Issues relating to separate lines of business, sampling, use of part-time employees, and application of the section 89 rules in the context of mergers or layoffs, among others, also have not been adequately addressed.

It is already too late for Treasury to provide timely guidance on these crucial issues. Employers and others need adequate lead time to implement changes in their welfare benefit programs, and three months or less is insufficient to design, draft, review and implement such programs.

2. Congress Has Not Adequately Addressed or Resolved the Problems Resulting from This Failure To Provide Timely, Adequate Guidance

In response to this problem, Congress has not reconsidered the appropriateness of the approach taken in section 89 for preventing discrimination in welfare plans. Instead, Congress has sought to deal with this problem through attempted quick fixes and interim rules in technical corrections. This has been coupled with indications that employers should rely on legislative history in the absence of formal guidance from Treasury. These "solutions" fail to adequately resolve the problem.

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a. Legislative History Does Not Constitute Adequate Guidance to Taxpayers

The Committee Report on the Miscellaneous Revenue Act of 1988 (at 493) states that "[b]ecause of the extensive guidance provided in the legislative history, comprehensive rules [Treasury regulations to be issued by October 1, 1988] are not required; the guidance is to address those areas not addressed by the statute or legislative history ..." (emphasis added).

We strongly disagree with the view of the Tax Committee staff, reflected in this statement, that legislative history is sufficient to provide guidance and statutory interpretations for taxpayers. Legislative history is provided without the procedural notice and comment period required for regulations. While helpful, it is inadequate as a substitute for formal regulations.

b. The Interim Rules and Protection for Reasonable Good Faith Efforts Proposed in the Technical Corrections Packages Do Not Adequately Resolve the Problems Created By Lack of Timely, Adequate Guidance

Similarly, the interim rules and protection for reasonable good faith efforts proposed in technical corrections do not adequately resolve this problem.

These interim rules, while helpful, would greatly increase the cost of administering benefit plans because administrative and computer programs and other compliance features would have to be put into place to comply with the interim rules for 1989 and then would have to be revised to implement a second set of compliance rules once formal guidance is issued. This likelihood imposes additional problems and uncertainty for employers trying to make long-range plans. The use of two different sets of rules in two different time periods will also make it more difficult for the Service to audit plans. In addition, once formal guidance is issued, as a practical matter, that guidance may unduly prejudice an auditor's view of the "reasonableness" of interim compliance efforts.

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Employers are apparently permitted to implement a "reasonable," "good faith" interpretation of the section 89 rules until formal guidance is issued. However, an unduly high standard as to the meaning of "reasonable" and "good faith" in this context is required. Further, such reasonable, good faith implementations may have to be changed once Treasury issues regulations. Even worse, there appears to be no requirement that such regulations, once issued, must provide a reasonable period to enable implementation before they go into effect.

All of this leaves employers and others who are trying to develop permanent, complying changes to their employee welfare benefit plans in the most difficult position of having to develop their own interpretations of the novel and complex section 89 rules. Even if employers' interpretations are judged by the Service to be "reasonable," they may nevertheless have to redesign their plans, procedures, etc., to comply with differences in the rules, as ultimately interpreted by Treasury. In addition, reasonable and effective redesign may be impossible for a testing year that has already commenced before new Treasury rules are issued.

3. Conclusion

Even if it is not possible to remedy adequately the problems we have discussed in the context of section 89, we urge you, at a minimum, to permit employers to follow a reasonable, good faith interpretation of section 89 until at least the beginning of the first testing period that begins at least six months after relevant Treasury regulations are issued. We also ask that in the future the tax-writing committees reflect on this experience with section 89 and give careful thought to the process by which timely and adequate guidance on any significant employee benefits legislation will be provided to employers, plan sponsors and trustees, and others.

Lastly, we strongly urge that when particular legislative requirements, such as these, create more problems in implementation than anticipated, Congress

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should be willing to consider fresh approaches rather than interim "patchwork" fixes.

