DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Memorandum

Date AUG 8 1994

From Michael Mangano for June Gibbs Brown
Inspector General

Subject Flexible Benefit Plans Negatively Impact Medicare's Hospital Insurance Program (A-05-93-00066)

To Bruce C. Vladeck
Administrator, Health Care Financing Administration, and
Secretary, Board of Trustees of the Federal Hospital Insurance Trust Fund

Attached is a copy of our final report entitled, "Flexible Benefit Plans Negatively Impact Medicare's Hospital Insurance Program." In this review we updated findings reported in our prior review on the effects of flexible benefit plans (FBP) on the Social Security and Hospital Insurance (HI) trust funds. These plans involve salary reduction agreements between an employer and employee whereby the employee elects a reduced salary so that payment can be taken in the form of fringe benefits. The fringe benefits selected instead of salary are exempt from Medicare, Social Security, and Federal income taxes. This current review concentrated on the status of FBP and their effects on the HI trust fund and on health care costs.

We found that FBP negatively impact Medicare's HI program in several ways. First, they deprive the financially unstable HI trust fund of much needed revenue. The Department of the Treasury estimated that over the next 5 years the trust fund will lose $2.1 billion of revenue due to FBP. While revenue declines, future expenditures will not decline since participants in FBP lower their liability for HI taxes but remain entitled to receive the full range of Medicare benefits. This full entitlement after a reduction in taxes seems particularly inequitable because, for many taxpayers, the costs of Medicare benefits received already far exceed taxes paid into the HI fund.

In addition, the tax break provided by FBP is discriminatory because it is available to only a minority of workers and it may contribute to the rapid rise of health care costs. Although FBP enjoy increasing popularity, employees having access to one are still a minority in the general work force. Also, since FBP permit using pretax income to pay health care costs, some of these tax sheltered dollars are used to pay coinsurance and deductibles, items that were meant to discourage unnecessary health care expenditures and control rising costs.

We believe that subjecting FBP to the HI tax would help alleviate the fiscal distress of the HI trust fund while correcting an inequity in the tax code. Therefore, we are recommending that the Health Care Financing Administration (HCFA) and the Board of Trustees of the Federal Hospital Insurance Trust Fund jointly sponsor legislation to require the value of amounts placed in FBP be included in the definition of wages for the HI portion of the Federal Insurance Contributions Act (FICA) taxable wage base.

In response to our draft report, HCFA agreed with our findings. However, since a provision in the Administration's health care reform legislation currently under consideration would eliminate the tax exempt status of health benefits in FBP, HCFA decided not to propose new legislation on this issue at this time. If the pending legislation on FBP is not enacted, we encourage HCFA to initiate legislation to subject FBP to the HI portion of FICA tax.

We would appreciate your views and the status of any further action taken or contemplated on our recommendation within the next 60 days. If you have any questions, please call me or have your staff contact George M. Reeb, Assistant Inspector General for Health Care Financing Audits, at (410) 966-7104.

To facilitate identification, please refer to Common Identification Number A-05-93-00066 in all correspondence relating to this report.

Attachment

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

FLEXIBLE BENEFIT PLANS NEGATIVELY IMPACT MEDICARE'S HOSPITAL INSURANCE PROGRAM

JUNE GIBBS BROWN
Inspector General

AUGUST 1994
A-05-93-00066

DEPARTMENT OF HEALTH & HUMAN SERVICES

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Subject Flexible Benefit Plans Negatively Impact Medicare's Hospital Insurance Program (A-05-93-00066)

To Bruce C. Vladeck
Administrator, Health Care Financing Administration, and
Secretary, Board of Trustees of the Federal Hospital Insurance Trust Fund

Medicare's ailing Hospital Insurance (HI) trust fund is losing billions of dollars in tax revenue because of salary reduction agreements known as flexible benefit plans (FBP). Essentially, FBP involve an arrangement between an employer and employee whereby the employee elects a reduced salary so that payment can be taken in the form of fringe benefits. The fringe benefits selected instead of salary are exempt from Medicare, Social Security, and Federal income taxes. Losses in revenue to only the HI trust fund will total $2.1 billion over the next 5 years according to Department of the Treasury estimates.

