

**CAFETERIA PLANS: A MENU OF NON-OPTIONS
FOR SMALL BUSINESS OWNERS**

HEARING
BEFORE THE
SUBCOMMITTEE ON ECONOMIC GROWTH,
TAX, AND CAPITAL ACCESS
OF THE
COMMITTEE ON SMALL BUSINESS
UNITED STATES
HOUSE OF REPRESENTATIVES
ONE HUNDRED FIFTEENTH CONGRESS

FIRST SESSION

HEARING HELD
MARCH 16, 2017



Small Business Committee Document Number 115-009
Available via the GPO Website: www.fdsys.gov

U.S. GOVERNMENT PUBLISHING OFFICE

24-531

WASHINGTON : 2017

For sale by the Superintendent of Documents, U.S. Government Publishing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

HOUSE COMMITTEE ON SMALL BUSINESS

STEVE CHABOT, Ohio, *Chairman*
STEVE KING, Iowa
BLAINE LUETKEMEYER, Missouri
DAVE BRAT, Virginia
AUMUA AMATA COLEMAN RADEWAGEN, American Samoa
STEVE KNIGHT, California
TRENT KELLY, Mississippi
ROD BLUM, Iowa
JAMES COMER, Kentucky
JENNIFFER GONZÁLEZ-COLÓN, Puerto Rico
DON BACON, Nebraska
BRIAN FITZPATRICK, Pennsylvania
ROGER MARSHALL, Kansas
VACANT
NYDIA VELÁZQUEZ, New York, *Ranking Member*
DWIGHT EVANS, Pennsylvania
STEPHANIE MURPHY, Florida
AL LAWSON, JR., Florida
YVETTE CLARK, New York
JUDY CHU, California
ALMA ADAMS, North Carolina
ADRIANO ESPAILLAT, New York
BRAD SCHNEIDER, Illinois
VACANT

KEVIN FITZPATRICK, *Staff Director*
JAN OLIVER, *Chief Counsel*
ADAM MINEHARDT, *Minority Staff Director*

CONTENTS

OPENING STATEMENTS

	Page
Hon. Dave Brat	1
Hon. Dwight Evans	2

WITNESSES

Ms. Jennifer Brown, Manager of Research, National Institute on Retirement Security, Washington, DC	3
Ms. Paula Calimafde, Chair, Small Business Council of America, Bethesda, MD	5
Ms. Elise Feldman, President, Feldman Benefit Services, Inc., Springfield, NJ	7
Mr. Matt Tassey, Treasurer, National Association of Insurance and Financial Advisors, Portland, ME	9

APPENDIX

Prepared Statements:	
Ms. Jennifer Brown, Manager of Research, National Institute on Retirement Security, Washington, DC	17
Ms. Paula Calimafde, Chair, Small Business Council of America, Bethesda, MD	22
Ms. Elise Feldman, President, Feldman Benefit Services, Inc., Springfield, NJ	28
Mr. Matt Tassey, Treasurer, National Association of Insurance and Financial Advisors, Portland, ME	31
Questions for the Record:	
None.	
Answers for the Record:	
None.	
Additional Material for the Record:	
Congresswoman Yvette D. Clarke Statement	36
U.S. Chamber of Commerce	38

CAFETERIA PLANS: A MENU OF NON-OPTIONS FOR SMALL BUSINESS OWNERS

THURSDAY, MARCH 16, 2017

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON ECONOMIC GROWTH,
TAX, AND CAPITAL ACCESS,
Washington, DC.

The Subcommittee met, pursuant to call, at 10:00 a.m., in Room 2360, Rayburn House Office Building. Hon. Dave Brat [chairman of the Subcommittee] presiding.

Present: Representatives Brat, Knight, Kelly, González-Colón, Fitzpatrick, Evans, Chu, Murphy, and Clarke.

Chairman BRAT. Good morning, everyone. We have a few competing committees meeting this morning so you will see people coming and going as we proceed. And I just want to thank you all for being with us today. I call this hearing to order.

The Tax Code has many purposes apart from revenue collection. Cafeteria plans are a prime example. They were enacted in 1978 to encourage employers to provide benefits for lower-paid employees. Cafeteria plans have become a popular form of employee compensation. They are employer-provided benefit plans under which employees may choose between cash and benefits. For example, if you participate in a Flexible Spending Account, commonly called an FSA, or have dental or vision coverage that you pay for directly from your paycheck, you are participating in a cafeteria plan. You have the choice to receive your full paycheck or to forego some portion of it in exchange for benefits that you choose and, most importantly, ones you receive pretax.

Cafeteria plans are available across the board to large- and mid-sized companies, nonprofits, schools, universities, and the Federal Government. However, one major category of people who are not allowed to participate in a cafeteria plan is small business owners. They can sponsor these plans for their employees, but they cannot personally participate. This provides a disincentive to offering the plan in the first place.

Today's hearing will focus on why small business owners are not treated on par with larger employers. Today's witnesses will also discuss the effects of this policy on small business employees and whether this policy should be changed.

I would like to thank our witnesses for coming today. I look forward to your testimony. I now yield to our Ranking Member Evans for his opening remarks.

Mr. EVANS. Thank you, Mr. Chairman. I would like to say good morning also to the panel of witnesses who are here today.

Employers are not required by law to offer benefits such as health coverage, retirement plans, or paid vacations. These types of benefits can be quite costly to small businesses. So why do employers offer them? The answer is simple: to hire and retain the most talented workers.

Many Americans rely on employer-based benefits, but small employers often face challenges in offering these benefits to their hard-working employees; small firms' administrative costs and complex rules when they contemplate employee benefits. For these reasons, many business owners often forgo them offers.

A lack of employer-provided benefits can harm the businesses because it makes hiring and retaining workers difficult. Without benefits, employees may not work as hard or stick around to help the businesses prosper. This is particularly important in competitive fields where employees have monthly options available to them. The businesses that can afford to offer benefits, even if small, usually have a wide pool of candidates available to them. Because of the perceived higher costs of benefits, small businesses are often reluctant to even investigate employee benefit plans.

Yet, what many small businesses almost may not realize that they have options, one of those options is the cafeteria plan under section 125 of the Internal Revenue Code. These plans can help employers use the Tax Code to their advantage while others benefit from their employees. By using pretax money, the employer saves by not having to pay FICA and unemployment tax. In many cases, this savings can add up to as much as 20 percent of every dollar being passed through the plan. Such savings can be reinvested in the business. However, there are also some complex rules making them confused to small business owners. For instance, nondiscriminatory rules exist to ensure fairness for all employees enrolled in the plan.

I think we can all agree that nondiscriminatory rules serve as an important purpose in that they protect rank and file employees, but these rules also have led employers to shy away from employee benefit plans. To cause further confusion, only small business owners can enroll in the very plans they offer their workers. Pass-through business owners are not allowed to participate in these plans, which create a significant problem because the majority of small entities are structured in that way. In fact, between 1980 and 2011, the number of pass-through business tax returns has increased by 175 percent, roughly 109 million returns to about 30 million returns.

Owners of business structure as pass-through entities are unduly penalized simply based on their business planning decisions. This in turn harms the millions of employees working for them because the rule impacts owners from decisions to offer the plan. Any policy regarding workers' benefits should ensure small employers have the resources they need to overcome challenges and starting and continuing to them. It is not only in their best interests, but it is in our economy's.

And that is why we are here today. This hearing will allow members of the Committee to learn more about how—the cafeteria

plans and how they can make it work better for our Nation's small businesses. I look forward today to the testimony and thank the witnesses for their participation.

I yield back. Thank you, Mr. Chairman.

Chairman BRAT. Thank you very much.

If Committee members have an opening statement prepared, I ask they be submitted for the record.

I would like to take a moment to explain the timing lights for everyone here. You will each have 5 minutes to deliver your testimony. The light will start out as green. When you have 1 minute remaining, the light will turn yellow. Finally, at the end of your 5 minutes it will turn red. I ask that you try to adhere to that time limit if at all possible.

And with that, we will start our introductions. I would like to start with Jen Brown. Our first witness this morning is Ms. Jennifer Brown, manager of research at National Institute on Retirement Security, NIRS, in Washington, D.C. In this position, she conducts original research and analysis regarding issues related to retirement. She is also an adjunct professor at American University, where I did my Ph.D. in economics. So welcome, fellow Eagle. And a fellow with American's Tax Policy Center. She is a contributor to the fifth edition of the ERISA litigation treaties and is widely published and quoted. She holds an LL.M. in taxation and a certificate in employee benefits law from Georgetown. She earned both her J.D. and her master's degree in law and society from American.

Ms. Brown, you have 5 minutes, and you may begin. Thank you very much.

STATEMENTS OF JENNIFER BROWN, MANAGER OF RESEARCH NATIONAL INSTITUTE ON RETIREMENT SECURITY; PAULA CALIMAFDE, CHAIR, SMALL BUSINESS COUNCIL OF AMERICA; ELISE FELDMAN, PRESIDENT, FELDMAN BENEFIT SERVICES, INC.; MATT TASSEY, TREASURER, NATIONAL ASSOCIATION OF INSURANCE AND FINANCIAL ADVISORS

STATEMENT OF JENNIFER BROWN

Ms. BROWN. Thank you, Chairman.

Thank you all for the invitation to join you today to discuss revisions to section 125 of the Internal Revenue Code as it relates to small business owners. Again, my name is Jennifer Brown, and I am the manager of research at the National Institute on Retirement Security, often called NIRS. In addition, I am also a tax policy fellow at American University's Kogod School of Business.

Section 125 of the International Revenue Code regulates "cafeteria plans," which are tax-favored methods for offering a variety of fringe benefits to employees on a pretax basis. They are called cafeteria plans because these plans give employees the ability to select benefits from a menu set by their employer in exchange for forgoing compensation.

The most popular fringe benefits that can be offered through such plans are accident and health benefits, adoption assistance benefits, dependent care assistance, flexible spending arrangements, and health savings accounts.

Similar to other types of employee benefit plans, cafeteria plans must meet separate nondiscrimination requirements, which were created in order to prevent benefits that are exclusively offered to “highly compensated” officers, shareholders, or spouses or dependents of an officer or a shareholder. But section 125 contains an additional nondiscrimination rule which limits nontaxable benefits offered to “key employees” or officers and owners of a company to 25 percent of all benefits offered in a plan.

Self-employed individuals, partners in a partnership, and 2 percent shareholders of an S corp are excluded from participating in section 125 cafeteria plans, but these individuals are still able to sponsor plans for their employees. This is unlike pension, profit-sharing, and stock bonus plans where section 401(c) of the code allows that self-employed individuals can participate in these plans alongside their employees.

I will now spend the remainder of my testimony focusing on the legislative history of section 125.

Provisions excluding highly compensated individuals from tax-sheltered retirement plans have been in place since the 1942 Revenue Act, after employers sought to provide tax-sheltered retirement benefits to officers, shareholders, and highly compensated employees.

Because the Tax Code did not prohibit the payment of employee health insurance premiums prior to 1978, many corporations adopted plans that reimburse the medical expenses of shareholders and officers, but not those of rank-and-file employees. The Treasury Department became very concerned about these “particularly abusive situations,” and singled out four closely held corporations which reimbursed the medical expenses of shareholder officers as a way to disguise otherwise taxable dividends.