Sincerely,

Vivian H. Berzinski, Chair
Welfare Plan Issues
Working Group

Patricia G. Lewis, Chair
Employee Benefits Committee

Enclosure

cc with Enclosure:
Harry Conaway, Associate Tax
Legislative Counsel

DRAFT
September 19, 1988

Comments on Technical Corrections
to Code Section 89 by Individual Members
of the Welfare Plan Issues Working Group,
Employee Benefits Committee of the
Section of Taxation of the District of Columbia Bar

The individual members of the Welfare Plan Issues Working Group Employee Benefits Committee of the Section of Taxation of the District of Columbia Bar¹ would like to make the following comments on the pending technical corrections to the welfare plan nondiscrimination rules of section 89. It is hoped that these comments will be seriously taken into consideration in the pending legislative process (including conference) and, to the extent still outstanding, in the "Blue Book" drafting and the regulation process under Section 89.

¹ These include: Vivian H. Berzinski, Esq., (Chair), Edward B. Cohen, Esq., Richard H. Fay, Esq., David D. Green, Esq., Evan Miller, Esq., Janelle Straszheim, Esq., Anne Moran, Esq., Daniel L. Morgan, Esq., Steven A. Weiss, Esq., and John A. Wilhelm, Esq.

These comments have been approved by the Steering Committee of the Section of Taxation of the District of Columbia Bar, which Section has approximately 1,200 members. The views expressed herein represent only those of the Section of Taxation of the District of Columbia Bar and not ~~those of the District of Columbia Bar~~ those of the District of Columbia Bar or of its Board of Governors.

1. "Good Faith" Compliance

a. Effective Date of Treasury Guidance

The Committee Reports on the technical corrections bills state that an employer may follow a reasonable, good faith interpretation of section 89 until Treasury issues formal guidance. Senate Report at 486; House Report at 493. However, employers will need some lead time after the issuance of regulations to bring their programs into compliance. In addition, it would be unnecessarily burdensome, and in some cases unworkable, to require employers to make changes in their programs during an ongoing plan year.

Accordingly, we suggest that employers be permitted to continue to follow a reasonable good faith interpretation until the first testing period that begins at least six months after Treasury regulations are issued.

b. Definition of "Good Faith" Compliance

We suggest that the definition of "good faith" compliance proposed in the House and Senate Reports is too strict in light of the fact that no formal or proposed guidance under section 89 is available and the legislative history of section 89 leaves significant questions unanswered and, in some cases, conflicts with other statements in legislative history or with the plain meaning of the statute. H. Rep. No. 795, 100th

Cong. 2d Sess. 493 (1988) ("House Report"); S. Rep. No. 445, 100th Cong. 2d Sess., 487 (1988) ("Senate Report"). We suggest that a taxpayer should be considered to be acting in good faith as long as he complies with a reasonable interpretation of the statute in light of reasonable business practices and there is no clear guidance in the statute, legislative history or from the IRS to the contrary.

2. Effective Date of Guidance on
Temporary Special Valuation Rule

The House and Senate Reports state that the Secretary may issue rules clarifying the meaning and application of the temporary special valuation rule without regard to the provisions prescribing the earliest date on which valuation rules in general may be effective. Senate Report at 492; House Report at 498. However, employers will need lead time to comply with guidance even on the temporary special valuation rule. Accordingly, we suggest that any such guidance be made to apply prospectively only, and provide sufficient lead time prior to its effective date for employers to analyze the new rules and bring their plans into compliance.