The tax break provided by FBP is discriminatory as it is not available to all workers and it may indirectly contribute to the rapid rise of health care costs. An exemption from Medicare taxes seems particularly inappropriate because the costs of Medicare benefits provided to individuals already far exceed taxes paid to the HI trust fund. Since FBP allow using pretax income to pay health care costs, some of these tax sheltered dollars are used to pay coinsurance and deductibles, items that were meant to discourage unnecessary health care expenditures and control rising costs.

We recommend that the Health Care Financing Administration (HCFA) and the Board of Trustees of the Federal Hospital Insurance Trust Fund jointly sponsor legislation to require that FBP, as defined by section 125 of the Internal Revenue Code (IRC), be included in the HI portion of the Federal Insurance Contributions Act (FICA) taxable wage base.

BACKGROUND

Two types of FBP are common--cafeteria plans and flexible spending accounts. Section 125 of the IRC authorizes these plans.

Section 125 of the IRC allows employees to choose between taxable and nontaxable benefits. Plans offering such choices are called cafeteria plans. Under these plans, an employer may offer a simple set of choices. For example, an employee may choose between two or more types of health coverage, or between a single benefit and cash. An employer may also offer a complex array of choices among a wide variety of fringe benefits including health care, dependent care, life insurance, and legal services.

Although a flexible spending account is different from a cafeteria plan, the Internal Revenue Service (IRS) has allowed certain types of these accounts to qualify for the salary reduction provisions of IRC section 125. A flexible spending account is an arrangement whereby an account is established in the employee's name to be used to reimburse certain of the employee's personal expenses. Qualifying expenses include health insurance premiums; out-of-pocket health spending, such as coinsurance and deductibles; dependent care; and certain other expenses. Any unused balance remaining in the account at the end of the year is forfeited to the employer. The account may be financed by the employer and/or by the employee through salary reduction.

Prior to January 1, 1979, employee benefits received instead of cash were taxable for both FICA and income tax purposes under the principle of constructive receipt. Under this principle, the employee was considered to have been paid wages and these wages, in turn, purchased the benefits. However, section 125 of the IRC, enacted by the Congress in 1978, effectively changed the principle of constructive receipt regarding taxation of amounts placed in FBP. Section 125 of the IRC allowed benefits chosen instead of cash to be excluded from the employee's gross income. To qualify under IRC section 125, the plan must offer a choice between cash and qualified benefits or between two or more qualified benefits, and must not discriminate in favor of highly paid employees.

Although IRC section 125 specifically excluded salary reduction agreements from Federal income taxes, the FICA tax status of these agreements was unclear until the Tax Reform Act of 1986 clearly excluded them from FICA tax.

OBJECTIVE AND METHODOLOGY

Our review was performed in accordance with generally accepted government auditing standards. The objective of this review was to update the findings in a prior Office of Inspector General report on FBP entitled, "Loopholes Affecting the Wage Base Will Lower Social Security Benefits for Some Workers and Cost the Social Security and Hospital Insurance Trust Funds Billions" (A-05-86-62602). In response to the prior report, HCFA indicated a willingness to consider our proposal for legislative change "...should the Administration decide to entertain proposals to expand the tax base...." We concentrated this review on the status of FBP and their effects on Medicare's HI program.

To accomplish our objective, we obtained the Department of the Treasury's latest projections of losses to the HI trust fund due to FBP. Also, we obtained data from the Department of Labor, Bureau of Labor Statistics, on the latest trends and patterns in FBP growth. To obtain updated data on employee contributions to these plans, we contacted private research firms which annually survey employers. We reviewed a 1985 report issued by the Office of the Assistant Secretary for Planning and Evaluation (ASPE), Department of Health and Human Services, which focused on the effects of FBP on health care spending. We contacted ASPE and found they have not done any additional work in this area. In addition, we reviewed the IRC and legislative history pertaining to FBP and reviewed articles in trade journals to obtain updated information on trends and developments in FBP.

We did not independently verify data obtained from other Government agencies, research firms, and trade journals. Instead, we focused on published material from governmental and private sources that we consider credible.