Treasury’s fears in 1978 have manifested themselves in three ways that impact small businesses. First, Congress and the Revenue Act of 1978 legislated the creation of cafeteria plans with the nondiscrimination provision that prohibits such plans that do not discriminate in favor of highly compensated participants.

Second, Congress, as part of the Tax Reform Act of 1984, addressed some of Treasury’s concerns regarding cafeteria plan nondiscrimination issues by prohibiting plans that favored the highest paid officers and owners, termed “key employees,” by prohibiting that they receive more than 25 percent of the total benefits provided by the plan. This provision disproportionately affects the ability of small employers and firms to offer cafeteria plans. In a large firm, a key employee could still be offered significant benefits through a cafeteria plan without exceeding the 25 percent threshold. On the other hand, in a small firm or organization, even limited benefits provided to a key employee could quickly exceed the 25 percent threshold.

Finally, in 2007, the IRS proposed regulations that prohibited sole proprietors, partners, 2 percent shareholders of an S corp, and directors of corporations from participating in cafeteria plans alongside their employees, but still allowed for these individuals to sponsor a plan.

In conclusion, Treasury’s concerns about the abuse of cafeteria plans by owners and officers of closely held corporations have

greatly impacted small businesses and their ability to sponsor these plans. Even though Congress in 2010 eliminated the strict nondiscrimination requirements for cafeteria plans sponsored by small employers with under 100 employees by creating “simple cafeteria plans,” today, small employers, including self-employed individuals, partners in a partnership, and 2 percent shareholders of an S corp may only sponsor cafeteria plans, but cannot participate in these plans alongside their employees. Thank you.

Chairman BRAT. Thank you, Ms. Brown. We appreciate your testimony. I see you put all those degrees to good work. Thank you.

Our next witness is Ms. Calimafde. Did I get that right? All right.

Ms. CALIMAFDE. Wait. I will put on my sign. You did.

Chairman BRAT. Ms. Calimafde is a principal at Paley Rothman, a small-business law firm in Bethesda, Maryland, where she chairs the retirement plans, employee benefits, and government relations practice group. She also chairs the Small Business Council of America, which represents the interests of privately held and family-owned businesses on Federal tax, healthcare, and employee benefits matters. She is widely published and has received numerous awards. She is barred in both Maryland and D.C., and received her law degree from Catholic University.

Ms. Calimafde, thank you for being here today, and you may begin your testimony. Thank you.

STATEMENT OF PAULA CALIMAFDE

Ms. CALIMAFDE. Thank you. And I thank all of you for having these hearings. It is a very important subject for small business. It may not sound too sexy, but it is really critical, and hopefully I will be able to prove to you why in the next few minutes.

I am also testifying on behalf of, in addition to the Small Business Council of America, the Small Business Legislative Council, which is a 40-year-old trade association comprised exclusively of trade associations which represent small business interests. And the SBLC covers interests of small business in all areas of our economy, including manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. So it covers the whole thing.

I am also a long-time member of the Employee Benefits Committee of the U.S. Chamber of Commerce, and I am not representing them today, but it is important that I have been with that committee for more than 20 years.

There are three points I would like to get across today. If I get nothing else, this is what I would like to get across. The first is that cafeteria plans provide extremely valuable benefits for small businesses and for all employees. And I will go into the benefits and why they are so important.

The second point I would like to get across is that every employee in the country, except for owner-employees of pass-through entities, is eligible to be in a cafeteria plan. So it is really discriminatory against all of these small business owners who are out there working every day, but because they chose to operate in a pass-through entity they are not eligible. And I will explain in real life what that translates to is most small businesses do not sponsor

full-fledged cafeteria plans for their employees. So not only is that provision harming the owner-employees of small businesses, it is also harming their employees themselves.

And third, I want to get across the idea that if HSAs, or health savings accounts, are an important feature in the new healthcare law that may be working its way through Congress, the best way to promote HSAs is through cafeteria plans. And I will explain why cafeteria plans make it easier for employees to select benefits in a moment.

So as mentioned by Jen, the cafeteria plans provide an enormous scope of benefits or can provide an enormous scope of benefits to employees, and it includes everything from paying for braces and eyeglasses to getting more dental or vision insurance, picking up supplemental health insurance plans that provide for such things as additional payments if you get cancer or you are hospitalized or accidents. It picks up, or it can pick up, disability income plans, both long and short disability income plans, group term life insurance, contributions to HSAs, contributions to 401(k)s. So picture, if you would, a large spectrum of benefits that these plans offer and the employees are allowed to pick which benefits are most important to them.

As I mentioned before, small businesses do not offer these plans widely, and even though you all passed legislation in 2010 known as the SIMPLE Cafeteria Plan, which helped the situation dramatically because before the SIMPLE, the types of discrimination laws in place basically made these unworkable for small businesses. They worked very well for large businesses, even mid-size, but they did not work well in the small business context. But the fact that owner-employees cannot participate, still, it is very difficult for an owner-employee to say, well, I am going to offer this large selection of benefits for my employees. It is going to cost a lot to offer these benefits. There are administrative costs and I cannot even participate. So that is a big problem, these plans.

I think one of the most important benefits of a cafeteria plan that is overlooked is that the employee—the benefits have been preselected for the employees by the employer. So you have a choice of a medical plan. You have a choice of a vision plan. You have a choice of a dental plan. You have a choice of long-term care. You have a choice of an HSA. It does not require the employee to go out and find these plans and determine which plans are best for that employee, and contributions going into the plan are pre-tax and are taken out of the employer's payroll. So the same reason why 401(k) contributions—and this is like a hard number to get your arms around, but believe it or not, it is 20 times more likely that an employee will make contributions to a 401(k) plan than they would to their own IRA. And part of that is they do not want to go and establish an IRA, but the second part is it is much harder to get your paycheck, take your money, and then bring it over to the IRA than having money taken out of your paycheck ahead of time. And you never see it and it just goes right into the plan and everything is fine because you were not counting on that money. You were not living on it.

So the same concepts apply in a cafeteria plan. It can be payroll deduction, so it does not hurt to save for the medical insurance or the dental vision or HSA contributions. It is done for you.

So, and one last comment I would like to make is that in addition to—if you asked me what is the single most important change you could do, it would be to allow owner-employees of pass-throughs to participate in the plans. I think that would promote the entire cafeteria plan system for small business. Second would be to increase the limits on dependent care, which is \$5,000 and has been for the last 35 years. So that would be my thoughts on how you could improve this. And thank you very much.

Chairman BRAT. Thank you very much.

And our third witness this morning is Ms. Elise Feldman, a certified pension consultant and accredited investment fiduciary who founded her own small firm, Feldman Benefit Services, Inc., in 1983, in Springfield, New Jersey. Ms. Feldman is a frequent speaker on the topics of retirement planning, employee benefit programs, entrepreneurship, and leadership. She is on the board of the Small Business Council of America, and is a member of the American Society of Pension Professionals and Actuaries.

Ms. Feldman, you have 5 minutes.

STATEMENT OF ELISE FELDMAN

Ms. FELDMAN. Thank you very much.

I am the president of Feldman Benefit Services, Inc., which is an actuarial firm, and Outsource, Inc., which is a human resources consulting firm. I am most pleased to be sharing my testimony with the Committee, and thank you for inviting me to do so.

Our firm is a full-service actuarial and employee benefits company, which clients are small- to mid-sized businesses, ranging in size from 1- to 3,000 employees. The majority are closely owned, generally 1 to 10 owners and under 100 employees, unless it is a professional service company firm, like a law firm or an accounting firm, where there would be many more partners. We are considered a small business, my own company.

The Section 125 Plan services that we provide cover annual testing—eligibility, key employee and concentration tests—annual compliance letters, and for those with flexible spending accounts, we provide reimbursement handling. With over 100 employees, we prepare the 5,500 annual reporting forms. Through providing these services, I have seen firsthand how the existing laws and regulations that apply to cafeteria plans impact the decisions that small business owners make with respect to the benefits they offer. So from our perspective, you are hearing from me as an actual plan administrator who does the annual compliance work so that our clients can have these plans. We do cafeteria plans, qualified plans, nonqualified, deferred compensation plans as well.

As a result of the current laws and regulations, owner-employees cannot participate in a Section 125 Plan that they sponsor for their own employees as you have heard, unless they are a C corporation. Very few small businesses today are organized that way. Rather, they tend to be Subchapter S, LLCs, and LLPs. Our small business clients tend to have a “paternalistic” attitude towards their employ-

ees and want to protect them and, as a result, want to offer benefits to them.

In addition to other benefits they may provide, the most prevalent is health insurance and considered the most valuable for the employees, and do so through a premium-sharing arrangement, with the employer paying part of the premium and the employee paying the rest. However, if a business does not sponsor a Section 125 Plan, the employees will only be able to pay for their portion of the premium with after-tax dollars. Thus, it makes good financial sense to encourage the small businesses to sponsor a Section 125 Plan, which can allow, among other things, the premium payment being on a pre-tax basis.

In addition to health insurance payments, these employers that sponsor a Section 125 Plan can make a number of other benefits available, such as medical reimbursement and dependent care. These give an employee an opportunity to provide better health care for themselves and their families as the 125 plan structure enables them to do so more easily and more affordably because they are pre-tax. The option to take advantage of these benefits is generally appreciated by the employees. I know, I give employee meetings.

However, while sponsoring a Section 125 plan can be good for employees, under current law small business owners who incur the expense and administrative burden of setting up these plans must do so with the understanding that they will not be able to participate in the plan themselves. For those owner-employees, their ability to utilize the benefits, most importantly the medical reimbursement and dependent care provisions, is solely because of their small size and form of entity. Had these individuals been employees and not owners, or had been C corporations, this would not be the case.

I would like to give you an example. On Monday, I had a meeting with an attorney in my office building, and I mentioned that I was coming here today, and he promptly said my wife has been upset with me because I keep telling her that I am not allowed to be in one of these plans and she has not believed me. And so I ran downstairs and said what would it be if we did the testing on our plan, and my actuary and I, who are owners, would be allowed to participate? And we found we failed the test by a small margin, but, nonetheless, we failed. And that could be corrected by reducing the amount that my actuary and I put into the plan, but we never tested it before because I knew we could not be in it. Alternatively, if we were allowed to participate, we could decide to change to a SIMPLE, but in exchange it would be overly complex and unfair testing that are imposed by the cafeteria plan that makes it so difficult to be in them.

Because the law firm upstairs has more owners and fewer employees by ratio, the testing would be even harsher for them and they would not pass. With three owners and two employees they would not be able to even sustain the benefits that we can in my own firm.

Each year, as we offer Section 125 services for our clients, we get the same routine questions from both employers and employees. The owner-employee asks when will I be able to participate, as well

as when will we be able to offer over-the-counter medications again?

As the medical and pharmaceutical industries have now adjusted so that medications which were previously only available by prescription can now be obtained over the counter, the financial dynamics have changed. Eye drops, allergy, stomach medications, to name only a few, must be paid for with after-tax dollars. Restoring the pre-tax benefit for over-the-counter medications would enable employees to better afford their medications. Employees who feel better, work better, are healthier, and are more productive.

Lastly, employees ask if there will be any significant increases to both the annual reimbursement and dependent care limits. Healthcare costs continue to rise, and there are more dual-income families now in the workforce. Providing the cost of child care continues to increase, and yet the limits have not gone up since the mid-'80s. Increasing the amount the employees can contribute to their Section 125 plans for these purposes will help employees cover these necessary costs.

