

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

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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 continues 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 majority 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

¹ Frequently 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.

² According 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).

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 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.

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.

³ Frequently 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.

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 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

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

⁵ Market 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.

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.