OUR FINDINGS

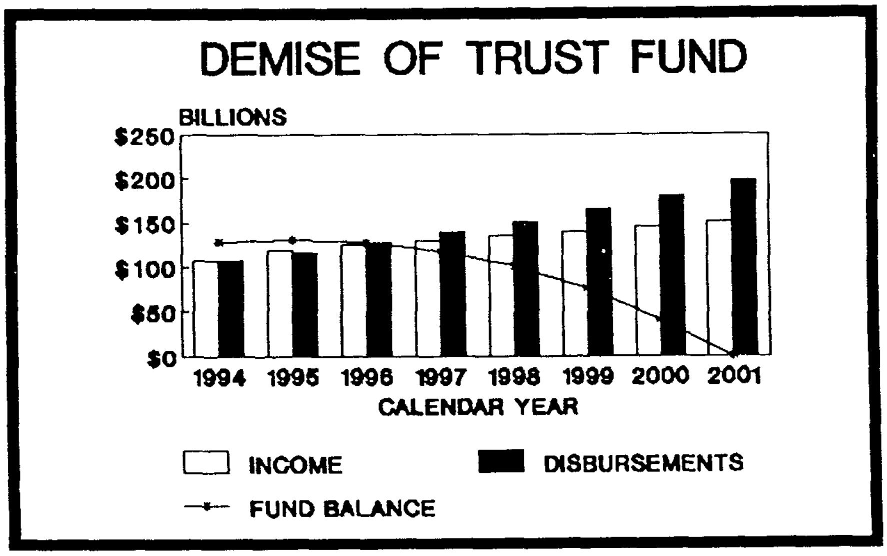
The financially unstable HI trust fund is being deprived of much needed revenue by FBP. These plans also raise questions of fairness and equity because only the employees who have the opportunity to participate in the plans can take advantage of the tax shelter. Workers who participate in the plans lower their liability for HI tax, but will still receive the full range of Medicare benefits. There is evidence that FBP may undermine efforts to control rising health care costs. We also found that precedents exist for subjecting FBP contributions to HI tax while exempting them from Federal income tax.

THE SOLVENCY ISSUE

Medicare HI expenses are paid from the HI trust fund. This fund is financed mainly by payroll taxes of 138 million workers and their employers.

Income to the HI trust fund has not kept pace with increasing expenditures. Medicare's HI outlays are affected by increases in inpatient hospital expenditures which have been rising faster than income to the trust fund. Since its inception in 1966, HI expenditures have been steadily increasing, reaching approximately $94 billion in Calendar Year 1993. As a result, the financial outlook of the HI trust fund is grim.

In its recent annual reports, the Board of Trustees of the Federal Hospital Insurance Trust Fund concluded that the HI trust fund is quickly approaching insolvency. The Board reported in its 1994 report that the present financing schedule for the HI program is only sufficient to pay benefits over the next 7 years. The Board predicted that, under most likely assumptions, the trust fund will be exhausted in 2001.



The Board concluded that the HI trust fund is severely out of financial balance and is unsustainable in its present form. Trust fund expenditures are expected to exceed revenues beginning in 1996. The Board also pointed out that the ratio of HI expenditures to taxable payroll has increased from 0.94 percent in 1967 to

3.25 percent in 1993, due, in part, to the higher rate of increase in program costs than in earnings subject to FICA tax.

The FICA exempt status of FBP reduces revenues to the trust fund. Recent estimates by the Department of the Treasury show that the trust fund has already lost substantial revenue as a result of FBP. The Treasury estimates that future losses to the fund will steadily increase, totaling $2.1 billion over the next 5 years.

TREASURY'S ESTIMATES OF LOSSES TO THE HI TRUST FUND DUE TO FLEXIBLE BENEFIT PLANS

Calendar Year	Losses (Millions)
1990	$111.5
1991	153.7
1992	190.7
1993	236.4
1994	290.6
1995	354.3
1996	420.8
1997	488.6
1998	554.8

THE HI TRUST FUND IS EXPECTED TO LOSE $2.1 BILLION OVER THE NEXT 5 YEARS BECAUSE OF FLEXIBLE BENEFIT PLANS.

The Board's report also notes that there are currently four covered workers supporting each Medicare enrollee. By the middle of the next century, there will be only two covered workers to support each enrollee. Reducing the wage base of available workers, through the use of FBP, will place even greater financial stress on the fund.