And I welcome your questions.

Mr. KNIGHT. [Presiding] Thank you very much.

I would like to now yield to the Ranking Member, Mr. Evans, to introduce Mr. Tasse.

Mr. EVANS. Thank you, Mr. Chairman.

It is my pleasure to introduce Mr. Matt Tasse. Mr. Tasse is the principal at Scribner Insurance, and Burwell & Burwell, an employee-based broker in Portland, Maine. He also serves as the treasurer of the National Association of Insurance and Financial Advisors. He is testifying today on behalf of that group, one of the Nation's oldest and largest associations representing the interests of insurance professionals. Welcome, Mr. Tasse.

STATEMENT OF MATT TASSE

Mr. TASSE. Thank you, Mr. Evans.

Good morning. I am Matt Tasse, testifying today on behalf of the National Association of Insurance and Financial Advisors. I want to thank you for the opportunity to be here and share our perspective on cafeteria plans.

As Mr. Evans mentioned, NAIFA is one of the oldest and largest associations representing the interests of insurance professionals from every congressional district in the Nation. Like myself, most NAIFA members routinely talk to their clients about cafeteria plans and the benefits that they offer.

There are two elements of the cafeteria plan rules that could be improved in our view. NAIFA strongly encourages Congress to permit owners of pass-through businesses to participate—to allow the inclusion of those pass-through shareholders as well as adding the ability to provide qualified long-term care insurance in a cafeteria plan.

Since their introduction, cafeteria plans have become a popular method for employers to provide employee-tailored benefits. Not every employee has the same needs. A family with young children has very different needs than a single employee. Some workers get their health insurance through their spouse's plan, making employer-provided benefits less attractive.

Many workers value the flexibility of the Flexible Spending Account arrangement in meeting their projected expenses that are not covered by insurance, while others would prefer not to participate and take increased taxable compensation. Cafeteria plans allow different workers to accommodate their unique situations in choosing benefits that are most valuable to them. The advantages of establishing a cafeteria plan for both employers and employees significantly outweigh any perceived disadvantages.

While not all pass-through businesses are small, most are. Business owners ultimately pay the bills for the salaries and the employee benefits of their organization. It is unfair that they cannot participate in the cafeteria plan. Owners have unique benefit needs just like their employees. The Section 125 discrimination rules prevent pass-through owners from designing a plan that would primarily benefit them. The rules require at least 75 percent of the plan benefits accrue to the non-highly compensated participants in the organization.

One of our clients, the Lincolnville Telephone Company is a family-owned company that serves phone and Internet coverage in Mid Coast Maine. They have around 40 employees, but 5 of those employees are family members who are excluded from participating. They provide a plan anyway to provide the benefit to their employees and their families and to help reduce the benefit costs for those employees and their dependents. They also use the Flexible Spending Account opportunity to reduce out-of-pocket costs for those employees.

The inability of small business owners to participate in a plan acts as a disincentive to design, implement, administer, and pay for the cafeteria plan. Allowing owners to participate would likely encourage more of them to make plans available to their workers. That in turn would increase the financial security of their employees and themselves. For example, we insure around 60 small employer groups. In my State, Maine, which happens to be the oldest State in the United States, it is routinely \$1,800 to \$2,400 a month for a family coverage for medical insurance. Their employees could enjoy that benefit, but they do not, so in the small employer market they choose not to create the plan and make it available.

The need for long-term care insurance is acute and growing. The ability to offer long-term care through the convenience of a cafeteria plan would likely increase the number of people who could protect themselves against the risk of expensive long-term care and nursing home costs. It may also ease some of the pressure on Medicaid and family resources for the loved ones who do incur long-term care expenses.

In summary, cafeteria plans allow employers to offer flexible benefits to their workers at a reasonable cost to both the workers and the employer. It is unfair to exclude pass-through business owners from eligibility and it may discourage them from offering and paying for cafeteria benefits to their employees. Long-term care is much like health insurance. It is a security product that should be permitted in a cafeteria plan.

Thank you for the opportunity to be here. I would be pleased to answer any questions that you may have.

Mr. KNIGHT. Thank you very much.

And we will go to panel discussion. We can take up to 5 minutes from up here, and we will try and be as direct as we possibly can in our questions.

I will go to Ms. Brown. You mentioned that fear was driving a force behind Treasury actions in this area through 2007. While there were certainly abuses early on, is there any more current evidence that those fears are still justified given the strong anti-discrimination provisions that have been added since 1978?

Ms. BROWN. Thank you for your question. It is not clear within the 2007 regulations, or any regulations proposed since 1978, that there were actual palpable concerns, though I will tell you that the IRS would probably remind everyone that there are additional protections in each section of the code below 125, meaning that any of these benefits that are offered have their own particular code section and additional protections under those code sections.

Mr. KNIGHT. Okay. And we will follow up a little bit on that. You noted that in 2010, the Affordable Care Act relaxed the non-discrimination requirements for small employers with fewer than 100 employees and provided a safe harbor for SIMPLE cafeteria plans. How does this safe harbor work?

Ms. BROWN. All right. So specifically, if a small employer has less than 100 employees, they are not required to perform non-discrimination tests on the plan for group life insurance, medical reimbursement, dependent care assistant programs, as long as they continued the plan without interruption, offer the plan to all eligible employees, and provided a minimum contribution for each employee that is not a key employee.

Mr. KNIGHT. Okay. Let's see. We will go to Ms. Feldman. There are a couple things on your testimony but we will start with this. You mentioned that absent a Section 125 Plan, an employee would not be able to pay his or her portion of health insurance premiums with after-tax dollars.

Ms. FELDMAN. Pretax dollars.

Mr. KNIGHT. With pretax dollars, correct. Is there a mechanism? Is there really no mechanism here? Or is there a mechanism by which this can be accomplished, that people can go into this system as you said, people will be more apt to put money into a 401(k) if it is being taken out of their paycheck than if they were of taking their own check and writing it into an IRA? Can you talk about this mechanism, how this will work better?

Ms. FELDMAN. Well, there are two main requirements for an employee to be able to pay for premiums pretax. One is that there has to be a plan document which says so under Section 125, and the second is that the employee has to elect to have that happen. It cannot be done automatically. So if a small employer has their own plan, they have the administrative cost of establishing the plan and then they just bill it through their payroll system. If they are a PEO, they go through a provider. Hopefully, there is a document there, and I have to tell you probably 60 percent of the time there is not one.

Mr. KNIGHT. And I know from my own experience, when I was a financial advisor, it was hard to go into companies and say that this is the best benefit for you to sign up for your 401(k). And they would all ask about an IRA or something that they could do. I

would say, you know, your number one thing that you can do is sign up for, your 401(k) in your business. It is taken out so that typically takes away from your kind of decision-making. You understand where your money is going every month, because it is already taken out, and that is kind of the best plan for you to get moving in your financial success or your independence when you retire. Sometimes that is hard for people to understand, and sometimes that is hard for people to sign up right there, especially young people that do not understand that they are going to be 50 or 60 or 65 one day. So it is very hard to get a 22-year-old to do that, but okay.

I am going to move on to the ranking member for his questions.

Mr. EVANS. Thank you, Mr. Chairman.

Ms. Feldman, I want to kind of follow up a little bit. There are quite a few Federal and State laws that define the employer and the employee relationship. This is particularly important for employee's spouse working for the company, who is also taking advantage of the cafeteria plan. In this instance, what are tax implications for the owner and the employee's spouse, and does this situation always impact on employers' decisions to offer cafeteria plans to the employees?

Ms. FELDMAN. In a small business where there are two-income families, it is very possible that each spouse works somewhere and has a plan. And that is also very difficult to test because we can double up on the rules. And if an employee's spouse is in a plan and they have an HAS, then the employee in the company with the cafeteria plan can double up on the rules. So we are now responsible for administering, trying to determine what an employee has outside of the place where they work. It makes it a little difficult to administer.

Mr. EVANS. Mr. Tasse, the goal of this Committee is to assist small businesses in providing benefit plans to the employees, but because of perceived costs, many small firms do not. Can you explain how modifying certain aspects of the cafeteria plan can help us accomplish that goal?

Mr. TASSEY. The way to accomplish that goal is to let the employer who is really ultimately responsible for paying the costs of running his organization to participate in the plan. It is voluntary, so if he does not see at least a positive effect for the employees at least and be benevolent and offer it even though they cannot participate, but it would be even more encouraging if he could participate. You will often find that in small businesses, and we deal with dozens of them because that is what Maine is, it is mostly small businesses, often there is a son in the business or there is a nephew in the business or a cousin, and they are not allowed to participate either because they are a family member. So allowing the pass-through owners and their families to participate would be the easy way. The document itself is very, very tried and true and is available in any number of providers. It is the follow-through and the testing that happens, but if you let the owner have some of the benefits that he is providing to his employee, I think that would go a long way.

I mentioned as part of my testimony, one of the most difficult things facing Americans that we do not talk about is long-term

care, and it is crushing our State. And being able to offer long-term care within that portfolio would be a big gain for most people. I hope that is responsive.

Mr. EVANS. Ms. Brown, the self-employed owner of specific types of pass-through entities are ineligible from participating in their own cafeteria plans. Are you aware of any abuses by small business owners or their plan sponsors that necessitate this rule?

Ms. BROWN. I am not aware of any, nor is there any in the legislative history of this provision of the code. So the only mention is, again, back from Treasury's initial identification of four closely held corporations in 1978.

Mr. EVANS. Thank you, Mr. Chairman. I yield back the balance of my time.

Mr. KNIGHT. Thank you very much. And we will go to Mr. Fitzpatrick for his questions.

Mr. FITZPATRICK. Thank you, Mr. Chairman, and thank you all for coming in today.

My question is for the whole panel, and it is going to just be a broader question. If you could just identify the top three hurdles that are preventing small businesses from having access to cafeteria plans and what this Committee can do, what Congress can do from the legislative side, how much of this is an administrative issue for the executive branch of government?

Mr. TASSEY. There are millions of small businesses, and when you talk about small businesses, the Federal Government, I think, defines that as under 1,000 employees. In our world it is under 25 employees or 20 employees, and cash flow is their first problem. Once they get over that and they have an established business, then they have to look at the costs.

The only thing in America that continues to go without any hope of solving are college tuitions and health care. And what is happening is as health care continues to escalate and people expect to be covered when they have health care, they may not know what they have, but they expect it to be covered, we have got to get a handle on that. And that is going to be difficult. But the easy way to at least move forward would be to allow that owner who may have three or four employees to be able to take care of his healthcare costs pretax. It is a burden. If you have a family business and they are going to net \$80,000 or \$100,000 after salary and I am going to charge them \$2,500 a month for their medical insurance, that is the burden. So to make it pretax would be a huge improvement for people. Thank you.

Ms. FELDMAN. I can hone in on three right off the top. One is to allow owner-employees pass-through entities to participate. Two is to increase the limits because the cost of coverage and the cost of expenses is well beyond the time period of when we established these plans, and to overcome the concern and fear about discrimination because even if owner-employees participate in the plan, they are not faking benefits, they are not faking expenses. And if they have a bill from a doctor, it is real. It is not that they are going to ask for money that is going to reimburse, one, they have not laid out, and two, that is not an exact form to pay the bills that they have.

