EBRI ISSUE BRIEF

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FLEXIBLE COMPENSATION AND PUBLIC POLICY*

ABSTRACT

Employee benefits have been established and encouraged by Congress as a way of providing economic security to workers, retirees, and their families. Both public and private programs face the challenge of adapting to an aging population, more women working outside the home, more two-earner households, and more single-parent families. With the enactment in 1978 of Section 125 of the Internal Revenue Code (IRC), Congress allowed employers to offer employees a choice among different benefits -- so-called flexible compensation or "cafeteria" plans. There is mounting evidence that this approach can be used to better meet employees' individual needs and also to achieve greater economic efficiency and help control the growth of benefit costs. More and more employers are adopting flexible benefit plans, even though the Treasury Department has still not issued the relevant regulations.

Meanwhile, as part of the Social Security Amendments of 1983, Congress considered changes in Section 125. Again, in the fall of 1983, the tax writing committees in the Congress discussed Section 125, this time focusing on what benefits are appropriate to include in a plan. H.R. 4170, a bill reported by the House Ways and Means Committee in October 1983, includes specific language on Section 125.

This issue brief provides an overview of why employers and employees find the flexible benefits approach attractive, and why public policymakers continue to consider modifications to the law. With more than 100 employers now sponsoring flexible benefit programs for more than 3 million workers, and with hundreds more employers considering them for millions of additional workers, the implications of a policy change can be extremely important.

* Portions of this issue brief were drawn from a forthcoming EBRI book entitled, Fundamentals of Employee Benefit Programs.

Introduction

In recent years, family relationships, lifestyles, trends toward early retirement and increased longevity have raised questions about the efficiency of conventional benefit plans. We have seen an influx of young workers and female workers whose lifestyles and values are different from the male breadwinners of twenty years ago. Changes in social and economic circumstances have affected the needs and preferences of workers.

Most employee benefit programs are designed to satisfy the traditional family's needs. Workers' benefit needs are largely determined by their ages, marital and family status, and compensation levels. Traditional programs do not reflect the circumstances of single workers with no dependents, two-earner couples and single-parent workers; additionally, they seldom consider the changes in workers' needs over time.

Some employers have implemented flexible compensation plans to respond to the differing needs of their workers and to help control employer costs.1/

What Is a Flexible Compensation Plan?

Section 125 (d) of the IRC defines a flexible compensation plan as:

> ...a written plan under which (a) all participants are employees, and (b) the participants may choose among two or more benefits.
>
> The benefits which may be chosen may be nontaxable benefits, or cash, property or other taxable benefits.

Compensation is flexible when employees are entitled to choose among benefit options paid for by employer contributions. Compensation is also flexible when employees can purchase nontaxable benefits through salary reduction arrangements. Within the terms of a flexible compensation plan, employees choose benefits that are: (1) currently taxable; (2) taxable at a future date; or (3) nontaxable. Until recently, the Internal Revenue Service (IRS) presented a deterrent to flexible compensation, because they took the position that employees were in constructive receipt of income (i.e., they received taxable income even though it was in the form of benefits) when employees were given the option to elect cash, taxable benefits or nontaxable benefits. Changes in the IRC in 1978 and 1980, however, have permitted employers to offer taxable and nontaxable benefits under flexible compensation plans without imposing tax penalties on plan participants.

Employee choice is not a new idea in benefit design; many traditional plans offer options to employees. For example:

1/ Flexible compensation plans are also known as cafeteria, supermarket and smorgasbord plans.

(1) Employees may choose among different levels of protection under group life insurance, survivor income and medical care programs.

(2) Employees may choose between cash and deferred profit sharing.

(3) Employees may choose between participating or not participating in a thrift (i.e., savings) plan, and among a number of contribution levels and/or investment options in such plans.