In order to avoid the imminent financial disaster facing the HI program, the Board concluded that "...prompt actions will need to be taken to increase revenues and/or reduce expenditures...." We believe that subjecting FBP to the HI portion of FICA tax would be an equitable source of additional revenues to help ease the financial distress of the HI trust fund.

While the estimated 5-year revenue loss projection of $2.1 billion is substantial, eliminating the loss by subjecting FBP to HI tax would not have a devastating effect on individual workers. There is no statutory limit on annual contributions to FBP, unless an individual benefit has a statutorily set limit, or the employer sets a limit. According to a 1992 survey by the Hewitt Associates, annual employee contributions to two of the most popular FBP account types averaged $651 and $2,959. Subjecting these amounts to an individual's 1.45 percent HI tax rate, would have meant an increased HI tax liability for the individual of $9.44 and $42.91, respectively.

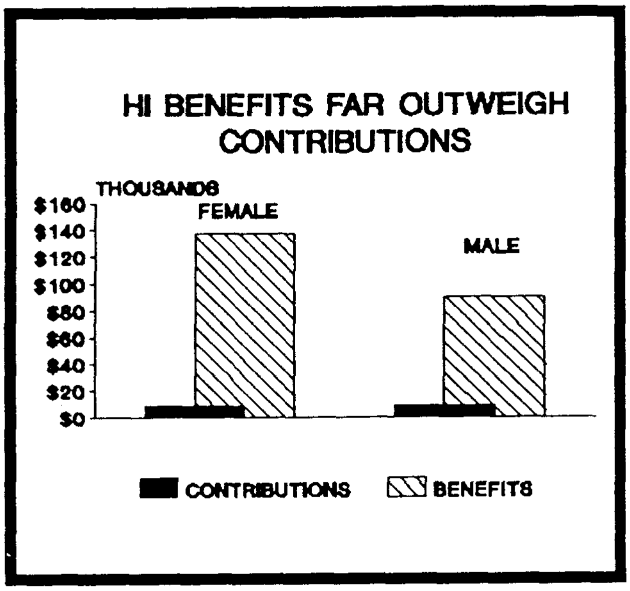
ISSUES OF FAIRNESS AND EQUITY

The tax-exempt status of FBP causes inequities in the tax system. Although the number of employees eligible to participate in these plans is increasing, they are still a minority. According to the most recent Department of Labor survey of private-sector firms with 100 or more employees, about 36 percent of employees were eligible for FBP in 1991. The Department of Labor's most recent surveys of small private businesses and State and local governments showed that only 8 percent and 32 percent of employees, respectively, had the opportunity to participate in FBP in 1990. For the majority of workers, the lack of a FBP means that they cannot shelter income from FICA and Federal taxes to meet anticipated expenses as can plan participants. As a result, employees with the same total compensation can have taxable incomes that are substantially different.

Health benefits are among the nontaxable benefits offered by FBP and are one of the most popular benefit choices. In 1992, the Council on Employee Benefits surveyed its members and found that 96 percent of its members having FBP offered medical coverage and 94 percent offered a health care spending account. Medical expenses (including medical insurance premiums, coinsurance, deductibles, and other expenses) paid for through FBP are paid with pretax dollars. Persons not participating in a FBP can deduct medical expenses for Federal tax purposes only if their unreimbursed medical expenses exceed 7.5 percent of their adjusted gross income. Persons not participating in FBP cannot shelter any of their income used for medical expenses from FICA tax.

Even though workers participating in FBP reduce their contributions to the HI fund, the fund will not have a reduced liability in providing their Medicare coverage. Under Medicare, a qualified worker is entitled to the full range of benefits irrespective of the amount contributed. This entitlement drains the fund and results in workers not participating in these plans bearing part of the cost of Medicare benefits for plan participants.

