

**STATEMENT BY
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**TO THE SUBCOMMITTEE ON CIVIL SERVICE AND
AGENCY REORGANIZATION
COMMITTEE ON
GOVERNMENT REFORM AND OVERSIGHT
U.S. HOUSE OF REPRESENTATIVES**

**HEARING ON
H.R. 1231
THE FEDERAL CIVILIAN/UNIFORMED SERVICES
PREMIUM CONVERSION BILL**

JULY 9, 2003

On behalf of our nation's 2.3 million federal annuitants, I am happy to testify in support of H.R. 1231 and S. 623, bills introduced by Representative Tom Davis and Senator John Warner, that would allow federal annuitants and military retirees and active duty personnel to use pre-tax earnings to pay their share of health insurance premiums. I also want to commend you, Chairwoman Davis, for holding the first ever congressional hearing on the federal/military premium conversion bills and for going to great lengths to protect the earned economic and health security of federal workers and annuitants.

Under this legislation, the amount retirees would pay for their share of health insurance premiums would be subtracted from the amount of their income reported to the IRS. For example, if a federal retiree's annual share of a FEHBP premium is \$1,700, then her adjusted gross income would be lowered by that amount for purposes of filing personal income taxes. The income tax paid by retirees would be lower because their taxable income would be lower (see Table 1). Federal and military retirees and active duty personnel would not be required to take any further action under this legislation since their reported income would automatically result in lower income tax. That means they would not have to itemize deductions, fill out special tax forms or depend on their accountant or family members to seek this relief. As a result, there is no guesswork here. The automatic nature of this tax relief would be especially important to older retirees who have difficulty – or need help – handling their own income tax filings.

The reasons Congressman Davis' and Senator Warner's bills should become law are clear. Premiums for plans available through the Federal Employees Health Benefits Program – along

with other employer-sponsored plans – have skyrocketed every year since 1998. While the authority to create a premium conversion plan had existed in the tax code since 1978, the repeated double-digit premium hikes helped persuade OPM to reconsider earlier interpretations that Section 125 of the Internal Revenue Code did not apply to the federal government as an employer. As a result, the premium conversion benefit was first granted to executive branch employees in October 2000 and then to legislative branch workers in January 2001.

We are glad that our colleagues who are still working receive this relief, but we were disappointed that annuitants were left out since the tax code is unclear on whether we may participate. As a matter of equity, federal annuitants must receive this same relief. Annuitants live on fixed incomes, and much of the 1.3 to 3.5 percent COLAs received by federal annuitants and military retirees during the last six years have been eroded by the double-digit increases in health insurance premiums (see Table 2).

At an average monthly gross annuity of \$1,869 -- most federal retirees and survivors -- while not poverty stricken – are not living in the lap of luxury either. The reality is that most of the average monthly cost-of-living adjustment of \$26.00 in 2003 was immediately consumed by this year's FEHBP enrollee share increases, like the \$22.52 jump in the Blue Cross/Blue Shield standard option family plan (see Table 3). There was little left over to absorb other rising expenses.

But more than just retirees should care about this legislation. Indeed, imagine the shock of a newly retired homeland security worker when he receives his first annuity check and learns that

the federal government no longer uses pre-tax earnings to pay his share of health insurance premiums. Under present law, that means the average annual tax savings of \$434 he received when working ends when he retires --- just when it is needed the most.

This rude awakening for today's active federal and postal workers will continue unless the Davis and Warner bills are enacted. For that reason, I am grateful to the federal, postal and military organizations -- including those testifying with me today -- who have given their strong support to H.R. 1231 and S. 623.

Some lawmakers have expressed concerns that premium conversion would only be extended to federal and military retirees -- and not other retirees -- under the proposed legislation. NARFE suggests that, because of their service to our country, providing premium conversion rights to federal and military retirees is a reasonable first step toward providing it to all retirees.

Towards that end, we believe that the Internal Revenue Service (IRS) should revisit their interpretation of whether the current tax code does allow retirees to participate in Section 125 premium conversion plans. In fact, Section 125 includes "former employees" within the definition of "employees" eligible to participate in the tax-favored plans. Consequently, we contend retirees, as former employees who receive deferred compensation from their employer, already should be considered eligible for premium conversion and related Section 125 tax plans.

In a February 1, 2000 "Coordinated Issue Paper" (UIL #125.05-00), the IRS said that retirees that receive income from Section 401(a) "qualified [retirement] plans" cannot shelter such funds

spent on the enrollee share of employer-sponsored health insurance from taxable income. The IRS argues that retired workers should not participate in Section 125 plans since Section 402 of the tax code does not explicitly allow such “former employees” to exclude qualified plan annuities spent on employer sponsored health insurance from their reported income. The paper asserts that there are only two narrow exceptions of when annuities can be excluded from reported income: (a) in distributions made to a former spouse under a court order [402(e)(1)(A)]; or, (b) rollovers from exempt funds that are transferred to an eligible retirement plan [402(c)]. We strongly believe that the third exception for all retirees should be Section 125 plans since annuities or pensions are deferred compensation for services rendered in the past and are no different from immediate compensation – wages – withheld for health insurance premiums that can be excluded from reported income under current interpretation of the tax code.

What distinguishes private-sector retirement plans from the federal government’s civilian retirement system – and what is not addressed in the IRS issue paper – is that for some purposes the government system is considered a Section 401(a) qualified retirement plan and for other purposes it is not. For instance, when a 40-year-old worker leaves his private-sector employer after 15 years of service, he receives both the employer and employee retirement contributions and earnings from a defined benefit plan. But unlike private sector workers, a Civil Service Retirement System employee would not be entitled to the government-employer retirement contributions – but only his own -- if he decided to pull out of CSRS upon separating from federal service before having enough years of employment to retire with an immediate annuity.