Types of Plans

In a typical flexible compensation plan, the employer provides a minimum level (i.e., a core) of certain basic benefits. The basic benefits generally include health insurance, life insurance, disability insurance, pensions and vacation. A second level of coverage may also be provided in the form of benefit credits. Employees use these credits to purchase: (1) additional coverage in the basic benefit areas; or (2) benefits in other areas such as child care, dental care and legal services.

Although the approach just described is common, there are many variations. For example, employers may provide a core of benefits, but they may also permit employees to choose among several levels of coverage in each basic benefit area. Again, benefit credits may be offered as a second tier of coverage and may be used for obtaining additional protection or services. Under another arrangement, employees choose from several predetermined benefit packages. All benefit packages represent equal value, but each is designed to meet the different lifestyles.

Through salary-reduction arrangements, flexible plans may also permit employees to purchase additional coverage with their own pretax dollars.2/ Within the structure of a particular cafeteria plan, therefore, an employee can use core benefits, benefit credits and personal contributions to design his own benefit package.

Reimbursement Accounts

A reimbursement account (also known as a flexible pay account, benefit bank or a spending account) offers benefit flexibility and is becoming popular. Here, the employer places a sum of money (e.g., $300, $500, $700) in a reimbursement account for each employee. The employee uses the account to purchase nontaxable benefits that are not provided by the standard benefit package. At year end, if the employee has not exhausted his account, the balance can be taken as cash compensation or placed in a deferred compensation plan. To help manage rising health care costs, some companies are using reimbursement accounts in conjunction with reductions in health insurance benefits.

2/ Although the salary-reduction approach appears to be permissible, IRS has not yet issued regulations that explicitly allow the use of salary reduction to finance flexible compensation plan benefits or reimbursement accounts. Final regulations governing 401(k) salary reduction plans are expected shortly, according to Treasury officials. Proposed rules for flexible compensation plans will not be ready by year-end as promised earlier but might be issued in 1984.

Funding

Flexible compensation plans and reimbursement accounts may be funded by employer contributions, employee contributions or both. As mentioned, some plans utilize a salary-reduction, which enables employees to use pretax dollars to purchase additional benefits. Through this approach, employees and employers share the costs of providing for the employee's health, welfare and retirement protection.

Establishing a Flexible Compensation Plan

A common method for establishing a flexible compensation plan is to reduce the employer's existing benefit package to a core of basic benefits. All or part of the cost difference between the original package and the core benefits is converted into benefit credits. Each employee then receives a share of the credits and uses them to purchase a second tier of coverage. Alternatively, the employer may retain his present benefit coverage as the core and grant a supplemental allowance to provide for benefit credits. This method is more costly than the first, but it is viable when employers are willing to allocate additional resources to employee benefits.

Benefit Taxation

As discussed earlier, IRS once took the position that all flexible compensation plan benefits were taxable to the employee, if a plan offered any taxable options. The Revenue Act of 1978, however, changed this. Section 125 of the IRC now states:

> ...no amount shall be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan.

Employers can now offer flexible compensation plans, which can include taxable and nontaxable benefits. Similar to other tax-qualified plans, with regard to participation, contributions and benefits, cafeteria plans may not discriminate in favor of shareholders, officers or highly paid employees. When an employee selects a taxable benefit, its cost is included in his taxable income in the year the benefit is received.

Advantages and Disadvantages of Flexible Compensation Plans

Flexible compensation plans offer employees and employers a number of advantages:

(1) Employees receive more benefit value, because employers provide a benefit program that is tailored to each employee's needs. Employees can change benefits as their lives change (e.g., when they marry or divorce, as their salaries increase or as their children mature and leave home).

(2) Employees become more aware and appreciative of their benefits. This may improve employee morale and productivity.

(3) Employees may become more involved in controlling benefit costs. Additionally, when employees want a new benefit, they are able to trade off another benefit, rather than looking to their employer to provide more.

(4) Flexible compensation plans can be used to convert worker's earnings into tax-free employee benefits, thereby producing a more valuable compensation dollar.