3. Time for Testing for Section 89 Compliance

a. Termination of Employment Should Not Be Treated as An Election

The proposed technical corrections would permit plans to test for compliance on one day in each year, provided that specified adjustments are made with respect to plans of the same type if, during the year, there is a change in plan design or any election by a highly compensated employee to change his or her benefits in any way. S. 2238 § 432(a)(2); H.R. 4333 § (a)(2). Termination of employment by a highly compensated employee will ordinarily terminate or at least modify the benefits made available to that employee. However, this should not be treated as an election to change his or her benefits and should not give rise to any requirement to do additional testing for or make any adjustments with respect to section 89 compliance.

b. Changes in Benefits Due to Changes in Family Status or Requirements of Law

It would also be helpful to provide that elections made by highly compensated employees to change from single to family coverage or vice versa in the event of a change in marital and/or family status, where such elections are available on a nondiscriminatory basis to all participants, will not give rise to a requirement to do any retesting or make any adjustments

with respect to section 89 compliance. We note that otherwise impermissible modifications of certain elections under cafeteria plans would be permitted in the event of a change in marital and/or family status under proposed regulations. Prop. Treas. Reg. § 1.125-1 Q&A-8. In addition, changes in coverage under a health plan made solely to comply with changes in state-mandated benefits rules should not give rise to the need to make any adjustments for section 89 purposes.

These types of changes are not within the control of the employer and are not subject to manipulation for abusive purposes. No significant increased potential for discrimination would arise as a result of such exceptions. These exceptions would therefore be a reasonable means to avoid imposing on employers the burden of retesting and making adjustments every time such a change occurs. This is particularly important in light of the frequency with which these changes, especially changes in marital and/or family status, could occur.

c. Valuation of Group Legal, Educational Assistance and Dependent Care Benefits

Code section 89(g)(3)(ii) states that, in the case of plans other than health or group term life insurance plans, the employee's employer-provided benefit is the value of the benefits provided under the

plan. It would be helpful to clarify whether, in the case of legal services, educational assistance and dependent care assistance programs, the employer-provided benefit on the testing day is the annualized value of the benefits provided on that day or is instead the annualized value of the benefits that have been provided during the plan year prior to and including that testing day.

d. De Minimis Rule

To avoid unnecessarily requiring employers to retest and make adjustments for section 89 compliance during an ongoing year due to de minimis changes in benefits provided to employees, we suggest that a de minimis exception be provided with respect to the requirement to make adjustments in testing for section 89 compliance whenever a highly compensated employee elects to change his or her benefits. In particular, we suggest that, provided that neither the options available under the plan nor the plan design is changed, elections by highly compensated employees to change their benefits be ignored if: (1) the number of people making such elections since the last testing date constitute less than five percent of all highly compensated employees as of such date; and (2) identical elections (adjusted for compensation) are available to all nonhighly compensated employees.

e. Testing Every Two Years Should Be Permitted Under Some Circumstances

We suggest that plans that comply with section 89 in one year be permitted to automatically comply in the immediately subsequent year as long as there are no changes in plan design and no highly compensated employees elect to change their benefits in any way. Such a rule would provide only a very minimal increased potential for discrimination and would reduce compliance costs considerably.

4. Sampling

a. Definition of Independent Third Party

It is important to define the term "independent third party." In particular, it would be helpful to specify whether the consulting firm that designs an employer's health benefits package can serve as an "independent third party" for purposes of sampling.

b. Employers Should Be Permitted to Use Their Own Facilities and Computers to Do Sampling

We suggest that employers be permitted to use their own facilities and computer systems to do sampling and process sample data to demonstrate compliance under section 89, as long as the results are audited by an independent third party. This would not significantly increase the potential for abuse and, in many cases, it

would result in a substantial decrease in employer compliance costs.

c. Compliance Failures
Based on Sampling

If an employer fails to satisfy the section 89 tests, based on a sample of its employees, it is not clear what, if any, adjustments the employer could make to bring its programs into compliance, based on sampling, without having to apply the tests to all of its employees. We suggest that some permissible simplified mechanisms be provided.