Given this example, federal civilian retirement is not conclusively a qualified plan as defined by Section 401(a). As a result, the IRS should rule that retired federal employees be allowed to participate in premium conversion plans since receiving distributions from qualified plans is the only tax code impediment to their participation in Section 125 plans.

While Congress would not directly consider the cost of an administrative resolution to the premium conversion issue, budgetary effects would be contemplated if legislation were necessary to extend this tax relief to retirees and the active duty uniformed services. If fully implemented, the Congressional Joint Committee on Taxation says that premium conversion legislation introduced by Chairman Davis and Senator Warner in the 107th Congress would cost \$7.1 billion over ten years. NARFE is certainly sensitive to the cost of any legislation, particularly in light of the federal budget deficit. Nonetheless, we also recognize that several proposals to use the tax code to help other Americans absorb skyrocketing health care costs are currently receiving favorable consideration. Indeed, the cost of H.R. 1231 and S. 623 is not out of line with other plans. Moreover, retirees and military personnel are likely to spend whatever tax savings they receive and thereby help the economy.

Some health care economists have argued that the tax relief provided by premium conversion is a disincentive for employees to select the most efficient and cost conscious health plans. They reason that enrollees would be less likely to search for an option with lower premiums and better coverage if rate hikes are cushioned by \$300 to \$500 in annual tax savings.

While health insurance is made more affordable by premium conversion, double-digit premium increases will continue to compel enrollees to shop around for better plans despite the addition of tax relief. NARFE takes this a step further by reminding our members during open season that they have a role in making FEHBP premiums, coverage and plans more competitive by encouraging them to switch to options of better value, if they are available.

Higher health insurance premiums have hit everyone in the federal family. That is why everyone who serves our country, including federal and military retirees, should receive the same tax relief to make health insurance more affordable. We commend Congressman Davis, Senator Warner and you for recognizing that retirees are struggling with rising health care costs.

Apparently, many of your colleagues agree with the legitimacy and value of this extension of premium conversion. Sixty-three percent of the House and 39 percent of the Senate have already indicated their support as cosponsors.

Thank you again, Chairwoman Davis, for holding this hearing. I can assure you of NARFE's full backing and cooperation in moving H.R. 1231 to the floor of the House as soon as possible.

Table 1: Comparing Taxpayers With and Without Premium Conversion.

Paying for Health Insurance With Pre-Tax Salary		Paying for Health Insurance With After-Tax Salary	
Annual Salary:	\$28,000	Annual Salary:	\$28,000
Insurance Premium Paid:	\$1,700	Insurance Premium Paid:	\$1,700
Income Reported to IRS:	\$26,300	Income Reported to IRS:	\$28,000
Federal Tax Rate:	x 28.0%	Federal Tax Rate:	x 28.0%
State Tax Rate:	x 6.0%	State Tax Rate:	x 6.0%
Federal & State		Federal & State	
Income Taxes Paid:	\$8,925	Income Taxes Paid:	\$9,480

Premium Conversion Savings	
Taxes Paid Without Premium Conversion:	\$9,480
Taxes Paid With Premium Conversion:	\$8,925
Total Savings:	\$555

Table 2: Federal Employees Health Benefits Program (FEHBP) Premium Increases versus Federal Annuity Cost-Of-Living Adjustments (COLAs).

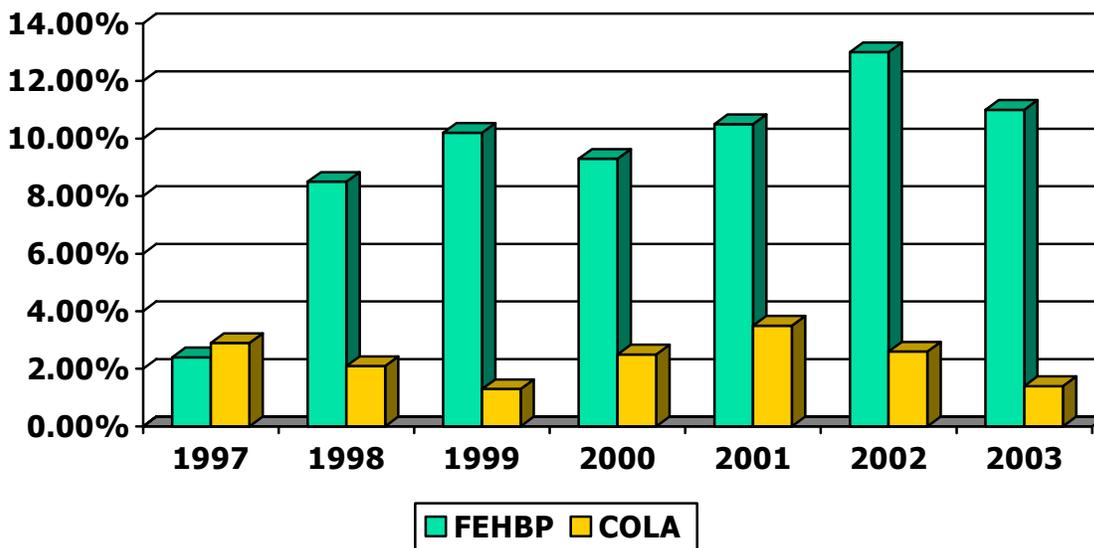


Table 3: Percentage of Average 2003 Federal Annuity COLA Consumed by FEHBP Blue Cross/Blue Shield Standard Option Family Plan:

