Benefits rule a headache to small business

By Mary DiPaolo
special writer

A Farmington veterinarian says he's been to three seminars since January and spoken to his accountant, but all he's got to show for his efforts are four different interpretations of what he describes as "one heck of a mess."

What's all this discussion about? *Section 89.*

Among other rules, Section 89 requires that employer-provided employee benefit plans pass several tests to determine whether benefit plans unduly favor highly compensated employees, generally those earning $50,000 or more per year. (See related story for Section 89 provisions).

"There are so many unanswered questions as to what and what does not constitute discrimination," says John Richardson, owner of Plaza Veterinary Hospital in Farmington. Richardson employs several part-time workers. Under Section 89, part-time workers who work as few as 17.5 hours per week must be included in calculations to determine whether plans are discriminatory.

"If I'm paying $1.25 per hour for each of my employees' benefits — and yet one works 20 hours and the other works 40 hours a week — is the total cost going toward each of these employee's benefits in itself discriminatory? One expert told me yes; the other said no," Richardson said.

He also questions the benefit eligibility issue.

"Suppose an employer has a standard waiting period of three months before new employees can receive health coverage. But you find an excellent full-time prospect that wants or needs coverage right away. So you make an exception for that person. Is that being discriminatory?

"How much is the 'mistake' going to cost in terms of specific tax penalties? Are employers better off dumping their benefits altogether? And if benefits are eliminated and offset by an increase in employee salaries, who's to say the extra funds would be used to obtain individual coverage?"

LEONARD GREY, officer with the Birmingham-based CPA firm of Grey and Trepeck, calls Richardson's questions typical.

"As I've explained Section 89 to our clients, the end result is that they're discontinuing their employee benefit plans and compensating some people so they can pay health insurance premiums out of their own pockets," Grey said.

Grey agrees that there aren't any guarantees that employees who are compensated to obtain health coverage on their own will do so.

"There are one million people in this state without health insurance at the present time. It will certainly be interesting to see how the numbers change by the end of this year.

"Up to now, approximately 10 of our small business clients with 10 or fewer employees have made the decision to dump their benefits," Grey said.

IF, IN FACT, Section 89 leads to employers dropping benefits, it will be the ultimate irony for those who believe that Section 89 represents Congress' attempt to extend employee benefits, especially health care coverage, to lower-income workers.

Sherry Mirasola, director of public affairs and communication with the Michigan Hospital Association, says

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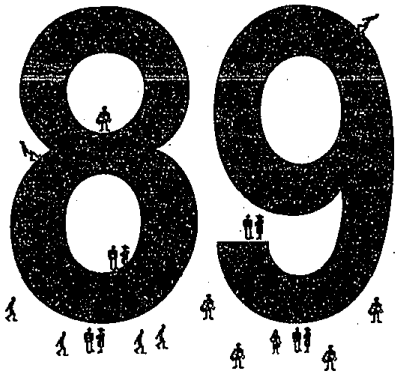
SECTION 89



Relief a year away

By Marilyn Fitchett
staff writer

Although one move is afoot in Congress to repeal Section 89 and another to amend it, employers should not expect to see any changes this year and are being advised to comply with the IRS ruling.

More than 250 members of Congress, including U.S. Rep. William Broomfield, R-Lake Orion, have signed on as co-sponsors of legislation repealing Section 89. The bill to repeal is being led by Small Business Committee chairman John Falce, a Democrat from New York.

On Tuesday, a hearing was scheduled for House Ways and Means chairman Dan Rostenkowski's bill to alter Section 89 in the form of an amendment to the national budget bill. Rostenkowski is a Democrat from Illinois.

According to Sean Foley, legislative aide to U.S. Rep. Sander Levin, D-Southfield, Rostenkowski's amendment clears up questions of discrimination in benefit plans and sets a health care guideline. Levin is a member of the Ways and Means Committee and is supporting the amendment.

"Rather than looking at who's participating in the (benefits) plan, you can look at the design of the plan and tell whether it meets Section 89," Foley said of the amendment.

In terms of benefit guidelines, there are two provisions.

"The first is that an employer provide at least a core medical package. Without defining what a 'core' package is, the amendment says that employers must provide health care coverage that will cost the employee

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'89' questions participation, discrimination

Section 89, a provision of the 1986 Tax Reform Act that goes into effect this year, has two major parts: qualification (or documentation/minimum participation) rules and nondiscrimination rules. Section 89 applies to all employers, both public and private. Only churches and church-controlled tax-exempt organizations are exempt.

According to Buck Consultants, the general requirements of Section 89 are similar to those for pension plans.

Under the qualification rules, an employer is required to provide a benefit plan and have notified employees of it. It must be: developed exclusively for employees, legally enforceable and maintained for an indefinite period of time. An employer must provide "reasonable" written notice of benefits available under the plan to employees who are eligible to participate by July 1, or, the first day of the plan year.

If the plan violates the qualification rules, all employees will be taxed on the cost of the plan benefits they received, and employers will be subject to tax penalties if taxable amounts are not reported on employee W-2s.

Donald H. Scharg, principal with the Fishman Group, a Bloomfield Hills law firm specializing in management/labor law, offers an example.