The value of Medicare HI benefits that most beneficiaries receive already far exceeds the amount of taxes they paid into the program. The Congressional Budget Office estimated that a male Medicare beneficiary who attained age 65 in 1992 will have Medicare entitlement, based on average life expectancy, with a present value of $44,094. Actual Medicare payments for this person could total more than $90,000 over his expected life span. The present value of a female beneficiary's Medicare entitlement is estimated at $54,618 with her estimated actual Medicare payments totaling over $137,000 during her lifetime. Based on an average worker's earnings, each of their cumulative contributions to the HI trust fund, plus interest, would have been $8,788. Exemptions from the FICA wage base that lower a worker's earnings, such as FBP, broaden even further the gap between contributions and benefits.



HEALTH CARE COST CONTAINMENT

There is also evidence that FBP may undermine strategies to control health care expenditures.

When flexible spending accounts began to appear in 1983, proponents claimed that the IRS rules were too stringent and contended that certain FBP could contribute to health care cost containment. As a result of the controversy between FBP proponents and the IRS, the Congress determined that further study was needed. Under the Deficit Reduction Act of 1984, the Congress mandated a study "...of the effects of cafeteria plans (within the meaning of section 125 of the Internal Revenue Code of 1954) on the containment of health care costs...." The study was also required to "...recommend what modifications might be desirable with respect to the cafeteria plan rules to optimize the potential to reduce medical costs while balancing against other health care policy goals...."

The study was conducted by ASPE in 1985. The study found that including health benefits in FBP gives employees an incentive to spend more on health care because they are paying with pretax dollars. Thus, FBP could encourage employees to purchase unnecessary health care services.

An ASPE study found that flexible benefit plans significantly increase health care costs.

The ASPE study also analyzed potential FBP policies to determine if any policy would help control health care expenditures. The study was not able to devise any conditions or policies that could transform FBP into a positive instrument of health care cost containment.

The ASPE study concluded that the overall impact of FBP on health care cost containment is unambiguously adverse, significantly increasing health care costs and seriously hindering cost containment efforts.

PRECEDENTS

The objective of Medicare's HI tax, to collect revenue to fund the HI program, is different than the objective of income tax. The Congress recognized this, and in 1983 added a provision to the IRC and the Social Security Act to allow the definition of wages to differ for income tax purposes and FICA purposes. In House Report 98-25 which accompanied the 1983 Social Security Amendments, the Committee on Ways and Means stated that "...the social security system [which includes Medicare] has objectives which are significantly different from the objectives underlying the income tax withholding rules...."

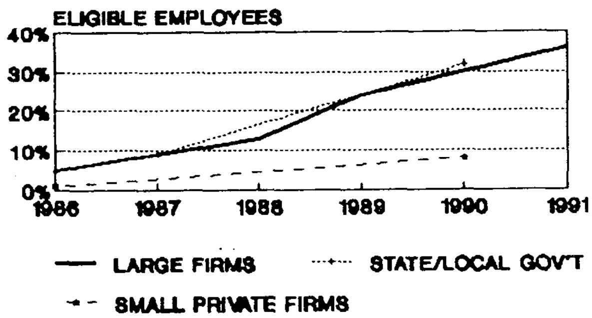
Since 1983, several precedents have emerged for wages being treated differently for income tax and FICA tax purposes. There are two examples which closely parallel FBP--that of section 401(k) pension plan benefits and section 403(b) retirement annuity plans. Both of these plans are employer based and involve salary reduction agreements, as do FBP. Both of these plans were at one time exempt from both FICA tax and income tax withholding, but are now included in the FICA wage base.

In 1983, the National Commission on Social Security Reform recommended subjecting section 401(k) plans to FICA tax as a means to raise additional revenue at a time when the Social Security trust funds were facing insolvency. As a result, the Congress enacted a provision as part of the Social Security Amendments of 1983 which made section 401(k) plan benefits subject to FICA tax.

Section 403(b) annuity plans were at one time excluded from FICA tax under a provision which excluded from the definition of wages employer payments for annuities under a plan or system established by the employer. The IRS later determined these section 403(b) salary reduction agreements were employee rather than employer payments and issued Revenue Ruling 65-208 to subject them to FICA tax. The Congress codified the IRS ruling in the Social Security Amendments of 1983.