Ms. CALIMAFDE. My top three are similar but not identical. One is, I think, clearly allowing small business owners to participate in the cafeteria plan. When we talk about small business owners, these are people who are actually working. They are owner-employees, so they are the only employees in the country who are not allowed to participate; really discriminatory. And from a practical viewpoint, it is difficult to convince an owner-employee of a pass-through to sponsor a full-blown cafeteria plan which offers a lot of these benefits when they know that he or she cannot participate.

So it is just human nature. It is a cost-benefit analysis and it is like thank you, I am not interested since I do not want to incur all this extra burden and administrative expense and I cannot even be involved.

The second would be, and I mentioned this earlier, the \$2,500 limit, which I think is \$2,600 today, was put in by the Affordable Care Act and, in a sense, is a revenue-raiser to pay for the Affordable Care Act. And that limit was never in place before, and at a minimum that should be \$5,000. And the \$5,000 for dependent care, as I mentioned, has been in place for 35 years. And 35 years ago, I am sure that was enough to get childcare and elder care. Today it is not.

And the third thing is I agree with Mr. Tasse, I think long-term care should become a qualified benefit under the cafeteria plan. I think it was not simply because it was not around when 125 came into place, and I think it is a very valuable benefit, and I think as our population ages, we have to do something to help. And in a cafeteria plan, the employees help themselves in effect.

Ms. BROWN. So I have similar suggestions. I would first suggest that the requirements for these plans are applied evenly, meaning they match 401(c) for pension profit-sharing plans. Treasury and the IRS have relaxed those rules for small business owners and entrepreneurs, and so it would make sense that they would be relaxed in this context as well.

Secondly, I agree with Mr. Tasse, long-term care benefits are essential. They should very much be offered in these plans. I do not understand why they were not offered or excluded.

And then last, I really believe that—and this is something that you could ask for—finalized regulations out of the IRS on this issue or new regulations out of the IRS would be a wonderful thing here. Currently, we are all working under 2007 proposed regulations. You know, we really should have some finalized regs. I have spoken with the IRS on this issue and they do want to look at this again and would welcome suggestions on it. But these regs are old and cold.

Mr. FITZPATRICK. Mr. Chairman, I yield back.

Chairman BRAT. [Presiding] Thank you all very much. I think I will continue with a couple questions that go a little further than what you were just getting at. Does the change in administration have any impact on what you were just getting at in terms of regs or putting it into law? And all of you are free to weigh in on that one.

Ms. BROWN. I can weigh in. I mean, I did speak to the IRS on Monday about this issue, and the reason they gave me, which makes sense to me—I suggested a reason to them and they echoed

it back to me, there was a change in administration after 2007. They then proposed the healthcare law. IRS has been very busy since 2010 in articulating these regulations. Depending on what happens and what priority this is given depends on whether or not this will be repropounded, but, at the same time, they are aware that this is out there. They understand that they need to look at this again. So there is some wiggle room here.

Chairman BRAT. That is great. And I want to open this up just to see. When I go back home I hear from small business people on this issue, And then I also hear that the same kind of limitation applies to health insurance purchases for employees under some of the mandates from the past, but the owner could not give themselves the same health care pretax advantage, not just cafeteria plans, but health insurance in general. Is that the case out there? Can you comment on that?

Mr. Tasse, if you want to start off, or anybody who wants to weigh in.

Mr. TASSEY. It is nondeductible, so it is his personal expense.

Chairman BRAT. Right.

Mr. TASSEY. Now, if he became a C corporation it is a deductible expense directly, but everybody went to a pass-through. And once you are in a pass-through, it costs you money to get out of it. So that is why. It is just a nondeductible item.

Chairman BRAT. And is that analogous to the issue we are talking here?

Mr. TASSEY. It is.

Chairman BRAT. I mean, is it the same issue?

Mr. TASSEY. It is a first cousin.

Chairman BRAT. Okay, good.

Mr. TASSEY. If we allow you to do pretax for pass-through entity—

Chairman BRAT. Right.

Mr. TASSEY.—shareholders, it solves the problem.

Chairman BRAT. Good. And should we bundle these together since we are going to go through some heavy lifting in the first place? I mean, do they fit? Are they first cousins of that order that they fit in the same regs and the same bill? Or should we just treat them separately?

Mr. TASSEY. I think it should be together. I am not a tax attorney. I would have to think about that.

Chairman BRAT. Anybody else want to weigh in what they experienced?

Ms. CALIMAFDE. Well, as a tax attorney I am willing to weigh in. They certainly could go together.

Chairman BRAT. Okay.

Ms. CALIMAFDE. And also, I am going to try to say this as diplomatically as possible—I may not be known for my diplomacy skills—but I do think there should be a difference in the way small businesses are approached in a new administration. I think for years and years, small business owners, particularly of pass-throughs, are just seen as like abusers of the tax system by some folks in Treasury and IRS; not all of them, but a number of them. And I think a great deal of time is spent sitting around, trying to figure out, gee, well, what if an owner did this? And what if an

owner did that? And you end up with regulations that are thousands of pages long because they are sitting around what if-ing instead of giving us bright-line tests that we can follow because the vast majority of small business owners that I have ever worked with are trying to stay well within the law. They have no interest in being a name on a Supreme Court case, I can assure you.

But what they want is bright-line tests. And the grayer they make the rules, it is harder for us to follow them. So I personally get very upset with this sense that you run into at IRS that small business owners are up to no good and they need regulations and regulations. Did I say that diplomatically?

Chairman BRAT. That was very diplomatic. And that is the feedback I hear back home, too. It is staggering the amount of paperwork and check work they are having to do just to comply.

Does anybody else want to weigh in? I have got a minute left.

Ms. FELDMAN. These are similar situations in qualified plans for the ADP and ACP tests for 401(k) plans and through the benefit limits that also affect small businesses and business owners that would not occur in a large business.

Chairman BRAT. Any concluding remarks in 43 seconds?

Ms. CALIMAFDE. I have one. I would like to thank you guys for your time and your attention to this matter. It really is important to small business owners, and as I mentioned earlier, it is not only going to be important to the owners; it is going to be important to their employees as well because then they will be able to get these plans. So thank you for your time and attention.

Chairman BRAT. Super. Same to all of you. Thank you very much today. And Mr. Evans, pretty much you are all set? All right. Good.

I would like to thank, obviously, all of our witnesses today for an outstanding job and for participating with us today. It has been a very good discussion. You have all raised important points and provided some real pathways for moving forward.

As we move forward on historic tax reform, it is critical that small business issues are not lost in the shuffle. This is an area that requires attention and can easily be fixed. I commend the witnesses for not only raising the issues, but for recommending real world solutions. It is important that we have established a record here today upon which to build tax reform for small businesses.

I ask unanimous consent that members have 5 legislative days to submit statements and supporting materials for the record.

Without objection, so ordered.

This hearing is now adjourned. Thank you all very much.

[Whereupon, at 10:50 a.m., the Subcommittee was adjourned.]

A P P E N D I X

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS

MARCH 16, 2017

Testimony of Jen Brown

Manager of Research, National Institute on Retirement Security (NIRS)
Tax Policy Fellow, American University Kogod School of Business

Thank you for the invitation to join you to discuss revisions to § 125 of the Internal Revenue Code as it relates to small business owners. My name is Jen Brown and I am the Manager of Research at the National Institute on Retirement Security (NIRS). NIRS is a non-profit research and education organization which was established to inform policymaking by demonstrating the importance of retirement security to employers, employees, and American economic performance. In addition, I am also a Tax Policy Fellow at the American University's Kogod School of Business, where I conduct non-partisan research on tax and compliance issues specific to small businesses and entrepreneurs. Prior to my appointment at Kogod and at NIRS, I was an Employee Benefits Law Specialist for the U.S. Department of Labor's Employee Benefits Security Administration, where I worked on retirement, welfare, and health plans. In addition to my federal government service, I was also an ERISA Legislative History Research Assistant at the Georgetown University Law Center.

Overview of § 125 “Cafeteria” Plans

Section 125 of the Internal Revenue Code (“Code”) regulates “Cafeteria Plans,” which are tax-favored methods for offering a variety of fringe benefits to employees on a pre-tax basis through a plan offered by an employer. They are called cafeteria plans because these plans given an employees the ability to select benefits from a menu set by their employer, in exchange for forgoing compensation. Some cafeteria plans offer a choice between cash and one or more type of insurance coverage, while other plans offer one or more reimbursement accounts.¹ The fringe benefits than can be offered through such plans are:

- 1) Accidental death and dismemberment insurance policy (§ 106);
- 2) Accident and health benefits (§§ 105-106);
- 3) Adoption assistance benefits (§ 137);

¹David Ralsh, *Cafeteria Plans*, 397 TAX MGMT. PORT. (BNA) B-4 (2017).

- 4) COBRA continuation coverage; (§ 106);
- 5) Death and dismemberment insurance;
- 6) Dependent care assistance (§ 129);
- 7) Flexible Spending Arrangements (FSAs);
- 8) Group term life insurance (§ 79);
- 9) Health Savings Accounts (HSA's) (§ 223 and § 125(d)(2)(D);
and
- 10) Long-term and short-term disability coverage (§ 106).²

Additionally, an employer can offer coverage under a 401(k) cash or deferred arrangement under a cafeteria plan.³

Non-Discrimination Tests

Similar to other types of employee benefit plans, such as 401(k) plans, cafeteria plans must meet separate non-discrimination requirements, which were created in order to prevent benefits that are exclusively offered to “highly compensated” participants and not to “rank and file” employees. These rules are echoed by many other places in the Code in regards to employee benefit plans. But, § 125 contains an additional non-discrimination rule which limits non-taxable benefits to “key employees” to 25% of all benefits.

These non-discrimination tests can be complicated, but they boil down to three basic themes:

- 1) Eligibility - if too many rank and file employees are excluded from participation in the plan, the plan will be discriminatory;⁴
- 2) Availability of Benefits - the plan will not pass the non-discrimination tests if the highly compensated participants or key employees can access more benefits or the benefits they can access are more valuable than the benefits of rank-and-file employees;⁵
- 3) Utilization - a plan will not pass the non-discrimination tests if the highly compensated participants or key employees actually elect more benefits under the plan than rank-and-file employees.⁶

If a cafeteria plan fails these tests, the highly compensated participants and key employees must include these otherwise tax-free benefits in their taxable income.

Highly Compensated Participants and Key Employees Defined

Section 125 contains separate definitions for highly compensated participants and also key employees. Highly compensated participants are defined in § 125(e)(1) as a participant who is

²I.R.C. § 125 (2006).

³I.R.C. §§ 125(d)(1)(B), (f) (2006).

⁴I.R.C. § 125(b)(1)(A) (2006).

⁵I.R.C. § 125(b)(1)(B) (2006).

⁶Prop. Reg. § 1.125-1, § 1.125-2, § 1.125-5, § 1.125-6 and § 1.125-7, 72 Fed. Reg. 43938 (Aug. 6, 2007).

- a) an officer;
- b) a shareholder owning more than five percent of the voting power or value of all classes of stock of the employer;
- c) highly compensated, or
- d) is a spouse or a dependent of an individual mentioned above.