Flexible compensation plans also present potential disadvantages to employees and employers. Most of these can be minimized, however, by careful planning:

(1) Some employees may not understand their choices well enough to choose the most needed benefits; thus, families could suffer from losses in areas where they did not select adequate coverage. This problem can be addressed, in part, by a mandatory core program that assures basic protection and also by an effective communications program.

(2) Effective employee benefit communication is always important, but it is critical in a flexible compensation plan. To assure that employees fully understand their plan and options, as well as their savings and consumption needs, the following techniques can be used:

(a) an advance survey to determine whether employees are receptive to flexible compensation--the survey can also be used to identify the benefits employees most need and want;

(b) a letter to employees' homes announcing the adoption of a flexible compensation plan;

(c) articles in company newsletters;

(d) a booklet describing the plan's primary features;

(e) meetings where benefit professionals explain the plan using slide or video presentations, workbooks and enrollment materials--question and answer period may be helpful;

(f) a telephone hotline when benefit elections are made to answer employee questions;

(g) after benefit elections are made, a personalized statement delineating each employee's individual elections.

(3) Flexible compensation requires substantial advance planning. Employers must make a number of basic decisions. For example: (a) How will the present benefit package be converted into a new flexible plan? (b) Will a core of benefits be provided? (c) What benefits will be optional? (d) What value will be placed on each option? (e) Will the employer provide supplemental money to expand current benefit coverage? (f) How can adverse selection (i.e., those with the highest risks select the greatest protection) be anticipated and minimized? (g) How often will employees be permitted to change elections?

(4) Flexible plans may result in increased utilization and adverse selection. Increased utilization and adverse selection can cause problems with group insurance underwriting requirements and may result in higher benefit costs. Plan features can be added to minimize adverse selection; for example, limits can be placed on coverage levels and the frequency of election periods.

(5) Greater benefit flexibility is likely to result in greater administrative complexity and costs. To some extent, administrative costs can be controlled by restricting employee options and the frequency of benefit election periods. These restrictions, however, limit the amount of flexibility under the plan. A number of packaged computer systems for handling enrollment, benefit payment and record keeping, however, are now available. Where appropriate, these systems can reduce the time and costs of implementing flexible compensation plans.

Employer Response

After weighing the advantages and disadvantages of establishing a flexible compensation plan, more and more employers are expressing interest in them. Currently, more than 100 employers have established flexible compensation plans covering some three million workers. More than 100 other employers are also exploring this approach. These employers include numerous Fortune 500 companies as well as major banks, hospitals, utilities and service organizations. An increasing number of small organizations (100-1,000 employees) are also introducing flexible compensation plans, although with a more limited range of options. If all of the companies currently exploring a flexible compensation plan go ahead and adopt one, more than five million employees could be covered under flexible benefit plans by 1985. This rapid expansion of flexible compensation plans, particularly in conjunction with salary reduction options, has raised a number of public policy concerns.

Major Public Policy Issues

The foregoing discussion has explained how flexible benefit plans work and why they are increasingly popular among employers and employees. But, beyond the interests of employers and employees, it can also be seen that flexible compensation plans serve a broader public policy interest because they can be a vehicle for reinforcing other public policy goals. For example, flexible compensation plans that feature a salary reduction option or a reimbursement account can be used to stimulate individual employee savings for retirement--a

goal of public policy that Congress recently reaffirmed in the individual retirement account provisions of the Economic Recovery Tax Act of 1981. Flexible benefit plans also allow employers to make adjustments in their benefits to take account of the changing work force--a goal that federal policymakers have recently articulated, for example, in making legislative changes in Social Security and proposed changes in private pensions to better reflect the changing needs and roles of women. Finally, flexible benefit plans also permit a better coordination of health benefits and other employer provided benefits, allowing for more efficient management of health care costs and encouraging employee choice among competing health providers and health plan options. In all these areas of public policy, flexible benefit plans clearly serve the needs of employers and employees as well as the public interest.

