EBRI

T-46

Statement On

The Impact of the President's Tax Reform Proposal on Employee Benefits

Before The

United States Senate Committee on Finance

July 19, 1985

of

Dallas L. Salisbury*
President
Employee Benefit Research Institute

*The views expressed in this statement are those of Dallas Salisbury and should not be attributed to the Employee Benefit Research Institute, its officers, trustees, sponsors, or other staff.

Dallas Salisbury is President of the Employee Benefit Research Institute, a nonprofit, nonpartisan, public policy research organization. Before joining EBRI he served in senior career policy research positions at the U.S. Department of Labor and the U.S. Pension Benefit Guaranty Corporation. This statement draws heavily from research studies conducted, published, and copyrighted by EBRI.

07/16/85

Summary

Employee benefits are effective and efficient providers of economic security. The Congress has been instrumental in their development. For some employee benefits commonly included in surveys the income tax system has not been important. For example, the 14 percent of wages and salaries spent on fully taxable benefits like leave, or the 9.5 percent spent on mandatory programs like Social Security. Together these account for 72 percent of all employee benefit expenditures. For others the income tax system has been very important. For example, the 5 percent spent providing tax-exempt health insurance and life insurance (16 percent of all benefit expenditures) and the 4 percent spent providing tax-deferred retirement and capital accumulation programs (12 percent of all benefit expenditures).

The President's tax reform package would change employee benefits and the public policy surrounding them.

- Since 1921 national policy has encouraged both "pension" programs and "capital accumulation" programs. The first to generally provide a retirement annuity. The second to provide savings for unforeseen circumstances or major events like education, and probably retirement. This national policy will be curtailed. The President proposes that policy be changed to allow tax incentives primarily for explicit retirement income delivery. Workers will save less, and national savings will decrease.
- New limits are proposed on what can be contributed to pension and capital accumulation programs, and on the benefits that can be paid without an excise tax. This will cause a further movement towards unfunded pension programs that depend on the "corporate promise" and some loss of benefits for lower income and small business workers.

- o New nondiscrimination standards are proposed for all employee benefit programs that are tax exempt or tax deferred. Present coverage of these programs almost exactly matches the wage and salary structure of the work force, but the President feels more rules are needed. These new rules would cause some plans to be disqualified that actually cover all workers. This problem is particularly bad for "conglomerates." The objective is laudatory, but much technical work on the proposal is needed.
- o Health insurance provided as part of employment would for the first time be taxed. The initial $10/$25 proposal is unlikely to reduce coverage, but should this "floor" rise over time, the consequences for health insurance provision could be dramatic, with young and low wage workers deciding they would rather have cash, and the cost of insurance for older workers being driven up. This is a proposal for a very significant change in national policy for 67 percent of those filing tax returns.

The President may be correct in his assessment that long standing employee benefits policy needs to be changed, but there is not evidence in the tax reform package that long-term consequences have been evaluated. And there are contradictions: reducing access to capital accumulation funds while expanding IRAs; proposing nondiscrimination tests that would cause some plans that cover all workers to be disqualified; taxing health insurance for 67 percent of taxpayers because the others don't have it; and encouraging a movement to nonfunded retirement programs after ten years of success with government mandated requirements for advance funding of the pension promise. Contradictions unexplained. They might make sense. They might mean far greater government expenditures in the future to meet economic security needs.

Statement

Mr. Chairman, it is a pleasure to appear before the Committee today to discuss the impact of the President's tax reform proposals on employee benefits. The Employee Benefit Research Institute has undertaken analysis which comprehensively assesses the interrelationship of the tax code and the provision of employee benefits. The Institute is a nonprofit, nonpartisan research organization based in Washington, DC. EBRI does not make recommendations for or against legislation the Congress may be considering, but we do work to make available pertinent facts that may bear on your decisions.

Employee benefits are effective and efficient providers of economic security. In an April 1985 survey conducted by Hamilton and Staff, employee benefits were found to be widespread. 82 percent reported being covered by company health insurance, 69 percent by company life insurance, and 50 percent by company pensions. For full time workers coverage is even more widespread, according to Census Bureau surveys. The world of employee benefits is made up of four primary components.

o Mandatory programs including Social Security, Medicare, workers compensation, and unemployment compensation represent the first component. These programs provide the basic level of protection demanded by society on a nearly universal basis. Over 25 million retirees now receive benefits from these programs. Social Security provides higher proportional benefits to low and moderate income individuals, and for higher income retirees, 50 percent of their benefit is taxed. A portion of unemployment benefits are taxed. The Reagan package would tax all unemployment and workers' compensation benefits. On average USA employers spend 9.5 percent of wages and salaries on these programs; 29 percent of all employee benefit spending.

- Voluntary tax-exempt programs, including health insurance, life insurance up to $50,000, educational assistance above $5,000, dental insurance and vision insurance, represent the second component. Ninety-six percent of all full-time workers in medium and large firms have health insurance; 96 percent have life insurance. The Reagan package would tax the first $10 of an individual health premium and $25 of a family premium paid by the employer. On average USA employers spend 5 percent of wages and salaries on these programs.
- Voluntary tax-deferred programs including retirement, capital accumulation, and long-term disability plans represent the third component. Eighty-two percent of all full-time workers in medium and large firms have retirement or capital accumulation plans and 50 percent have disability protection. Nearly half of all recent retirees receive retirement income from these programs. Payments out of these plans are treated as taxable income to the degree that contributions were not. The Reagan package would change nondiscrimination rules and establish excise taxes for some benefit payments. It would establish an $8,000 limit for 401(k) plans and change distribution rules. On average USA employers spend 4 percent of wages and salaries on these programs.
- Voluntary tax-exempt fringe benefit programs including parking, cafeterias, merchandise and travel discounts, are frequently viewed as the fourth component. Spending on these programs is less than 1 percent of wages and salaries, and frequently they exist for the convenience of the employer. Discussion of these programs should not

be allowed to color basic employee benefits which provide economic security.

- o Voluntary taxable programs including vacation time, sick time, and other time not worked, are too often included when talking about employee benefits. The average USA employer spends almost 14 percent of wages and salaries on these programs, or nearly 43 percent of what are reported as "employee benefit" expenditures.

Media reports and government discussion generally lump all these different types of employee benefit program expenditures together and assume that it is all tax exempt. NOTE: 72 percent is either mandatory or fully taxable; just over 12 percent is taxed upon benefit payment; while just under 16 percent is tax exempt.

This may seem a minor point, but the debate over the taxation of employee benefits takes on a much different caste when the perception is that 32 percent of wages and salaries escape taxation as a result of voluntary employer and employee action -- even if the fact is that only 5 percent escapes total taxation. As you well know, perception has the effect of reality when it comes to influencing decisions.

Let us take a moment to look at employee benefit programs against some of the perceptions that have driven legislative debates in recent years, and also come up at times in the current debate over tax reform and the tax treatment of employee benefits.

<u>Why Do We Have Employee Benefits</u>?

There is general agreement on why employers and unions established employee benefit programs and why the government chose to encourage them with tax incentives.

- o protection against loss of income due to illness, disability, unemployment, or retirement;
- o productivity gain due to employee psychological well being;
- o enhancement of the ability to manage work force size and to allow timely retirements; and
- o to obtain group purchase advantages.

The Employee Retirement Income Security Act of 1974 gave recognition of multiple needs by providing clear incentives to encourage savings both for retirement <u>and</u> for separation from employment at earlier ages.

The government has generally:

- o agreed that it was appropriate national policy to provide incentives to have workers protected against loss of income;
- o wanted to encourage private dollars to supplement Social Security for retirees;
- o liked not having to enact National Health Insurance because employer provided health insurance had become almost universal; and
- o generally felt that employers and unions were acting responsibly.

<u>Effects of Taxing Employee Benefits</u>

The Reagan Administration tells us that the rationale for what they have proposed is to achieve fairness, growth, and simplicity. What they have proposed may in fact be appropriate for public policy; that is for the Congress to determine. The Reagan proposal for employee benefits taxation is not the fairest alternative; may be adverse to capital formation, and therefore, for economic growth; and would add to the complexity of employee benefit plan administration rather than simplifying it. As a result, one cannot help but ask: what is the rationale for the employee benefit changes as compared to the rationale for the full package?

Why Change The Tax Treatment of Benefits?

A reading of the Reagan package, backed up by conversations with government staff, indicates as least four rationales for the changes. Each represents a desire to change long-term national policy.

What is Retirement Income?

Since 1921 the Congress has attempted to encourage savings and capital accumulation "until separation from employment" in addition to retirement income that might be paid out as a stream of payments beginning at retirement. This dual track policy was readily evidenced by the tax treatment given lump-sum distributions upon separation of employment or after age 59 and 1/2. The Reagan proposal seeks to narrow national policy to encourage the use of a stream of payments rather than lump-sum distributions. While lump-sum distributions are still allowed, the Reagan package reverses the current incentives. Its proposed changes would provide tremendous incentives to roll over the dollars into another retirement account and to withdraw the dollars over one's entire expected retired life. The proposal, in short, represents a fundamental policy change.

How Much is Enough?

Between 1921 and 1974 the Congress provided incentives for savings and capital accumulation without a concept of particular limits. Economic growth had been assumed to be benefited by capital formation. Therefore, the objective was, for practical purposes, to encourage as much as possible.

Congress introduced limits in 1974 on the amount of defined benefit that could be funded for and the maximum annual addition to a defined contribution account, but did not place a limit on the maximum ultimate payout. They provided in this way an incentive to seek high rates of return and to save at the maximum possible level. With TEFRA in 1982, the Congress took another step and introduced a lower combined plan limit on what could be set aside for any individual. The Reagan proposal asks Congress to go one step further: to limit the maximum annual benefit one can receive by introducing an excise tax on "excess" amounts. And, the proposal strikes at those who would hoard the savings for their heirs by asking the Congress to require retirees to draw funds out of plans at a minimum rate. In short, the Administration proposal says that there is an amount of money which represents too much tax-favored retirement income <u>and</u> that it is intended that plans only provide retirement or penalty taxes will be imposed.

<u>Shouldn't Everyone Get The Same Thing</u>?

Over the years the Congress has introduced nondiscrimination and coverage requirements intended to assure that the benefits of tax incentives go to more than the highest paid. The Administration proposal moves further in that direction by expanding the group that must be included in all plans and by narrowing or eliminating contribution and benefit differentials.

<u>Should Anything Escape All Taxation</u>?

From 1921 until 1981 the Congress expanded the tax incentives for employee benefits frequently. 1982 marked a distinct change in that direction as they began to tighten and to narrow. This was the year in which the maximum defined benefit that could be funded for and the maximum defined contribution addition, and the combined limits, were all reduced and frozen. The employee benefits legislation of 1984 continued that trend, as do most of the proposals to date for "tax reform." The proposal for a health floor (or the health tax cap of the November Treasury proposal), if adopted, would bring us to the point where no widespread employee benefit was tax free.

Who Receives Employee Benefits?

The provision of employee benefits follows a pattern: basic benefits are provided first. The normal sequence: health, life, retirement, savings, and on from there. For an employer the single biggest determinants of when employee benefits will be provided are profitability, unionization, and work force size. The availability of benefits falls across the entire earnings spectrum, but is heaviest for full time workers. Eighty-three percent of all nonagricultural wage and salary workers in 1983 earned less than $25,000.

Retirement and Capital Accumulation

Over 800,000 employer sponsored plans are now in operation in the private sector. Thirty-seven percent are defined benefit plans, with more than 40 million active participants. Sixty-three percent are defined contribution plans, with over 27 million active participants. As many as 80 percent of the participants in defined-contribution plans also participate in a defined-benefit plan.

Of all civilian workers, the Census Bureau found that 52 percent are covered by these plans. Of those meeting ERISA participation standards, 70 percent are covered by these plans. Eighty-two percent of all full-time workers in firms with 250 or more employees are covered by a plan. And 76 percent of those covered and 70 percent of those vested earned less than $25,000 in 1983.

What about actual benefit receipt? The Social Security Administration reported recently that among new retirees in 1981 56 percent of married couples and 42 percent of unmarried retirees had income from an employer-sponsored pension -- more than double the rate of 1961. In 1983 over 10 million workers reported to the Census Bureau that they had been in a plan in previous employment and 6.6 million either took a lump-sum distribution or were entitled to an eventual annuity.

Employee Salary Reduction Programs

The Revenue Act of 1978 provided for these new programs under section 401(k) of the Internal Revenue Code. The November Treasury proposal would have ended them. As you have heard, the new proposal would modify them. As of 1983 nearly 5 million employees were eligible for these programs and 1.2 million actually participated. A recent survey placed the number of eligibles in 1985 at 20 million.

Health Insurance

Health insurance is the most widespread employee benefit. 60 percent of all civilian workers have primary health insurance coverage and another 20 percent have secondary coverage. The addition of dependents and retirees more than doubles this number. Sixty-nine percent of all tax returns filed in 1983 would have been affected by a tax on health insurance.

