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1988

## Section 89 Practice Guide

American Institute of Certified Public Accountants. Tax Division

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November 18, 1988

To the Members of the AICPA Tax Division:

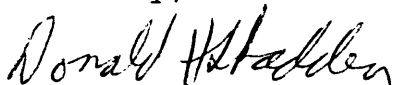
Enclosed is a copy of the AICPA practice guide on IRC Section 89. This Section, enacted by the Tax Reform Act of 1986, imposes new qualification rules on a variety of employer benefit plans and requires many businesses to apply mechanical nondiscrimination tests to their health and group-term life insurance plans.

This practice guide focuses on employers with only one (or comparable) health plan(s) and their compliance with the nondiscrimination rules. Penalties for failing to satisfy these standards can be severe. These rules become effective for plan years beginning after 1988.

It is not too early for companies to prepare for compliance. Your clients must accumulate a significant amount of data regarding plans and employees to perform the nondiscrimination tests. This data collection may require more time than the actual testing and subsequent plan redesign or inclusion of income on Form W-2.

In the absence of regulations we hope you find this information helpful.

Sincerely,



Donald H. Skadden  
Vice President - Taxation

**AICPA TAX DIVISION**  
**Section 89 PRACTICE GUIDE**

**NOTE:** The following is preliminary guidance on our understanding of how Internal Revenue Code (IRC) Section 89 will be applied. This material is subject to change as Internal Revenue rules and regulations are published. The capitalization of terms indicates they are defined terms.

**INTRODUCTION**

The Tax Reform Act of 1986 enacted IRC Section 89 requiring nondiscrimination tests for health and group-term life insurance plans (Statutory Employee Benefit Plans) effective generally for plan years beginning after December 31, 1988. Certain other statutory fringe benefits may be covered under Section 89 at the election of the employer. The stated purpose for the nondiscrimination tests is to encourage greater coverage of a broader cross-section of employees in employer sponsored fringe benefit plans. If the nondiscrimination tests are not met, the highly compensated employees (HCEs) must include the excess benefits they receive in income in the year in which ends the plan year in which the excess occurs. An excise tax is imposed upon the employer for failure to include this benefit in the W-2 of the highly compensated employee when the nondiscrimination tests are not met.

The purpose of this practice guide is to determine whether or not an employer sponsored health or group-term life insurance plan meets the nondiscrimination tests and to provide some guidance on courses of action to alleviate discrimination in a plan. This guidance is intended for use with small employers not participating in multiemployer plans and not offering multiple options or benefits through a cafeteria plan. For employers with multiple plans covering different groups of employees, much greater analysis will be required and is beyond the scope of this practice guide. It is anticipated that a great majority of small employer plans will be able to satisfy the "80 percent coverage test" as described later and no further testing will be required.

In addition to the nondiscrimination tests, Section 89 contains qualification requirements for all Employee Benefit Plans that must be met to avoid adverse consequences. If the qualification requirements are not met, all employees (including nonhighly compensated employees (NHCEs)) must include the value of the benefits in income for the year in which the benefits are received to the extent they are attributable to employer contributions.

## PART ONE - OVERVIEW

### QUALIFICATION REQUIREMENTS

There are five requirements that an Employee Benefit Plan must meet to qualify under Section 89 as follows:

1. The plan must be in writing by the end of the 1989 plan year.
2. The employee's rights under the plan must be legally enforceable.
3. The plan must be established with the intention of being maintained for an indefinite period of time.
4. Employees are provided reasonable notification of benefits available in the plan.
5. The plan is maintained for the exclusive benefit of employees.

According to the Technical and Miscellaneous Revenue Act of 1988 (Section 3021(c)(3)(B)), reasonable notice of the benefits available in the plan must be provided on or before the beginning of the plan year. For example, a calendar year plan must notify employees before January 1, 1989.

Failure to comply with the five above requirements will require the employer to include the value of benefits paid under the plan on each employee's (HCEs and NHCEs) Form W-2. If not included in a timely filed W-2, failure to do this will result in an excise tax of 28 percent of the amounts which should have been included on a Form W-2. In addition, penalties for underwithholding and underreporting on a W-2 could apply.

### NONDISCRIMINATION TESTS

Under IRC Section 89 the plan must contain a provision relating to eligibility to participate which discriminates in favor of HCEs (subjective test). In addition, there are two nondiscrimination tests available for Statutory Employee Benefit Plans as follows:

- A. The 80 percent coverage (or alternative) test is the simplest test to use. This test provides that if a plan benefits at least 80 percent of an employer's NHCEs, such plan is considered to satisfy this nondiscrimination test. The employee must actually benefit from the plan (i.e., receive coverage under the plan) eligibility to receive coverage is insufficient to satisfy the test.