Similarly, § 125 defines a key employee, in reference to § 416(i)(1), and includes:

- a) an officer of the employer who has an annual comp
- b) a five percent owner of the employer; or
- c) a one percent owner of the employer who receives an annual compensation of more than \$150,000.⁷

Self-Employed Individuals, Partners in a Partnership and S-Corp. Stakeholders

Self-employed individuals, partners in a partnership, and 2% shareholders of an S-Corporation are excluded from participating in § 125 cafeteria plans, but are still able to sponsor plans for their employees.⁸ This is unlike § 401(c), where self-employed individuals can participate in pension, profit-sharing and stock bonus plans along-side their employees.⁹ And in § 129, where these individuals can also participate in dependent care assistance programs.¹⁰

Legislative History

Provisions excluding highly compensated individuals from tax-sheltered retirement plans have been in place since 1942, after employers sought to provide tax-sheltered retirement benefits to “key employees,” including officers, shareholders, and highly compensated employees.¹¹ These “key man trusts” were first introduced in 1936 and were legislatively prohibited in the 1942 Revenue Act.¹²

The same prohibitions against highly compensated individuals participating in tax-sheltered retirement plans did not extend to the payment of employee health insurance premiums.¹³ Between 1936 and 1978, many corporations adopted plans that reimbursed the medical expenses of shareholders and officers, but not those of rank-and-file employees.¹⁴ Treasury became very concerned with these “particularly abusive situations,” and singled out four closely held corporations which reimbursed the medical expenses of share-

⁷ I.R.C. § 416(i)(1) (2006).

⁸ Prop. Reg. § 1.125-1, § 1.125-2, § 1.125-5, § 1.125-6 and § 1.125-7 (hereinafter “2007 proposed regulations” or “2007 Prop. Reg.”), REG-142695-05, 72 Fed. Reg. 43938 (8/6/07).

⁹ I.R.C. § 401(c) (2006).

¹⁰ I.R.C. § 129 (2006).

¹¹ James Wooten, THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974 - A POLITICAL HISTORY, 31-32 (2004).

¹² Revenue Act of 1942, § 127(a), Pub. L. No. 753, 56 Stat. 798, 825, codified as Internal Revenue Code of 1939, § 23(x).

¹³ Daniel Schaffer & Daniel Fox, *Tax Law as Health Policy: A History of Cafeteria Plans 1978-1985*, 8 AM. J. TAX POL’Y 1, 6 (1989).

¹⁴ *Id.*

holder-officers as a “way to disguise [otherwise taxable] dividends.”¹⁵

This fear pervaded Treasury’s actions through 2007. In the introduction of the cafeteria plan legislation, Treasury Department proposed stricter anti-discrimination rules—specifically in regards to highly compensated individuals.¹⁶ Treasury feared that, without stricter anti-discrimination rules in a cafeteria plans, higher paid employees would select non-taxable health benefits, while lower-paid employees would select taxable cash payments.¹⁷ To prevent this, Treasury’s rules were designed to ensure that lower-paid employees actually used the available non-taxable benefits.¹⁸ But, Congress did not seem to echo Treasury’s fears in the Revenue Act of 1978 - as § 125 was enacted with only the provision that “a cafeteria plan does not discriminate where nontaxable benefits and total benefits do not discriminate in favor of highly compensated participants.”¹⁹ Yet the legislation left the door open for Treasury to “prescribe such regulations as may be necessary to carry out the provisions of this section.”²⁰

But, during the time period between 1978 to 1983, Treasury did not issue any regulations regarding non-discrimination in § 125 plans.²¹ Thus, employers were left with the statutory language from Congress as guidance regarding these plans. After Treasury issued a set of proposed regulations in 1984 in the form of questions and answers,²² Congress, as part of the Tax Reform Act of 1984 (“TRA”) addressed some of Treasury’s concerns regarding cafeteria plan non-discrimination issues by adding additional language defining key employees and the benefits that can be received by these employees.²³ The TRA prohibited plans that favored the highest paid officers and owners—key employees—especially those that received more than 25% of the total benefits provided by the plans.²⁴

This addition of this key employee provision in the TRA disproportionately affected the ability of small firms to offer cafeteria plans. In a large firm, a key employee could still be offered significant benefits through a cafeteria plan without exceeding the 25% threshold. On the other hand, in a small firm, even limited benefits

¹⁵*Id.* (citing Department of the Treasury, *The President’s 1978 Tax Program: Detailed Descriptions and Supporting Analysis of the Proposals 145* (January 30, 1978), reprinted in *The Presidents 1978 Tax Reduction and Reform Proposals: Hearings Before the House Committee on Ways and Means, 95th Cong., 2d Sess. 160, 304* (1978)).

¹⁶Daniel Schaffer & Daniel Fox, *Tax Law as Health Policy: A History of Cafeteria Plans 1978-1985*, 8 *AM. J. TAX POL’Y* 1, 14 (1989).

¹⁷*Id.*

¹⁸*Id.*

¹⁹Revenue Act of 1978, Pub. L. No. 95-600, § 134(a), 92 Stat. 2763, 2783, codified as Internal Revenue Code of 1954, § 125.

²⁰Revenue Act of 1978, Pub. L. No. 95-600, § 134(a), 92 Stat. 2763, 2783, codified as Internal Revenue Code of 1954, § 125.

²¹See Daniel Schaffer & Daniel Fox, *Tax Law as Health Policy: A History of Cafeteria Plans 1978-1985*, 8 *AM. J. TAX POL’Y* 1, 31-37 (1989).

²²49 Fed. Reg. 19321 (May 7, 1984).

²³Tax Reform Act of 1984, Pub. L. No. 98-369, § 53, 98 Stat. 494, codified as Internal Revenue Code of 1954, § 125.

²⁴Tax Reform Act of 1984, Pub. L. No. 98-369, § 53(b)(2), 98 Stat. 494, codified as Internal Revenue Code of 1954, § 125(b)(2).

provided to a key employee could quickly exceed the 25% threshold.²⁵

Then, in 2007 the Internal Revenue Service issued proposed regulations which finally enacted a test that ensured that lower-paid employees actually used the available non-taxable benefits.²⁶ Specifically, the 2007 proposed regulations provide that:

a cafeteria plan does not discriminate with respect to contributions and benefits if either qualified benefits and total benefits, or employer contributions allocable to statutory non-taxable benefits and employer contributions allocable to total benefits, do not discriminate in favor of highly compensated participants. A cafeteria plan must satisfy this paragraph . . . with respect to both benefit availability and **benefit utilization. Thus, a plan must give each similarly situated participant a uniform opportunity to elect qualified benefits, and the actual election of qualified benefits through the plan must not be disproportionate by highly compensated participants (while other participants elect permitted taxable benefits).**²⁷

Later, in 2010, as part of the Patient Protection and Affordable Care Act (the “PPACA” or the “ACA”), Congress relaxed the nondiscrimination requirements for § 125 Cafeteria plans for small employers with under 100 employees.²⁸ Specifically, the ACA provided for “simple cafeteria plans” which provided employers a safe harbor from the nondiscrimination requirements of cafeteria plans and any nondiscrimination requirements for any of the benefits provided under a cafeteria plan.

Conclusion

Since 1978, Treasury and Congress have focused on preventing the abuse of cafeteria plans by owners of closely held corporations due to fears from particular abuses by corporations in 1978. Congress has provided small employers with relaxed nondiscrimination requirements in simple cafeteria plans through the ACA in 2010. However, self-employed individuals, partners in a partnership, and 2% shareholders of an S-Corporation may only sponsor these cafeteria plans today, but cannot participate in these plans.

²⁵ See, e.g., Testimony of Hon. Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration, Hearing on the Small Business Retirement and Benefit Extension Act S. 1426, October 23, 1987 (<https://www.finance.senate.gov/imo/media/doc/hrg100-518.pdf>).

²⁶ Prop. Reg. § 1.125-7, 72 Fed. Reg. 43938 (Aug. 6, 2007).

²⁷ Prop. Reg. § 1.125-7, 72 Fed. Reg. 43938 (Aug. 6, 2007) (emphasis added).

²⁸ Pub. L. No 111-148.

**Testimony to the U.S. House of Representatives
Committee on Small Business
Subcommittee on Economic Growth, Tax, and Capital
Access**

March 16, 2017

Prepared by Paula A. Calimafde, Esq.

Chair of the Small Business Council of America

President and General Counsel of the Small Business Legislative Council

The Small Business Council of America (SBCA) and the Small Business Legislative Council (SBLC) appreciate the opportunity to submit testimony to the House of Representative's Committee on Small Business Subcommittee on Economic Growth, Tax and Capital Access.

The SBCA is a national nonprofit organization which for 38 years has represented the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 30,000 successful enterprises in retail, manufacturing and service industries, virtually all of which provide health insurance and retirement plans for their employees. The SBCA is fortunate to have many of the leading small business advisors in the country on its Board and Advisory Boards, many of whom are the leading experts in the tax and health care laws and how those laws impact small and family-owned businesses.

The SBLC is a 40-year-old, permanent, independent coalition of approximately 50 trade and professional associations that share a common commitment to the future of small business. SBLC members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. SBLC policies are developed by consensus among its membership.

I am a long time member of the Employee Benefits Council of the U.S. Chamber of Commerce and a partner in the Bethesda law firm of Paley Rothman where I am a senior benefits and tax lawyer. In this role, I have counseled hundreds of small businesses on employee benefits.

Introduction:

Cafeteria plans (also known as IRC Section 125 plans) are a unique and extremely valuable system for delivering benefits to employees. Such plans allow participants to pay for certain types of limited-scope health coverage, dependent care costs (IRC Section 129), adoption expenses (IRC Section 137), paid time off and out-of-pocket medical expenses (IRC Section 105) on a pre-tax basis. Cafeteria plans can allow employees to obtain and pay for, on a pre-tax basis, employee benefits, such as deductibles, co-pays, prescription drugs, braces, glasses and other health care expenses, as well as, dependent care costs, contributions to health savings accounts (HSAs) and 401(k) accounts, disability income plans and group term life insurance. Cafeteria plans currently provide many Americans with greater access to health services, while allowing them to select the benefits that they need the most. While employers determine the benefits to be offered under a cafeteria plan, employees have the flexibility to select only the particular benefits that are of greatest value to them. Thus, flexibility in the selection of benefits and affordability through the use of pre-tax dollars are the hallmarks of the cafeteria plan.

Unfortunately, cafeteria plans are still not widely offered by small businesses. While the enactment of legislation in 2010 creating the SIMPLE Cafeteria Plan went a long way towards making it easier for small business owners to sponsor cafeteria plans, the fact that small business owner-employees still cannot participate in their businesses' plans continue to be a significant impediment to the growth of cafeteria plan sponsorship amongst small businesses.

While employees of most large and mid-sized businesses as well as non-profits, schools, universities and the federal government can take advantage of the valuable benefits provided by cafeteria plans, most small business owners are not allowed to participate in a cafeteria plan. Specifically, cafeteria plans can be utilized by common-law employees, but not by sole proprietors, partners in a partnership, S-corporation shareholders holding an interest of 2% or greater (and by attribution, their family members) and members in a limited liability company that has elected to be taxed as a partnership. According to recent data from the U.S. Small Business Administration (SBA), seventy-three percent of small employers are sole proprietorships, partnerships or S-corporations—meaning, that almost three-quarters of small business owners are excluded from participating in a cafeteria plan.¹ Because of this, small business owners are less likely to take on the cost and effort of sponsoring a cafeteria plan which deprives the small business employees of the opportunity to obtain greater health coverage and other valuable employee benefits that are generally available to their counterparts working for larger businesses or in the public sector.