Other

Other voluntary tax exempt programs include life insurance up to $50,000, educational assistance, dental insurance, vision insurance, group legal, and dependent care. Ninety-six percent of all full-time workers in medium and large firms have life insurance; 71 percent have dental insurance; and 27 percent have vision care.

Who Would be Affected by Benefit Tax Change?

The numbers just presented provide an indication of the total number of workers and families that will in some way be affected by changes in the tax treatment of employee benefits. Precise effects are difficult to pinpoint, however, because individuals have different career patterns and different packages. But a general framework can be set out. For over 800,000 unions and employers, an effect would be a reduction in flexibility to structure the total compensation package to meet the needs of a changing work force.

Defined Benefit Plans

As many as 20 percent of defined benefit plans allow for lump-sum distributions instead of annuities. The numbers are small, but growing. And all defined-benefit plans can make distributions when the total dollar value is less than $3,500. The Reagan proposals would make this design approach very unattractive.

Defined-benefit plan annuity tax treatment remains constant under the proposal. Wage and salary growth would make the new maximum benefit rule apply to large numbers at which time significant design change will need to be contemplated. The proposed nondiscrimination tests that treat all units of a controlled group of companies as one employer would cause many large companies to have plans lose their tax-favored status, even in situations where all workers are covered. The goal is a worthy one, but significant technical work is needed beyond the May proposal.

Defined-Contribution Employer Contribution Plans

These plans -- money purchase and profit sharing primarily with their 27 million participants -- would be dramatically changed in the terms of the distributions and the taxation of distributed amounts.

These changes would require the plans to be rethought and would require a new tax planning and retirement planning approach for individuals. The "phase out" of ten year forward averaging will make this redesign a long term process. For participants it will make them look at these plans as a place to park money for retirement quite clearly, or until the next job, rather than saving for special needs or emergencies. Based upon documented experience this means that employees will voluntarily set aside much less in these plans.

Employee Salary Reduction Programs

These plans and their approximately 8 million active participants would be affected by distribution changes and discrimination test changes. Maximum contributions capped at 8,000 with an IRA offset could affect 5 percent of participants in year one, with that number growing each year.

Employers are still likely to offer these programs, but they are likely to play a much smaller role than some had contemplated. Due to the proposed restrictive rules on access to funds, employees are likely to use these plans less.

Health Insurance

Approximately 63 million workers would have new income to declare were initial health insurance premium dollars taxed. The equity in the proposal is hard to find. It makes no difference what the level of coverage is that you have or what percent of the total premium the taxable amount represents.

The floor at $10 and $25 is unlikely to cause a drop in provision. The main question? What if it rises? EBRI research indicates that as more and more of the insurance is taxable, more and more workers won't want it. Adverse selection will be most intense among younger workers. As a result, the cost of insurance for all others will increase as the group declines in size. Over time, this could have dire consequences. This, at a time when the Congress is concerned about those without health insurance.

Cafeteria Plans and Reimbursement Accounts

We estimate that approximately 5 million workers now have these plans available to them. Most would be affected by the Reagan proposal, either having to drastically change their reimbursement accounts or eliminate them.

Full choice plans will continue to be attractive to those primarily seeking to please employees and meet changing work force needs. Those seeking to use the arrangements for health cost management could still do it with a reimbursement account funded by employer dollars at the same level for all employees. But for many employers that have established premium payment only reimbursement accounts or accounts for other purposes with very low participation rates, plan continuation will be troublesome.

New Nondiscrimination Standards

As noted above, the new standards could cause many workers to lose certain types of coverage while other coverage would have to expand to meet the rules. They would make some plans like 401(k) less attractive to employers. They would add significantly to the complexity of plan administration, and complexity itself creates loopholes. The objectives are laudable, but technical work is needed.

Fringe Benefits

Reagan proposes to apply nondiscrimination standards to these benefits. Since the Deficit Reduction Act of 1984 said many of these benefits were difficult to value, applying nondiscrimination standards to them would be difficult. To the extent that these benefits create a nuisance for employers, they could be dropped.

Would Benefit Plans Still be Offered?

The general answer must be "yes" in the initial years. But, out year consequences as wages and prices change could be significant.

Conclusion

The government began building a legal structure for employee benefits in 1921. The goal: to protect workers and their dependents against loss of income; to provide economic security. The result: near universal protection for employees of medium and large businesses; growing protection for employees of small businesses; and a very significant reduction in the demands placed upon the government for direct expenditures that would far exceed the revenue cost of the incentives.