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- B. If a plan fails the 80 percent coverage test, it must pass the following three parts of a more complex eligibility and benefits test.
1. The 50 percent eligibility test; at least 50 percent of the employees eligible to participate in the plan must be NHCEs. Alternatively, the percentage of HCEs eligible to participate in the plan cannot be greater than the percentage of NHCEs who are eligible.
  2. The 90 percent/50 percent eligibility test; at least 90 percent of the NHCEs are eligible for a benefit that is at least 50 percent as valuable as the largest benefit available to any HCE under all plans of the same type (i.e., medical, group-term life). For purposes of this test, all plans of the same type are aggregated.
  3. The 75 percent benefits test; the average employer provided benefit actually received by NHCEs under all plans of the same type must be at least 75 percent as valuable as the average employer provided benefit actually received by HCEs under all those plans.

#### DEFINITIONS

Statutory Employee Benefit Plan: An accident or health plan under IRC Section 105(e) and a group-term life insurance plan under IRC Section 79. The employer may elect to treat certain other employee benefit plans as statutory employee benefit plans (Section 89(i)(2)).

Employee Benefit Plan: As distinguished from qualified retirement plans, these include health benefits, group-term life insurance, group legal services, dependent care assistance, cafeteria and educational assistance plans and welfare benefit funds.

Plan: Each option or different benefit offered is treated as a separate plan except that in the case of group-term life insurance, the provision of insurance coverage that varies in proportion to compensation is not considered as the provision of different options or benefits with respect to such varying coverage.

Highly Compensated Employee (HCE): Any employee who during the year or the preceding year:

1. Was at any time a greater than 5 percent owner of the employer, or
2. Received compensation from the employer in excess of \$75,000 (subject to cost-of-living adjustments, for 1988 it is \$78,353), or

3. Received compensation from the employer in excess of \$50,000 and was in the top paid group\* of employees for such year (subject to cost-of-living adjustments, for 1988 it is \$52,235), or
4. Was at any time an officer and received compensation greater than 150 percent of the 30,000 (for 1989 it is 50 percent of the Code Section 415 defined benefit plan limit subject to cost of living adjustments). However, regardless of the level of compensation, at least one officer must be treated as a highly compensated employee.

\*Top Paid Group - Such group consisting of the top 20 percent of the employees when ranked on the basis of compensation paid during such year.

Any employee who is not highly compensated will be a nonhighly compensated employee (NHCE).

Employer: All related employers under Section 414(b), (c), (m), (n), (o) and (t) are treated as a single employer. (General Explanation of the Tax Reform Act of 1986, prepared by the Staff of the Joint Committee on Taxation, May 4, 1987, p. 793.)

#### SWORN STATEMENTS

The 80 percent coverage test and the 75 percent benefits test could be easily failed if a number of employees have health insurance coverage through another employer. To avoid this result, the employer can make an election to disregard testing employees who have a family that is covered by a health plan that provides core medical benefits and that is maintained by another employer of the employee, spouse, dependent, or parent of the employee. This is accomplished by having each employee complete a sworn statement as to outside coverage. (See APPENDIX I.)

Likewise, both the 80 percent coverage test and the 75 percent benefits tests will be failed unless sworn statements are completed. In the case of the 80 percent coverage test this failure results because the percentage of employees with actual spouse and dependent coverage is determined in reference to all employees. However, sworn statements allow the test to be calculated taking into account only employees with a spouse or dependent who are not covered by a health plan providing health benefits maintained by another employer. In the case of the 75 percent benefits test this failure usually results because a smaller percentage of NHCEs have spouse and dependent coverage than do HCEs. Therefore, it is usually beneficial to separate out spouse and dependent coverage and test only HCEs against NHCEs who have this coverage.

## CONCLUSION

All employers with a single health or group-term life insurance plan for all employees should first try the 80 percent coverage test. This test will typically be passed unless:

- (a) There are a number of employees who are part-time and not eligible for the plan but who work over 17-1/2 hours per week and/or
- (b) There are some employees who choose not to receive coverage even though they are not covered by another plan.

If these conditions exist, the 80 percent coverage test may be failed and the second set of tests must be completed. Alternatively, all HCEs could simply report the value of this coverage as taxable income. (This approach may cause the HCEs to report more taxable income than required. Therefore, it might still be better to perform the tests and determine the exact amount of discriminatory excess.)

The Technical and Miscellaneous Revenue Act of 1988 makes it clear that IRC Section 89 compliance can be tested on any date during the first plan year after December 31, 1988, and that plan modifications prior to the test date but during the plan year are permitted to eliminate discrimination. This means that a calendar year plan can be modified at any time during 1989 to meet the nondiscrimination rules. However, modifications affecting the employer-provided benefit of an HCE by reason of any change in the terms of the plan or the making of an election by such employee requires an adjustment of the amount taken into account for such employee's employer-provided benefit. This adjustment is based on the portion of the test year during which the changed benefit is provided (or made available). Therefore, even if compliance with the nondiscrimination tests by January 1, 1989, is not necessary, early compliance would mitigate the extent of adjustments necessary to meet the tests.

In addition, because of the complexities of the law and the lead time necessary to make plan changes, it is prudent to start the testing as soon as possible. For this reason we have illustrated under "PART TWO - TESTING" the data gathering requirements, methods of calculating the 80 percent coverage test and the eligibility and benefits tests in case they have to be used. We have also included a sample client letter in APPENDIX II, a flowchart of the nondiscrimination tests in APPENDIX III, and a bibliography and reference section in APPENDIX IV.

## PART TWO - TESTING

### DATA REQUIRED

You must first determine your employee group. For this purpose, the general common law rules apply. (Reg. Sec. 31.3401(c)-1). Having defined the group of individuals performing services for the employer as employees, certain individuals can be excluded. Specifically, assuming no employee in any of the following classifications of employees is provided health benefits\*, the following groups of individuals can be excluded for testing health plans (IRC Section 89(h) and Technical Corrections and Miscellaneous Revenue Act of 1988, Section 6070):

- o employees who have not completed one year of service (six months if core medical coverage is being tested);
- o employees who normally work less than 17½ hours in a week (if the employer has less than 10 employees, this hour limit is increased to 35 hours for 1989 and 25 for 1990);
- o employees who normally work less than six months annually;
- o employees who are younger than age 21;
- o collectively bargained employees; and
- o nonresident aliens.

\*NOTE: However, if the plan's eligibility requirements allow anyone who could be excluded above to participate, then you are required to include that employee as well as all similarly situated employees.

Once the excluded groups of employees have been determined, the remaining employees are the group that will be used for the nondiscrimination tests.

Having defined the employee group to be tested, then separate the group into HCEs and NHCEs. The next step is to determine how many plans the employer maintains. In general, each separate variation in coverage, option, and employee contribution required will be a different plan for testing purposes. Thus, each HMO and each indemnity plan will be a separate plan for testing. Each indemnity plan or HMO that differs in any way from another HMO or indemnity plan will be a separate plan for testing. (IRC Section 89(j)(11)).

Having defined each separate plan, the next step is to value each plan if the employer has more than one plan. If the employer has only one plan, the valuation rules and aggregation rules to be discussed below are not applicable. In this case, you may proceed to the CALCULATION sections.

Until the Treasury Department issues valuation tables, employers can use a reasonable method of their choice to value the coverage provided by each plan (Technical and Miscellaneous Revenue Act of



1988, Section 3021(c)(1)). In many cases, employers are using the cost of coverage or the cost of coverage for the COBRA continuation rules as the value of benefits for the nondiscrimination tests.

Having valued each plan, one can now determine if two or more plans can be aggregated, or considered as one plan, for testing purposes of the 80 percent coverage tests. The purpose of all these aggregation rules is to determine if the employer can limit the number of plans which need to be tested. If plan values are within 90 percent of each other, the plans can be aggregated for testing purposes. This can be lowered to 80 percent if 90 percent of NHCEs are provided coverage. In addition, a plan may be aggregated with another plan if the percentage of NHCEs covered under the plan with the greater value is at least 80 percent of the percentage of HCEs covered under such plan.

Plans may be aggregated if such plans are available on the same terms to all employees, and the difference in annual cost to the employees between the plan with the smallest employee cost and the plan with the highest employee cost is not more than \$100. Any other plan may be aggregated with the group of plans if the value is within 90 percent of the value of the plan within the group with the largest employer-provided benefit (80 percent if the 90 percent coverage test applies).

#### CALCULATION - 80% COVERAGE TEST

After determining the minimum number of plans to be tested, the employer should apply the 80 percent coverage test to each plan and the subjective test to each plan. The subjective test is satisfied if the plan does not contain any provision relating to eligibility to participate which discriminates in favor of the HCEs. The 80 percent coverage test is passed if 80 percent of NHCEs are covered by the plan.