In particular, it would be helpful to provide that the employer may comply with Section 89 by treating as taxable the benefits of the number of its highly compensated employees necessary to cause the sample that has already been selected and that previously failed the section 89 tests to satisfy those tests. The highly compensated employees who would be taxed would be selected from among all of the employers' highly compensated employees, not just those highly compensated employees who happened to be in the sample. They would be taxed in order of compensation, from highest to lowest. Thus, the most highly compensated of all of the employers' employees would be taxed first, regardless of whether or not he or she is in the sample. Then the second most highly compensated employee, then the third,

etc., until the necessary number of highly compensated employees that happened to be in the sample have been taxed.

5. Definition of a "Comparable" Plan

a. Application of 95 Percent
Test on an Average Basis

Code section 89(q)(1) defines a comparable group of plans as "any group (selected by the employer) of plans of the same type if the smallest employer-provided benefit available to any participant in any such plan is at least 95 percent of the largest employer-provided benefit available to any participant in any such plan." The Conference Report, however, indicates that a comparable "helper plan" with which another plan may be aggregated is a plan in which "the average value of the employer-provided coverage per employee" is "at least 95 percent of the average value of the employer-provided coverage per employee in the nonhelper plan." H.R. Rep. No. 99-841, 99th Cong. 2d Sess., II-531-32 (1986). A technical correction to reconcile the statute with this legislative history would be helpful to clarify that this comparison should be done on the basis of average, rather than individual, benefits provided under the plans.

b. Permissible Aggregation
of Comparable Plans

The House Report on H.R. 4333 states that, "[b]ecause comparable options can be aggregated to constitute a plan, comparable plans cannot be aggregated." H.R. Rep. No. 795, 100th Cong. 2d Sess. 503-504 (1988). The meaning of this statement should be clarified. Does this mean that, if all aggregable options are aggregated to form a single plan, no unaggregated comparable plans will remain in existence because they have all been treated as options and aggregated into a single plan? If not, what does it mean? Is this in conflict with the mandatory comparability rules of proposed Code section 89(g)(1)(C), which would be added by section 111B(a)(3) of S. 2238?

c. Comparability Safe Harbor

S. 2238 section 432(a)(6) would provide that, for purposes of the 80 percent test, a group of plans is treated as comparable with respect to a group of employees if: (1) such plans are available to all employees within the group on the same terms; and (2) the difference in annual cost to the employees between the plan in the group with the smallest employee cost and the plan in the group with the largest employee cost is no more than \$100, indexed for inflation. It

would be helpful to clarify that, for purposes of determining the annual cost to employees, deductibles and coinsurance payments required under the plans are ignored.

6. Other Coverage

a. 80 Percent Rule

Both H.R. 4333 and S. 2238 provide that, for purposes of applying the 80 percent test to accident or health plans, an employer generally may elect to disregard any employee or family member of an employee if such individual is covered by a health plan that provides core benefits and that is maintained by another employer of the employee or of any member of the employee's family. Section 322(a)(7) of H.R. 4333 does this by substituting "the requirements of subsection (e) or (f)" for the words "the requirements of subsection (e)" in section 89(g)(2). Section 432(a)(7) of S. 2238 would also make this change. However, in addition, section 432(a)(7) would replace "(e)" with "(e) or (f)" in section 89(g)(2)(A)(ii). These two provisions should be reconciled.

b. Overriding Rules

Section 322(a)(8) of H.R. 4333 and Section 432(a)(8) of S. 2238 would add a new section 89(g)(2)(E) to the Code to provide that no nonhighly compensated employee (or family member) may be disregarded based on

his or her receipt of other core health coverage unless, under the plan, the employee has the right, if such other coverage ceases, to elect health coverage from the employer without regard to whether it is otherwise open season. The statute should make clear that this requirement applies only if the employment relationship exists on the date that the other core coverage ceases.

7. Definition of "Plan"

The proposed technical corrections would redefine the term "plan." In general, the different options or benefit structures within a plan that have previously been referred to as separate "plans" would, under the proposed bills, be referred to as "options." This change in terminology was made to avoid confusing employers. However, rather than avoiding confusion, this change creates further confusion.