Nevertheless, the rapid expansion of flexible compensation plans has underscored two areas of particular concern to policymakers.

1. <u>What is the magnitude of potential tax revenue loss--if any--generated by flexible compensation and the use of salary reduction to fund the purchase of nontaxable benefits?</u>

   Although salary reduction is not specifically allowed (or even addressed) under Section 125, a rapidly increasing number of companies are implementing flexible compensation plans with salary reduction as one source of funds (or, in some cases, as the only source of funds). Concern has been expressed about the magnitude of the revenue losses to the U.S. Treasury generated by the use of salary reduction to fund the purchase of nontaxable benefits in the flexible compensation plan.

   Published materials measuring the revenue losses--if any--resulting from the spread of flexible compensation plans are scarce. Such estimates would naturally vary, depending on assumptions about the behavior of employers and employees over the short term and the long term. The estimates would also have to take into account that, in setting up a flexible compensation plan, the employer is often shifting expenditures that are already tax deductible to the employer (e.g., health insurance premiums) into the flexible benefits plan. That kind of shift does not generate revenue losses.

   Actually, the long-range effects of flexible compensation plans could also increase or slow the erosion of tax revenues. For example, a common approach in flexible benefits plans is to use a tax favored reimbursement account to finance certain health care expenditures. To the degree that the employee reduces personal health care expenditures and opts to take the funds from the reimbursement account in cash, that generates income tax revenues. Also, over the long term, to the extent that flexible benefit plans succeed in holding down the growth of other (tax deductible) employer-provided benefits, federal tax revenue could result. For example, employer contributions to health insurance are now fully tax deductible to the employer and are not considered taxable income to the employee. If a flexible benefits approach were to contain the growth of health insurance premiums, more of total compensation would be paid in cash, which would generate tax revenues.

Given the difficulty in analyzing the revenue effects of flexible compensation, it is not surprising that congressional estimates have varied widely. When the Revenue Act of 1978 (P.L. 95-600) was passed by the Congress, it was estimated that Section 125 of the Tax Code "will have no effect on budget receipts." The Joint Committee on Taxation reached a similar conclusion about deferred compensation 401(k) plans.3/

A different view of the revenue loss issue was presented to the Congress earlier this year. In March 1983, during consideration of the Social Security Amendments of 1983, the House-passed bill (H.R. 1900) had a provision--which was subsequently modified--that would have treated employer payments to a 401(k), 403(b) or "cafeteria" employee benefit plans as covered earnings under Social Security. In a memorandum estimating the short-range effects of the bill, the Social Security Administration's (SSA) Office of the Actuary gave the following explanation of the revenue loss effects:

> "Our estimates of future Social Security tax income under present law do not explicitly reflect the loss in tax income that would result from a rapid expansion in the number of these plans. Thus it would be misleading to indicate that the tax income projected under present law could be significantly increased if plan payments were made subject to payroll taxes. The estimates shown in this memorandum, accordingly, do not include such effects. It is important to note, however, that a rapid expansion of these plans now appears to be fairly likely. In the absence of the provision in H.R. 1900, the potential reduction in annual OASDHI tax income attributable to such an expansion could easily amount to roughly $1-2 billion within a few years."4/

Another SSA memorandum estimated the long-range savings to the Social Security OASDI program from the same House-passed provision to be 0.02 percent of payroll.5/ To repeat, these SSA revenue estimates apply only to the loss of Social Security payroll taxes--and do not include potential loss of general tax revenues.

Despite these caveats about estimating the tax revenue effects, a particular area of concern has been underscored by some benefits experts regarding the use of salary reduction in connection with a flexible benefits plan.

3/ U.S. Congress, Joint Committee on Taxation. General Explanation of the Revenue Act of 1978 (H.R. 13511, 95th Congress; P.L. 95-600). Prepared by the staff of the Joint Committee on Taxation, March 12, 1979, pp. 79-84.