"If an employee needed major surgery and the company's health plan pays out $100,000 to cover it, that money will become taxable income to the employee" if the benefit plan does not meet the qualification regulations of Section 89, Scharg said.

The following plans are included in the qualification requirements of Section 89 if the employer pays for any portion of the benefit or arranges for a discount for employee paid benefits:

- Accident or health plans
- Group life insurance
- Qualified tuition reduction programs
- Cafeteria plans
- Employee discounts
- Employer operated eating facilities
- Voluntary Employees' Beneficiary Associations
- Qualified group legal services
- Educational assistance.

ACCORDING TO Steve Hacker, general agent with American Community Mutual Insurance Co. of Livonia, Section 89 encourages employers to develop more consistent benefit packages for their employees.

"The law does not prohibit plans that are discriminatory; rather it works to ensure that these types of benefits be treated as taxable income," Hacker said.

The non-discrimination tests compare the value of employer-provided benefits available to highly compensated employees to the value of benefits available to the rest of the work force. They apply to employees working as few as 17.5 hours per week. In general, a highly compensated employee earns more than $50,000 per year. The non-discrimination rules are more complex and apply specifically to employer-provided health care, accident and group life insurance plans.

If the benefit plan is found to be discriminatory in favor of highly compensated employees and the employer fails to include the amount of additional benefits in the employees' W-2 forms, the employer is subject to an excise tax that is computed by a complex formula.

Battling the IRS in court

For most people, taking on the Internal Revenue Service is as farfetched as stepping into the ring with Mike Tyson. But the Farmington Hills-based Michigan Association of CPAs points out that the IRS is not unbeatable. If you believe that an examiner's findings are unfair or inaccurate, you have the right to appeal within the IRS or through the court system.

How you initiate an appeal depends, in part, on the type of audit you have undergone and the amount of tax liability in dispute. For a field audit involving a tax dispute of $2,500 or more, you are generally required to file a written statement or protest. But in a correspondence or office audit, where the IRS asks you to submit documentation related to certain items on your tax return, you can usually begin an appeal simply by asking to meet with the examiner's supervisor. The supervisor will review the audit, discuss your concerns and try to resolve the dispute.

IF YOU cannot reach an agreement on this level, your next step is requesting an appeals conference within the IRS. In either case, if you plan to appeal an examiners's decision, make sure that you do not sign the agreement form that the IRS agent provides at the end of an audit.

The majority of tax disputes are resolved during appellate hearings. These proceedings are relatively informal and you may even choose to represent yourself. But you may ask a certified public accountant or attorney to appear before the IRS on your behalf.

Because the hearing is generally limited to one meeting, be prepared to present and discuss documentation for each and every item in dispute. The appeals officer will review the government's chances of winning in court and, in most cases, argue for a speedy resolution. It's the appeals officer's job to settle the case out of court whenever possible. As a result, you may find that the appeals officer is more willing to negotiate than was the original auditor. During the hearing, expect a great deal of bargaining to occur and be prepared to make your own concessions.

IF YOU cannot reach an agreement in the appeals office, you still have the right to appeal to the courts. But do not make this decision lightly. Court disputes can be time consuming and extremely expensive. In some cases, litigation can last years and cost a small fortune. Before taking your case to court, put aside your hard feelings and re-examine your tax bill. You can argue the case on principle, but make sure you consider whether it makes sense to spend thousands of dollars to dispute a $1,000 tax bill. On the other hand, your future tax bills may in fact be affected by the principle you fight to support.

If you decide to take the litigation route, there are two paths you can follow. You can go directly to the United States Tax Court or your may appeal to the United States District Court or the Court of Claims. Don't assume that all roads lead to the same result. In 1987, taxpayers won complete or partial victories in 68.4 percent of the regular tax cases fought in Tax Court, but they won only 19.5 percent of those argued in the District Court and 14.8 percent of those argued in the Court of Claims.

The U.S. Tax Court is totally independent of the IRS. In the small tax claims division for cases involving $10,000 or less in disputed tax, you can attend with or without an adviser. But in cases involving disputes of more than $10,000, you will have to follow the same rules of procedure as those in effect in regular courts.

If you choose to go to Tax Court, you do not have to pay the disputed amount, as is the case if you choose to appeal in federal court. But be warned: Decisions made in the small tax claims division are final. Neither you nor the IRS can appeal.

If you decide to take your appeal to a federal court, you must first pay the amount in dispute plus any interest and penalties owed. Next, you file a claim for a refund. If the claim is rejected, you may bring your suit to the U.S. District court where you live or the Court of Claims that hears cases in Washington D.C. The proceedings in either case are formal, and you will most likely need an attorney.

Why then would you select the District Court over Tax Court? For one, you may choose this route if you believe your case would fare better before a jury. (Tax Court hearings have no jury.) Or your professional advisers are aware of previous rulings that make it likely that a federal court would judge your case favorably. In other cases, such as those involving employment taxes, you have no choice; the case must be argued in the District Courts.

CPAs recommend that you make every attempt to settle your case early in the appeals process. But if you are convinced that your case is just, don't accept an unfair decision simply because your are afraid of getting into the ring with the IRS.