Although we realize that the Congress specifically exempted FBP from FICA tax in the Tax Reform Act of 1986, we believe that in the current environment these plans should be reexamined as they are evolving and growing to an extent that may not have been envisioned by the Congress. Since their inception, FBP have steadily increased and expanded. Recent surveys by the Council on Employee Benefits and the Employee Benefit Research Institute indicate that FBP will continue to proliferate as a result of the changing demographics of the work force, and as a result of efforts by employers to better manage their escalating health care costs, remain competitive, and enhance recruitment efforts.

FLEXIBLE BENEFIT PLANS ARE BECOMING MORE POPULAR



SOURCE: BUREAU OF LABOR STATISTICS

CONCLUSION AND RECOMMENDATION

The HI trust fund is losing billions of dollars because of FBP. As much as $2.1 billion will be lost over the next 5 years according to Treasury estimates. These plans are only available to a minority of workers, resulting in unequal tax treatment. There are also indications that FBP are contrary to health care cost containment efforts.

We believe that subjecting FBP to the HI tax would help alleviate the fiscal distress of the HI trust fund while correcting an inequity in the tax code. Therefore, we are recommending that HCFA and the Board of Trustees of the Federal Hospital Insurance Trust Fund jointly sponsor legislation to require the value of amounts placed in FBP be included in the definition of wages for the HI portion of FICA tax.

In response to our draft report, HCFA agreed with our findings. However, since a provision in the Administration's health care reform legislation currently under consideration would eliminate the tax exempt status of health benefits in FBP, HCFA decided not to propose new legislation on this issue at this time. If the pending legislation on FBP is not enacted, we encourage HCFA to initiate legislation to subject FBP to the HI portion of FICA tax. Comments from HCFA on our draft report are included in their entirety as the appendix to this report.

DEPARTMENT OF HEALTH & HUMAN SERVICES

Health Care
Financing Administration

Memorandum

Date JUL 6 1994

From Bruce C. Vladeck
Administrator

Subject Office of Inspector General Draft Report: "Flexible Benefit Plans Negatively Impact Medicare's Hospital Insurance Program," (A-05-93-00066)

To June Gibbs Brown
Inspector General

We reviewed the subject draft report which examined the effects of flexible benefit plans (FBPs) on Medicare's Hospital Insurance (HI) program.

We agree with the findings in the report and support action to promote the fiscal integrity of the Medicare trust funds. However, the Administration's proposal for comprehensive health reform, the Health Security Act, contains a provision (section 7202) that would, as of January 1, 1997, remove health benefits from FBPs. While this provision does not address entirely the FBP-HI revenue issue, we would not want to propose new legislation while this is being considered. Additional comments on the report are attached for your consideration.

Thank you for the opportunity to review and comment on this report. Please advise us if you would like to discuss our position on the report's recommendation at your earliest convenience.

Attachment

Comments of the Health Care Financing Administration (HCFA) on Office of Inspector General (OIG) Draft Report: "Flexible Benefit Plans Negatively Impact Medicare's Hospital Insurance (HI) Program" (A-05-93-00066)

Additional Comments

Recent legislation removed the cap on reportable "wages" (the "contribution and benefit base") for purposes of the HI portion of the Federal Insurance Contributions Act (FICA) tax, while retaining it for the Retirement, Survivors, and Disability Insurance (RSDI) portions. However, the definition of "wages" remains the same for all parts of the FICA tax. Thus, the report's recommendation to subject flexible benefit plans to HI tax would require much more complicated wage reporting by affected employers, and much more complicated recordkeeping by the Social Security Administration (SSA), as SSA processes W-2s and maintains the earnings records on which Social Security benefits are computed.

Additionally, the recommendation would appear to be inconsistent in its treatment of government programs. Has consideration been given to the benefits of including the RSDI components of Social Security withholding in this recommendation? For example, if the proposal were made to benefit all the Trust Funds, the definitions would continue to be uniform with respect to all parts of the FICA tax; recordkeeping would be simplified for employers, SSA, and the Internal Revenue Service; and the RSDI Trust Funds would have the benefit of increased revenues.

The first full paragraph on page 7 of the draft report, should more specifically refer to "Medicare Part A benefits," since only those benefits are supported by the HI portion of the FICA tax. Since beneficiaries do not pay FICA taxes for Part B benefits, it is imprecise to assert that the "value of Medicare benefits that most beneficiaries receive already far exceeds the amount of taxes they paid into the program."