4/ U.S. Congress, Social Security Act Amendments of 1983, Report of the Committee on Ways and Means on H.R. 1900, Report No. 98-25, Part I, March 4, 1983, p. 160.

5/ Ibid., p. 165.

Because there are no dollar limits or utilization tests under Section 125, some of these plans (particularly those at small professional corporations) are reported to allow salary reduction of up to $20,000 or $25,000 per employee in a year. While this is not widespread, the potential tax revenue loss from introduction of these plans with large salary reduction maximums should be evaluated.

2. <u>How can nondiscrimination in the operation of a flexible compensation plan be ensured?</u>

The favorable tax treatment afforded to flexible compensation plans (i.e., the elimination of the doctrine of constructive receipt) is based on the satisfaction of certain nondiscrimination requirements as to the covered employee group and the benefits being provided. Because there are no dollar limits and because there may be no retrospective (utilization) test, there are some concerns that those plans could be developed in a way to maximize the benefits for highly compensated employees without providing comparable advantages for other employees.

<u>Policy Options</u>

A number of alternative approaches have been suggested to preparing regulations for Section 125 and/or modifying Section 125 through legislation which can substantially solve the issues of concern to plan sponsors and public policymakers. Although this list is not exhaustive, the major alternatives which work within the framework of the existing Internal Revenue Code are summarized below:

1. <u>Introduce a utilization test similar to that found in Section 401(k).</u>

   Under this alternative, the employee group would first be divided into the highest-paid one-third and the lower-paid two-thirds. The average selection of nontaxable benefits for the higher-paid should not exceed that for the lower-paid plus a margin of difference. A margin of difference submitted to the Treasury Department by consultants was three percent of pay plus $750.

2. <u>Introduce a dollar limit on the cash option under Section 125.</u>

   Under this approach, there would be a maximum dollar amount (or percent of pay plus dollar amount) which could be elected as cash under a flexible compensation plan. A maximum of this type would effectively limit the amount of salary reduction because the employee would always be given the opportunity to restore his salary by electing that the salary reduction amount be taken in cash.

   Any maximum amount should be high enough to allow significant employee flexibility to select cash in lieu of some benefits (e.g., to select out of medical coverage if the employee's spouse has full family medical coverage through their employer) but should be low

enough to limit the potential revenue loss and any potential discrimination. Amounts such as $3,000 or three percent of pay plus $2,000 have been suggested by some experts.

3. Place maximums on other IRC sections which provide the nontaxable basis for benefits often provided under Section 125 plans.

   If this approach were to be adopted, the specific sections of the Internal Revenue Code governing dependent care assistance plans (129), group legal services plan (120), and/or self-insured medical expense reimbursements plans (105(h)) would be amended to introduce specific limits on the nontaxability of the benefits. The limits could be specific dollar amounts plus a percentage of pay or a dollar amount based on the average salary of the covered employee group.

4. Place maximums under Section 125 with respect to benefits payable under Section 129, 120 or 105(h).

   This approach would require the modification of Section 125 and would have a very similar effect to approach 3. In some ways, this is less appropriate than approach 3 because it would only serve to limit the amounts available under flexible compensation plans without affecting employers who wish simply to add separate tax-favored plans covering each of these areas (dependent care, group legal, uninsured medical).

5. Prohibit the use of nonstatutory fringe benefits within Section 125 plans.

   Concern has been expressed about the potential of significant revenue loss or discrimination through the introduction of flexible compensation plans which include nonstatutory fringe benefits such as employee parking, employee discounts, etc. Of the plans currently in effect at major employers, we are aware of only one which includes any such nonstatutory benefits on a nontaxable basis. In addition, we are not aware of any significant interest among corporate employers in adding nonstatutory benefits to flexible compensation plans. The most popular options to date have been health care benefits (100 percent), death benefits (57 percent), disability benefits (41 percent), vacation buying and/or selling (41 percent), dependent care benefits (38 percent), and group legal benefits (10 percent).