Why Small Business Employees Need Cafeteria Plans:

Perhaps the single most important benefit that a cafeteria plan can offer an employee is the ability to use pre-tax dollars to pay for group health insurance premiums. The major-

¹Frequently Asked Questions, U.S. Small Business Administration, Office of Advocacy (June 2016), available at https://www.sba.gov/sites/default/files/advocacy/SB-FAQ-2016_WEB.pdf.

ity of small businesses with ten or more employees offer employees the opportunity to enroll in group health insurance.² However, it is very rare for a small business to pay the full cost of the premiums for group health insurance for its employees and their spouses and dependents. When a business sponsors group health coverage but does not pay the entire premium, the portion of the premium paid for by the employees can only be paid with pre-tax dollars if the business sponsors a cafeteria plan and offers health insurance as a benefit under that plan (this is commonly known as a “premium conversion” plan). If the business does not have a cafeteria plan, employees must use after-tax dollars to pay for their portion of the premiums. The pre and post-tax distinction, is particularly important in the context of small businesses that often face higher insurance premiums because they lack the same bargaining power as larger businesses.

Looking more broadly, also of great significance to small business employees is the fact that cafeteria plans can allow small businesses to offer employees a wider swath of benefits that more closely resemble what is commonly available to employees of larger companies. Even if a cafeteria plan is an employee pay all plan (meaning that the employer sets up the plan but doesn’t make contributions into it), by allowing employees to pay for premiums and other costs pre-tax, such plans help employees and their families afford health and other benefits that they may not otherwise be able to afford if they were paying for the benefits on an after tax-basis. A comprehensive cafeteria plan can offer employees benefits that not only help the employees individually but that also can have broader positive social impact by allowing employees to better protect and care for themselves and their families. For example, cafeteria plans often offer dependent care spending accounts to help employees pay for child care and elder care on a pre-tax basis. Particularly as the working population and their parents continue to age, this will be become an increasingly important benefit for helping ensure quality of life in old age (which is why we argue below that the dependent care limits should be increased). Additionally, through a cafeteria plan, employees can use their own money to secure themselves against unexpected or otherwise uninsured medical expenses. Flexible spending accounts (FSAs) allow employees to pay for medical expenses not covered by insurance (such as glasses or braces) and supplemental insurance plans (such as those offered by Aflac) can help protect employees financially in the event of significant medical events that may not be fully covered by medical insurance plans, such as cancer, accidents, or hospitalization. Above all, cafeteria plans allow employees to mix and match the benefits they need most at prices they could not otherwise get. Perhaps just as important, by pre-selecting the benefit programs for the employees, the employer makes it much easier for the employees to pick up needed programs that they may otherwise not have taken the time to find or even be aware of on their own.

²According to recent data from the Employee Benefit Research Institute (EBRI), 73.5% of businesses with 25-99 employees, 48.9% of businesses with 10-24 employees and 22.7% of businesses with fewer than 10 employees, offer health benefits in 2015. Notes, Employee Benefit Research Institute (EBRI), Vol. 37, No. 8 (July 2016).

Why Small Business Owner-Employees Need Cafeteria Plans:

It is no surprise that many more small business employees are offered qualified retirement plans than are offered cafeteria plans since small business owner-employees of pass-through entities are eligible to participate in retirement plans. Small business owners are inevitably less motivated to implement a benefit they can't participate in than one that they can. This is not because small businesses don't care about their employees. Particularly in the early years, most small business owners are focused on the challenges of maintaining and growing their businesses. According to the SBA, only about half of new businesses survive their first five years and only about a third of new businesses survive 10 years or more.³ No matter how much a business cares about its employees, offering a benefit like a cafeteria plan comes down to a cost benefit analysis.

Non-owner small business employees are not the only ones who need the benefits that can be provided through a cafeteria plan. Many closely held small business owners and their families make personal financial investments and sacrifices to keep their businesses going while knowing that they may not be able to sell the business in the event of an unexpected or catastrophic situation. A number of the benefits that can be offered in a cafeteria plan, such as life insurance and voluntary supplemental health benefits, could help small business owners protect themselves and their families and ensure the financial stability necessary to allow them to continue to run and grow their businesses. Accordingly, if given the opportunity to participate in a cafeteria plan, many small business owners would view the administrative expenses and burdens of setting up the plan for the entire business as a small price to pay to allow them to obtain the benefits available in such a plan.

In short, while some small business owners today might provide a premium-only plan for the non-owners, which would at least allow employees to pay their portion of the health insurance premium on a tax-free basis it would be highly unlikely that the employees would be covered under a more comprehensive cafeteria plan offering vision and dental benefits, flexible health care spending accounts, dependent care flexible spending accounts, additional life insurance and so on. **However, if small business owner-employers were allowed to participate in the cafeteria plan, the likelihood of their sponsoring a comprehensive cafeteria plan would increase significantly—meaning that more small business employees would have the opportunity to take advantage of this valuable benefit.**

Current Treatment of Small Business Owners and Cafeteria Plans:

IRC Section 125 does not specifically include self-employed individuals in its definition of "employee." Based on this, the Internal Revenue Service has taken the position that Congress intended to

³Frequently Asked Questions, U.S. Small Business Administration, Office of Advocacy (June 2016), available at https://www.sba.gov/sites/default/files/advocacy/SB-FAQ-2016_WEB.pdf.

exclude owner-employees of small and closely held businesses from being “employees” for purposes of IRC Section 125. We contend that Congress did not intend such result because, at the time Section 125 was enacted, small business owner-employees, regardless of what type of entity they were working for (a pass-through or otherwise), were deemed employees for purposes of qualified retirement plans. Regardless, this is the current IRS position and we’ve been assured time and time again by officials at the Treasury and IRS that absent legislation to the contrary, they will maintain this position. **This is plain and simple discrimination against small business owners.**

This rule is also bizarre in light of the fact that small business owner-employees are, of course, allowed to participate in qualified retirement plans. There is no good reason to think that small business owner-employees should be treated differently for a similar type of employee benefit—the cafeteria plan—particularly given that everybody else can be covered by a cafeteria plan. As a result of IRS’ interpretation of Section 125, sole proprietors, partners, shareholders owning 2% or more in S-corporations, and members of most limited liability companies are all unable to participate in cafeteria plans. As mentioned above, this is a significant disincentive for small business owners to provide cafeteria plans for their employees.

Recommendations for Improving the Cafeteria Plan System:

First and foremost, owner-employees of small and closely held businesses should be permitted to participate in cafeteria plans and the variety of benefits that can be offered through a cafeteria plan. **To achieve this, we urge Congress to pass legislation to: (1) modify 26 U.S.C. § 125 to make it clear that self-employed individuals, including sole proprietors, partners, S-corporation shareholders and members in a limited liability company that has elected to be taxed as a partnership, are deemed to be employees for the purpose of eligibility to participate in a cafeteria plan and (2) modify the statutes governing the specific benefits that can be included in a cafeteria plan, including 26 U.S.C. § 79 (life insurance and accidental death), 26 U.S.C. §§ 105-106 (medical, dental, vision, short- and long-term disability), and possibly 26 U.S.C. § 129 (dependent care), to make it clear that self-employed individuals (i.e., owner-employees) are deemed to be employees for the purposes of eligibility to participate not just in the cafeteria plan itself but in the specific benefits that may be offered through the cafeteria plan.**

Additionally, we would argue that the limits on how much a cafeteria plan participant can contribute tax-free towards a flexible spending account (FSA) or dependent care are too low and need to be increased in order for these to be truly meaningful benefits for employees. The 2017 FSA contribution limit is \$2,600 and the dependent care contribution limit is \$5,000 (or \$2,500 for married filing separately). The very low limits on FSAs were placed into the law as a revenue raiser for the Affordable Care Act and are so low as to almost be absurd. The limit on dependent care is not subject

to COLA and has been \$5,000 for the last 35 years! It is simply not realistic to think that employees can get quality child care or elder care today for \$100 a week. According to data from the Economic Policy Institute, the average annual cost for infant care exceeded \$5,000 in 49 out of 50 states (often by thousands of dollars) and the average annual cost for care for a four year old exceeded \$5,000 in 43 out of 50 states.⁴ Moreover, according to MetLife's 2012 Market Survey of Long-Term Care Costs, the average national cost for adult day care services is \$71 per day (or over \$25,000 per year).⁵ **We urge Congress to pass legislation to increase and index the contribution limits for FSAs and dependent care accounts so that they better reflect the true costs that employees are facing.**

Finally, particularly as the population ages and the stress on the social systems supporting the elderly increases, we believe that it would be desirable to allow cafeteria plans to be able to provide employees with the option of purchasing long-term care insurance as a qualified benefit. If allowed to purchase long-term care insurance on a pre-tax basis and by payroll deduction, it is far more likely that employees will elect to be covered by long-term care. Encouraging citizens to finance their own long-term care is desirable as it will help to shift the burden away from the government in addressing the long-term care needs of older citizens. The entire country wins when Congress can incentivize individuals to purchase long-term care insurance on their own. **We urge Congress to pass legislation to consider modifying 26 U.S.C. § 125 to remove the exclusion for long-time care insurance and allow long-term care insurance to be a qualified benefit that may be offered through a cafeteria plan.**

Most importantly, it is essential to treat owner-employees of pass-through entities as employees for all of these employee benefits. It is blatant discrimination against small business owner-employees to prohibit them from using these plans just because they have chosen to operate their businesses as a pass-through entity. By making this change, it is far more likely that the valuable world of cafeteria plans will be made available to all small business employees so they will have parity with their counterparts who work for the government or who work for entities operating as a C corp regardless of the size of the company. Enactment of the SIMPLE cafeteria plan was a significant step forward in assisting small businesses with sponsoring cafeteria plans but without allowing owner-employees to participate in the plan, it will not accomplish its purpose of expanding this valuable plan for all small business employees.

⁴Child Care Costs in the United States, Economic Policy Institute, available at <http://www.epi.org/child-care-costs-in-the-united-states/>.

⁵Market Survey of Long-Term Care Costs, MetLife (2012), available at https://www.metlife.com/mmi/research/2012-market-survey-long-term-care-costs.html?WT.ac=PRO_Pro3_PopularContent_5-18491_T4297-MM-mmi&oc_id=PRO_Pro3_PopularContent_5-18491_T4297-MM-mmi#keyfindings.

Elise Feldman Testimony for The Committee on Small Business
Subcommittee on Economic Growth, Tax, and Capital Access,
Hearing titled "Cafeteria Plans: A Menu of Non-Options for
Small Business Owners

Thursday, March 16, 2017

Room 2360 Rayburn House Office Building

My name is Elise Feldman, President of Feldman Benefit Services, Inc. with offices in Springfield, New Jersey and Boca Raton, Florida. I am a Certified Pension Consultant and Accredited Investment Fiduciary. I also own Outsource, Inc., a Human Resources consulting firm. I am most pleased to be sharing my testimony with the Committee and thank you for inviting me to do so.

Our firm is a full-service actuarial and employee benefits company, which clients are small to mid-sized businesses, ranging in size from 1 - 3,000 employees. The majority are closely owned, generally 1 - 10 owners and under 100 employees (unless a professional service firm such as accounting or legal which would have more partners.)

We have approximately 350 clients. The primary services we provide are in regard to qualified retirement plans. In addition, we provide services for non-qualified deferred compensation plans and certain welfare benefit plans. We either provide "full service" or consulting services for Section 125 Cafeteria Plans.