Employers, practitioners and others have been struggling for the last two years to understand and apply section 89. They have become familiar with the current definition of a "plan." Changing this terminology at this point will therefore create confusion.

In addition, the current definition of a "plan" for purposes of section 89 is similar to the definition of a "plan" for purposes of the health care continuation coverage requirements of section 162(k). To the extent

possible in light of the differences in these two Code sections, it would be less confusing to use the same terminology.

8. Special Multiemployer Plan Rules

a. Excludable Employees

Multiemployer plans typically provide generous coverage rules. Further, coverage under multiemployer plans is based not only on service with an employee's current employer, but also on service with other contributing employers for whom the employee worked previously. In addition, employers contributing to multiemployer plans have little or no control over, and often have no knowledge of, the plans' coverage rules. It is therefore important to clarify that employers contributing to a multiemployer plan may exclude, for purposes of testing for section 89 compliance of their other plans, all otherwise excludable employees, even if such employees or members of their excludable group are covered under a multiemployer plan to which that employer contributes.

The Senate bill, in section 432(a)(5), which would add a new section 89(h)(6) to the Code, provides such a rule. However, under section 322(a)(5) of the House Bill, Code section 89(h)(6) would be modified to exclude coverage under multiemployer plans from consideration only for purposes of the exclusion of

employees who have failed to satisfy an initial eligibility requirement. We urge you to adopt the more comprehensive Senate version of this provision.

b. Denial of Special Rules to Plans Covering a "Professional"

The reports on the proposed technical corrections state that the special excludable employees rule described in (a) above, and the special rule permitting employers contributing to multiemployer plans to treat the value of an employee's coverage under a multiemployer plan as equal to the amounts the employer contributes with respect to that employee (with adjustments) do not apply to a multiemployer plan that covers any "professional," (e.g., a doctor, lawyer, or investment banker). House Report at 501, 511; Senate Report at 495, 509. The term "professional" needs further clarification.

In particular, multiemployer plans often cover the staff of the associated union and/or the fund itself. The union and fund often have staff attorneys and/or accountants. Clearly, this is not the type of situation that the rule relating to "professionals" sought to address.

We suggest that this problem be resolved by providing that the denial of the special rules will apply on an employer-by-employer basis only to those

employers that have a "professional" employee covered under the plan. In most cases, the result would be that the union and the fund would not be able to treat the amount of their contributions to a multiemployer plan as the value of the benefits provided by that plan and would not be permitted to exclude from other plans members of an otherwise excludable group if members of that group are covered by the multiemployer plan. However, because the staff of the union and the fund tend to be smaller and less mobile than other multiemployer plan participants, the denial of these special rules to these particular employers is unlikely to create any insurmountable problems, as long as all other employers contributing to the multiemployer plan are still permitted to take advantage of the special rules.

9. Valuation of Group Term Life Insurance

We suggest that Code section 89(g)(3)(C)(1) be amended to provide expressly, as indicated in the Blue Book (at 789) that, in applying the benefits test of Code section 89(e) and the 50 percent component of the 90 percent/50 percent test of Code section 89(d)(1)(A)(ii) to a group term life insurance plan, except in cases where group term life insurance plans are aggregated with plans of a different type for purposes of the benefits test, the value of the benefit

provided may be adjusted by dividing it by the compensation of the participant.

10. Employer Sanction Under Code Section 6652(k)(2)(A)

It would be helpful to clarify whether the amount taxed to the employer under Code section 6652(k)(2)(A) for failure to include an excess benefit in the W-2 of a highly compensated employee is computed at the surcharge rate of Code section 1(g).

11. Election to Treat Group Legal, Educational Assistance or Dependent Care Plans as Statutory Employee Benefit Plans

Congress should clarify that the election, under Code section 89(i)(2), to treat a group legal, educational assistance and/or dependent care assistance plan as a statutory employee benefit plan applies on a plan year by plan year basis. An employer that has made such an election for one plan year should be permitted to revoke it and to test its plans under otherwise applicable rules for subsequent years.