   Therefore, some experts have suggested that it might be appropriate to prohibit the use of nonstatutory fringe benefits (with the exception of vacation buying and selling) within Section 125 plans under any of the policy options described above. This basic approach has been incorporated in the Tax Reform Act of 1983 (H.R. 4170), a bill reported by the House Ways and Means Committee on October 21.

Pending Legislation

The following description of the changes in H.R. 4170 pertaining to flexible benefit plans is taken from the Ways and Means Committee report:

> "The bill amends the definition of cafeteria plans for purposes of Code Section 125 to provide that such plans may offer employees choices only among cash or those fringe benefits (other than scholarships or fellowships, educational assistance, vanpooling, and those benefits excludable under provisions of the bill) that are excludable from gross income under a specific section of the Internal Revenue Code.
>
> For this purpose, group-term life insurance that is includible in income only because the amount of the insurance exceeds $50,000 is treated as a nontaxable benefit. With respect to vacation days offered under a cafeteria plan, vacation days which cannot be cashed out in a later year also are to be treated as a nontaxable benefit. However, vacation days which may be cashed out in a later year are to be treated as deferred compensation which may not be offered under a flexible compensation plan."7/

The proposed legislative changes in Section 125 are part of several provisions in Title V of H.R. 4170 relating to fringe benefits. The Ways and Means Committee estimates that Title V of the bill--as a whole--will have "no significant revenue effect. The bill serves to codify many present practices under which employers provide their own products and services tax-free to a broad group of employees."

In the Senate, any changes in Section 125 could well be considered in connection with the overall package of federal deficit reduction measures. When asked what, specifically, he wanted to do about fringe benefits, Finance Committee Chairman Bob Dole told U.S. News & World Report, in an interview published October 3, 1983:

> "We ought to look at those benefits as a source of more tax revenue. Employer contributions to employee health-care plans, for instance, are now fully deductible. We should allow a significant portion of that contribution to be deductible, but at the same time we ought to put a cap on it. Other benefits--payment of parking fees, discounts, free airline tickets--can be limited by Congress without negating the benefit to the employe and employers. We will have to monitor some of the so-called cafeteria plans, too, which let an employe choose among a number of different fringe benefits."

7/ U.S. Congress, Tax Reform Act of 1983, Report of the Committee on Ways and Means on H.R. 4170, Report No. 98-432, Volume I, (October 21, 1983) p. 303.

The Senate Finance Committee has instructed its staff to come up with a package of deficit reduction measures by February 15, 1984.

Conclusion

Flexible benefit packages are becoming increasingly popular because they allow employees to choose the combination of benefits to suit their individual needs and they afford employers the opportunity to increase the economic efficiency of their employee benefits. If all of the companies now considering flexible benefits go ahead and adopt a plan, more than five million employees could be covered under flexible benefits plans by 1985.

This growth in flexible benefits is all the more significant because it takes place in an atmosphere of uncertainty created by the five year delay in the relevant Treasury regulations. Meanwhile Congress continues to evaluate Section 125 of the Internal Revenue Code as part of its tax reform initiatives.

But the analysis and evaluation of flexible benefits should be made on the basis of the public policy goals served. For example, at a forum sponsored by EBRI on October 19, 1983, entitled "Reforming Health Care Finance," speakers discussed the uses of flexible benefit plans in controlling the employer cost of health insurance benefits; accommodating employee demand for new benefits; and encouraging employees to save more for retirement. When questioned about the potential role of the federal government in reforming private health care financing, many speakers believed that clarification of existing law and issuance of the long-awaited federal regulations governing flexible benefit plans would be important steps in furthering private-sector reform of health care financing. Because flexible benefit plans can be a vehicle to reinforce other public policy goals, legislative changes in flexible benefits could have a much broader public policy impact than simply their revenue effects.

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