The Section 125 Plan services include annual testing (eligibility, key employee and concentration tests), annual compliance letters, and for those with flexible spending accounts, we provide reimbursement handling. When over 100 employees, we prepare the 5500 Annual Reporting Forms. Through providing these services, I have seen first-hand how the existing laws and regulations that apply to cafeteria plans impact the decisions that small business owners make with respect to the benefit that they offer.

As a result of current laws and regulations, owner-employees cannot participate in a Section 125 plan they sponsor for their employees unless they are a C Corporation. Very few small businesses are organized as C-Corporations. Rather small businesses tend to be organized as Sub Chapter S Corporations, LLCs or LLPs. Our small business clients tend to have a "paternalistic" attitude towards protecting their employees, as they recognize the business would not be as successful were it not for their efforts. As a result, these employers want to offer benefits to their employees. In addition to other benefits they may provide, the most common (and, to employees, perhaps the most valuable) benefit that our clients tend offer is health insurance, though with a premium sharing arrangement, with the employer paying part of the premium and the employee paying the rest. However, if the business does not sponsor a Section 125 plan, the employees will only be able to pay their portion of the premium with after-tax dollars. Thus, it makes good financial sense to encourage small businesses to sponsor Section

125 plans which can allow, among other things, the employees to pay their share of premium on a pre-tax basis.

In addition to health insurance premium payments, those employers that sponsor Section 125 plans can make a number of other benefits available to employees, such as the Medical Reimbursement benefit as well as the Dependent Care benefit. These benefits give the employees an opportunity to provide better health care for themselves and their family members, because the Section 125 plan structure enables the employees to do so more easily and more affordably (because the contributions are made on a pre-tax basis). The option to take advantage of these benefits is generally appreciated by the employees.

However, while sponsoring a Section 125 plan can be good for employees, under current law, small businesses owners who incur the expense and administrative burden of setting up a plan must do so with the understanding that they will not be able to participate in the plans themselves. For these owner-employees, their ability to utilize the benefits, most importantly the medical reimbursement and dependent care provisions, is solely because of their small size and form of entity. Had these individuals been employees and not owners, or had the business been a C-Corporation this would not be the case.

I would like to give you an example: On Monday, I had a meeting with an attorney in my office building, and I mentioned that I was coming here today. He then mentioned that his wife did not believe him when he told her he could not be in one of these plans.

Interestingly, even if the lawyer had been allowed to participate in the plan, assuming he was not an owner of a pass-through entity, he would have only been allowed very few benefits in the plan because of the onerous discrimination tests imposed on cafeteria plans (absent the firm adopting a SIMPLE cafeteria plan). For instance, if I and my company's Actuary who is also an owner, were allowed to participate in our cafeteria plan, the discrimination tests would fail. Correction by lowering the amount the two owners put in would enable it to pass the concentration test. Alternatively, if we were allowed to participate, we could decide to change to the SIMPLE cafeteria plan which would require the company to put in contributions for our employees, but in exchange we would not be required to do the overly complex and frankly unfair tests imposed by the cafeteria plan rules on small businesses.

Because the law firm upstairs has more owners and fewer employees, the way the testing works in the context of a small business would have cause their testing results to not come in as well as my company's and the contributions for the owner-employees would have been far more restricted.

Each year, as we offer Section 125 services for our clients, we get the same routine questions from both the employer and employees.

The owner-employee asks "when will I be able to participate?", as well as "when will we be able to offer over-the-counter medications again?"

As the medical and pharmaceutical industries have now adjusted so that medications which were previously only available by prescription can now be obtained over the counter, the financial dynamics have changed. Eye drops, allergy, and stomach medications, to only name a few types, must be paid for with after-tax dollars. Restoring the pre-tax benefit for over the counter medications would enable employees do better afford their medications. Employees who feel better, work better, are healthier, and more productive.

Lastly, employees ask if there will be any significant increases to both the annual medical reimbursement and dependent care limits. Health care costs continue to rise. More dual income families are now in the workforce, and the cost of providing child care has continued to increase. The dependent care limits, however, have remained unchanged since the 1980's. Increasing the amount that employees can contribute to their Section 125 plans for these purposes will help employees cover these necessary costs.

I welcome the opportunity to answer your questions.



National Association of Insurance
and Financial Advisors

TESTIMONY
OF
NATIONAL ASSOCIATION OF INSURANCE AND FINANCIAL ADVISORS
MATTHEW TASSEY, TREASURER

HOUSE SMALL BUSINESS COMMITTEE
SUBCOMMITTEE ON ECONOMIC GROWTH, TAX, AND CAPITAL ACCESS

“Cafeteria Plans: A menu of Non-Options for Small Business Owners”

March 16, 2017

Good morning Chairman Brat, Ranking Member Evans, and Members of the Subcommittee. My name is Matthew Tasse, and I am testifying today on behalf of the National Association of Insurance and Financial Advisors (“NAIFA”) for whom I currently am serving as Treasurer. Thank you for giving us this opportunity to share our perspective on cafeteria plans.

Founded in 1890 as The National Association of Life Underwriters (NALU), NAIFA is one of the nation’s oldest and largest associations representing the interests of insurance professionals from every Congressional district in the United States. NAIFA’s mission is to advocate for a positive legislative and regulatory environment, enhance business and professional skills, and promote the ethical conduct of its members. Most of our members work with small businesses and their owners on a wide variety of security and financial needs confronting the businesses, their owners, and employees. As a result, most NAIFA members routinely talk to their clients about cafeteria plans and the benefits they offer the business, the workers, and the owners.

I am a principal of Scribner Insurance and Burwell & Burwell, an employee benefits broker in Portland, Maine. I work with small and some large employer groups in all aspects of benefit plans and design.

On behalf of my colleagues at NAIFA and most importantly, on behalf of our small business owner clients, thank you for your interest in allowing them to participate in a cafeteria plan.

Background

A cafeteria plan is a separate written plan maintained by an employer for employees that meets the specific requirements of and regulations of Section 125 of the Internal Revenue Code. It

allows eligible workers to choose from among a variety of qualified benefits, or instead receive taxable cash. Usually, if a worker chooses one or more of the benefits offered in the plan, the benefits are paid for by way of a pre-tax salary reduction amount.

A qualified benefit is a benefit that does not defer compensation and is excludable from an employee's gross income. Qualified benefits include:

- Accident and health benefits (but not Archer medical savings accounts or long-term care insurance)
- Adoption assistance
- Dependent care assistance
- Group-term life insurance coverage
- Health savings accounts, including distributions to pay long-term care services

Section 125 requires the plan to specifically describe all benefits, establish rules for eligibility and elections, and to be offered on a nondiscriminatory basis. To ensure compliance, the Internal Revenue Code sets forth testing requirements that must be satisfied. These testing requirements are in place to make certain that Cafeteria Plan benefits are available to all eligible employees under the same terms, and that the Plan does not favor highly compensated employees, officers, and owners.

Premium Only Plan (POP)

Employers may deduct employees' portion of the company-sponsored insurance premium directly from employees' paychecks before taxes are deducted.

Flexible Spending Account (FSA)

In an FSA, employees may set aside on a pre-tax basis a pre-established amount of money per plan year. Employees can use the funds in the FSA to pay for eligible medical, dependent care, or transportation expenses.

Improve Cafeteria Plans by Making Pass-Through Business Owners Eligible to Participate, and Allowing Cafeteria Plans to Offer Qualified Long-Term Care Insurance

There are two elements of the cafeteria plan rules that could be substantially improved: first, under current law, owners of pass-through businesses—Subchapter S corporations, partnerships, LLCs, and sole proprietorships—may not participate in a cafeteria plan. This should be changed. Second, a security benefit of growing importance to America's workers, long-term care insurance, is not a permissible benefit in a cafeteria plan. This, too, should be corrected.

NAIFA strongly encourages Congress to correct these two issues, by making pass-through business owners eligible to participate in a cafeteria plan and to allow inclusion of employer-sponsored qualified long-term care insurance in cafeteria plans.

Cafeteria Plan Benefits Outweigh Disadvantages

Since their introduction in the early 1980's, cafeteria plans have become a popular method for employers to provide health and other benefits in a way that results in employee tailored benefits.

Not every employee has the same security needs as their co-workers. A family with young children will value a cafeteria plan's dependent care benefit, while a single worker who has no children will find that benefit of no real value. Some workers get their health insurance through their spouse's plan, making their own employer's offer of health insurance less valuable. Some workers find the flexibility of an FSA valuable in meeting their projected health expenses that are not covered by insurance, while others would prefer a different benefit or taxable cash compensation. Cafeteria plans allow different workers to accommodate their unique situations in choosing the benefits that are most valuable to them.

The uniform reimbursement aspect of section 125 allows an employee to be reimbursed for qualified medical expenses that exceed their contributions to date. This rule can put the employer at risk if an employee in a health FSA quits before contributing the full amount for which he has been reimbursed, and there is a modest employer cost to installing and maintaining a cafeteria plan.

Under the "use it or lose it" rule, an employee must forfeit unused FSA contributions at the end of the plan year. However, with appropriate planning and good communication, the effect of any disadvantages can be greatly minimized.

The advantages of establishing a cafeteria plan for both employers and employees significantly outweigh any perceived disadvantages. Employees can receive the benefits they want while at the same time helping to control benefit costs.

Make Pass-Through Business Owners Eligible to Participate in Cafeteria Plans

Small employers are often organized as pass-through businesses. The Small Business Administration 2016 profile indicates small businesses employed 56.8 million people or 48 percent of the total U.S. workforce.

While not all pass-through businesses are small, most are. And most employ workers. Business owners, or in the case of the Subchapter S business, its partners-shareholders ultimately pay the bill for the workers' salaries, and for all the employee benefits that their businesses offer. It is unfair, to say the least, that these business owners cannot participate in a benefits plan as valuable as the cafeteria plan. These business owners have unique security and benefits needs just like their employees. The discrimination rules contained in IRC Section 125 would prevent a pass-through business owner from designing a plan that primarily benefits him or herself.

Cafeteria plan rules require that at least 75 percent of the plan's benefits accrue to the plan sponsor's non-highly-compensated/non-key employees.

Lincolntonville Telephone is a family owned company providing phone/internet coverage in mid-coast Maine with 40 employees. There are five family members who are excluded from participating in the Section 125 program. They offer it anyway to provide this benefit to their employees and their families to help reduce the costs for themselves and their dependents. They also use the FSA opportunity to reduce out of pocket costs.

RHR Smith & Co, a 20 person accounting/audit firm in Buxton, Maine does the same thing in spite of the three shareholders being excluded.

The inability of the small business owner to participate in a cafeteria plan acts as a disincentive to design, implement, administer and pay for a cafeteria plan—which, according to the rules of section 125, must be in writing and permanent in nature. Making small business owners eligible to participate in cafeteria plans would likely encourage more of my small business clients interested in making these flexible plans available to their workers. That, in turn, would increase the financial security of their employees and themselves.

We insure about 60 smaller companies who do not participate because they are structured as partnerships Sub-S corporations, and they may only have part-time employees and are denied participation. As the "oldest state in the country" healthcare can often cost a family \$1800-\$2200/monthly and these small business owners are unable to take advantage of this very important benefit.

Make Long-Term Care Insurance a Permissible Cafeteria Plan Benefit

Qualified long-term care insurance is, for tax purposes, treated as health insurance. Because it is also considered akin to deferred compensation, this increasingly valuable form of insurance is not permitted to be included in the menu of cafeteria plan offerings.

With our aging population, the pressure on Medicaid, and an increasing sense of responsibility for planning for the expenses of "living too long," the need for long-term care insurance is acute and growing. The ability to provide for that need through the convenience of an employer-sponsored cafeteria plan would likely increase the number of people who protect themselves against the risk of expensive long-term care via qualified long-term care insurance.

This would contribute to workers' peace of mind, and quality of work-life balance. It would ease some of the pressure on Medicaid and family resources as loved ones incur the long-term care expenses. And, qualified long-term care insurance is subject to protective rules, both on the quality of the policies and on the cost to taxpayers of making those policies available—as is the case for long-term care insurance purchased outside of a cafeteria plan.

Summary

Cafeteria plans allow employers to offer flexible benefits to their workers, at a reasonable cost to both the workers and the employers. The flexibility of being able to let workers choose benefits best suited to their unique circumstances is often the most important reason for an employer to establish and maintain this type of benefits plan.

It is unfair to pass-through business owners to exclude them from eligibility to participate in cafeteria plans. And, it may discourage these owners from offering—and paying for—cafeteria plan benefits to those who work for them.

Long-term care insurance is more like health insurance than like deferred compensation. It is a security product that should be permitted as a cafeteria plan option.

Thank you again, Mr. Chairman and members of the Subcommittee, for this opportunity to provide you with NAIFA's views on this important topic. I'd be pleased to answer any questions you may have.



CONGRESSWOMAN YVETTE D. CLARKE
REPRESENTING NEW YORK'S 9th CONGRESSIONAL DISTRICT

Event Name: Small Business Committee on Economic Growth, Tax, and Capital Access Hearing on Cafeteria Plans

Date: March 16, 2017

Time: 10:00AM

Location: RHOB 2360

Assigned Staffer: Harry

Host(s): Congresswoman Yvette D. Clarke

Additional materials: Hearing memo attached.

Talking Points/Remarks

- Thank you Mr. Chairman and a pleasant good morning to everyone.
- We are here today to discuss the tax treatment of Section 125 cafeteria plans.
- These plans provide employees at all levels of the corporate hierarchy with crucial tax benefits that make it easier to afford health insurance, prescription drug coverage, adoption assistance, and numerous other benefits that are crucial to quality of life.
- Unfortunately, proposed regulations from the Treasury Department, combined with statutory ambiguity, make it hard for small business owners to participate in the benefits of these plans.
- This places small business owners in a comparatively worse position than their big business counterparts for no clear reason. It also makes it less likely that they will sponsor cafeteria plans which leaves their employees worse off.
- I am grateful to the Chairman and Ranking Member for highlighting this issue, since it is an important one on which I hope we can work together.
- This hearing is particularly timely in light of the continuing discussion over tax reform. While there is much talk concerning reforming the way that we

tax corporations overseas, this hearing reminds us that ultimately the tax code impacts everyday people here at home.

- It is my hope that we do not lose sight of this fact in the months ahead and that we continue to do everything in our power to ensure that small business owners receive the tax benefits that they deserve.
- I look forward to learning more about this important issue and to working with my colleagues to help ensure that small business owners receive fair treatment in accessing tax benefits.



Statement of the U.S. Chamber of Commerce

**ON: Cafeteria Plans: A Menu of Non-Options for Small
Business Owners**

**TO: Subcommittee on Economic Growth, Tax, and Capital
Access of the House Small Business Committee**

BY: U.S. Chamber of Commerce

DATE: March 16, 2017

1615 H Street NW | Washington, DC | 20062

The Chamber's mission is to advance human progress through an economic,
political and social system based on individual freedom,
incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Statement on
Cafeteria Plans: A Menu of Non-Options for Small Business Owners
Hearing before
The Subcommittee on Economic Growth, Tax, and Capital Access
of the
House Small Business Committee
on behalf of the
U.S. CHAMBER OF COMMERCE
March 16, 2017

The U.S. Chamber of Commerce would like to thank Chairman Brat, Ranking Member Evans, and members of the Subcommittee for the opportunity to provide a statement for the record. The topic of today's hearing—cafeteria plans and the lack of options for small business owners—is of significant concern to our membership.

The Chamber very much supports the statement given during the March 16, 2017 hearing by Paula Calimafde, who is an active and long-standing member of the Employee Benefits Committee of the U.S. Chamber of Commerce. Specifically, we concur with Ms. Calimafde's recommendations to permit owner-employees to participate in cafeteria plans.

A significant portion of Chamber membership is made up of small businesses. While many of these small businesses offer substantial benefits to their employees, they should be encouraged and—at the very least—not discouraged from offering as wide an array of benefits as possible. However, when it comes to cafeteria plans, small business owners are at a significant disadvantage and, therefore, it discourages them from implementing cafeteria plans for their employees. Consequently, we urge Congress to allow small business owners to participate in cafeteria plans and, thereby, encourage the expanded implementation of cafeteria plans by small businesses.

Introduction

Cafeteria plans are governed by IRS Section 125 which allows employees to make contributions to designated accounts before taxes are calculated; thereby, providing workers an opportunity to receive certain benefits on a pretax basis. Benefits provided under cafeteria plans include health insurance, disability insurance, life insurance, 401(k) plan contributions, dependent care assistance, adoption assistance, and contributions to Health Savings Accounts (HSAs).

Discussion

Small Business Owners Should be allowed to Participate in Cafeteria Plans. Sole proprietors, partners, members of limited liability companies and most stockholders in a Sub-S corporation are not allowed to participate in a cafeteria plan. These types of entities represent a significant portion of American business—approximately 78% of all non-farm businesses are organized in a manner under which the owners of the business are not permitted to participate in a business sponsored cafeteria plan. This rule clearly discriminates against business owners/employees based solely upon the type of entity in which they are operating their business.

Since they are not able to participate, owners are discouraged from implementing cafeteria plans. Because these entities choose not to sponsor a cafeteria plan, their employees do not have the opportunity to participate in a cafeteria plan. Therefore, changing this law would increase opportunities for not just business owners to benefit from cafeteria plans, but also their employees.

Consequently, we urge Congress to pass legislation to modify IRS section 125 to make it clear that self-employed individuals, including sole proprietors, partners, S-corporation shareholders and members in a limited liability company that has elected to be taxed as a partnership, are deemed to be employees for the purpose of eligibility to participate in a cafeteria plan. Moreover, such language should also make it clear that self-employed individuals are deemed to be employees for the purposes of eligibility to participate not just in the cafeteria plan itself, but in the specific benefits that may be offered through the cafeteria plan.¹

Congress Should Encourage Expansion of the Types of Benefits That Can be Provided in a Cafeteria Plan. Long-term care insurance is specifically excluded from the list of qualified benefits under a cafeteria plan.² However, there are increasing concerns about long-term care. The number of Americans in need of long-term care services, either at home or in institutions, is projected to increase from 12 million today to 27 million by 2050, and 70% of people who reach age 65 will require long-term care services at one point in their lives.³ Moreover, 45% of Americans ages 40 and older have provided long-term care for a family member or close friend at some point.⁴ Paying for long-term care can be prohibitively expensive. Long-term care costs after age 65 is estimated

¹The Chamber supported S. 555 - (110th Congress) the SIMPLE Cafeteria Plan Act of 2007 and encourages Congress to move forward with similar legislation.

²Code section 125(f)(2).

³Bipartisan Policy Center, Long-Term Care Initiative, "America's Long-Term Care Crisis: Challenges in Financing and Delivery," (April 2014), available at <https://bipartisanpolicy.org/library/americas-long-term-care-crisis/>.

⁴Associated Press-NORC Center for Public Affairs Research, "Long-Term Care in America: Americans' Outlook and Planning for Future Care," (July 2015), available at <http://www.longtermcarepoll.org/Pages/Polls/long-term-care-in-america-americans-outlook-and-planning-for-future.aspx>. Among those with experience providing care for a family member or friend, 19% are currently providing assistance and 65% have household incomes less than \$75,000 a year.

to be about \$138,000.⁵ These rising costs are particularly troubling because families will pay about half of the total share of long-term care costs through out-of-pocket spending, which can be a drain on personal savings, retirement accounts, and other assets.⁶ About the other half (44.8%) of these long-term costs will be borne by government programs, particularly Medicaid and Medicare.⁷

Long-term care insurance policies are more affordable and accessible when the applicant is below retirement age. The cost of a basic policy with average benefits is \$1,725 a year for a 45-year-old; however, the same policy for a 65-year-old is double that amount, at \$3,451 a year.⁸ To help pay for these premiums while they are affordable, the Chamber recommends that employers be allowed to offer long-term care insurance through a cafeteria plan.

While longevity insurance is not specifically excluded, it would be helpful if Congress could encourage the inclusion of this benefit in cafeteria plans. As we are aware, life expectancy is increasing. While living longer is a great thing, it can create challenges for retirement security. The most obvious longevity challenge is outliving one's retirement savings. In 2015, life expectancy at birth was 78.8 years for the total U.S. population.⁹ This represents an increase of approximately 30 years since 1900 and 8 years since 1971.¹⁰ Moreover in 2015, life expectancy at age 65 for the total population was 19.4 years.¹¹ Thus, workers must plan for longer lives that could include a longer period in retirement. To avoid this situation, a retiree could purchase longevity insurance, a form of deferred annuity with a payment start date that begins at a later age in retirement. Thus, individuals can protect themselves against the financial risk of outliving their retirement savings. An effective way to encourage the purchase of longevity insurance is to allow employees to purchase it through a cafeteria plan.

Conclusion

We reiterate the importance of encouraging small business owners to implement benefit plans. Changing IRS section 125 to allow owners to participate and expanding benefits offerings under the plan would encourage more small businesses to implement cafeteria plans. We look forward to working with this Subcommittee and Congress to enact legislation that will encourage further par-

⁵Melissa Favreault and Judith Dey, U.S. Department of Health and Human Services, Office of Disability, Aging, and Long-Term Care Policy, "Long-Term Services and Supports for Older Americans: Risks and Financing," ASPE Issue Brief, (July 2015), available at http://aspe.hhs.gov/sites/default/files/pdf/106211/ElderLTCrb_0.pdf.

⁶Id.

⁷Id.

⁸Long-Term Care Insurance Premium Sample, available at <http://www.guidetolongtermcare.com/premiumsample.html>.

⁹Jiaquan Xu, M.D., Sherry L. Murphy, B.S., Kenneth D. Kochanek, M.A., and Elizabeth Arias, Ph.D., "Mortality in the United States," NCHS Data Brief No. 267 (December 2016), available at <https://www.cdc.gov/nchs/products/databriefs/db267.htm>.

¹⁰In 1900, the average life expectancy in the U.S. was 49.24 years and in 1971 it was 70.75 years. National Vital Statistics Reports, Vol. 64, No. 11, September 22, 2015. https://www.cdc.gov/nchs/data/nvsr/nvsr64/nvsr64_11.pdf.

¹¹Jiaquan Xu, M.D., Sherry L. Murphy, B.S., Kenneth D. Kochanek, M.A., and Elizabeth Arias, Ph.D., "Mortality in the United States," NCHS Data Brief No. 267 (December 2016), available at <https://www.cdc.gov/nchs/products/databriefs/db267.htm>.

ticipation by small business owners and their employees in cafeteria plans. Thank you for your consideration of this statement.