EXAMPLE 1: Assume the employer has one plan for its 40 employees. Of this employee group, 6 employees are HCEs and 34 are NHCEs. The plan covers 35 employees, 6 HCEs and 29 NHCEs. The plan is nondiscriminatory because the plan covers at least 80 percent of the 34 NHCEs or 28 NHCEs.

Assume that the plan being tested (or aggregated group of plans being tested) cannot meet the 80 percent coverage test. The employer should now see if, by applying the special rule for family coverage, the plan or plans can satisfy the test. Under this special rule, the coverage of employees and the coverage of spouses and dependents may be tested separately, as if they constituted two different types of plans. Further, with respect to coverage of spouse and dependents, the employer may disregard employees who do not have a spouse or dependent. Alternatively, if an employee is entitled to coverage for his or her spouse or dependents under the plan, such employee is considered to receive such coverage despite the fact that such employee may not have a spouse or dependents. An employer who elects this special rule is required to obtain and

maintain adequate sworn statements to demonstrate whether employees have a spouse or dependent. These can be maintained for a statistically valid sample of employees (a 95% level of confidence and no more than a 3% margin of error).

EXAMPLE 2: Assume an employer has 40 employees. All of the employees are eligible, but only 33 elect to participate in the plan.

	<u>HCE</u>	<u>NHCE</u>
Employees with <u>no</u> spouse or dependents		
PLAN A - COVERED	1	22
- NOT COVERED	-	5
Employees with a spouse or dependents		
PLAN A - COVERED	5	5
- NOT COVERED	-	2
	<u>6</u>	<u>34</u>

To apply the tests separately, we look first to the NHCE employee coverage. Our total NHCE population is 34. Thus, to satisfy the 80 percent test, 28 NHCEs must be covered. Because our plan covers 27 NHCEs, the test is failed. Next, we apply the test to the group of NHCEs with spouses or dependents, only considering those NHCEs with spouses or dependents. This NHCE group is 7, and the plan must cover 6 NHCEs to be nondiscriminatory. Because the plan only covers 5 NHCEs, the discriminatory test is failed for the plan providing spouse and dependent coverage.

The next step is to determine if any employees have coverage provided by another employer. For this, sworn statements are also needed. Assume in the foregoing example that all employees who do not have health coverage, have coverage from another employer. Thus, our employee group for testing purposes shrinks to 33 employees (6 HCEs and 27 NHCEs) and the 80 percent coverage test is passed because all NHCEs in the group have coverage.

If the employer has a number of part-time employees, special adjustments need to be made to these computations. A part-time employee can receive less valuable employer-provided health benefits and not adversely affect the discrimination tests.

EXAMPLE 3: Assume the following employee group receives the indicated coverage:

	<u>HCE</u>	<u>NHCE</u>
Employees with <u>no</u> spouse or dependents		
PLAN A - COVERED	1	22
NOT COVERED	-	-
OUTSIDE COVERAGE	-	5
Employees with a spouse or dependents		
PLAN A - COVERED	5	5
NOT COVERED	-	-
OUTSIDE COVERAGE	-	2

	<u>HCE</u>	<u>NHCE</u>
Part-time employees with <u>no</u> spouse or dependents		
PLAN A - COVERED	-	-
NOT COVERED	-	1
OUTSIDE COVERAGE	-	4
Part-time employees with a spouse or dependents		
PLAN A - COVERED	-	-
NOT COVERED	-	3
OUTSIDE COVERAGE	-	<u>7</u>
		<u>49</u>

Because our NHCE group is now expanded to 49, the plan must cover 40 (80% of 49) NHCEs to be nondiscriminatory. Assuming sworn statements are obtained to determine other employer coverage and family status, the employer plan must cover 80 percent of the 31 NHCEs, or 25. This plan will satisfy the nondiscrimination test since 27 NHCEs are covered. The spouse and dependent plan must cover 80 percent of 8 NHCEs, or 7. Because this plan only covers 5 NHCEs, the plan fails the nondiscrimination test. For this test to be passed, 2 additional NHCEs must receive coverage. However, because there are part-time NHCEs and the coverage provided can be adjusted, these 20-hour NHCEs can receive only half of the coverage provided to full-time employees and the employer's plan will satisfy the nondiscrimination test. If NHCEs are required to pay for part of their coverage, it may be necessary for the employer to pay for all of the coverage of these two part-time NHCEs to encourage their participation in the plan.

In summary, the employer must first define his employee group and the coverage provided. This 80 percent coverage test is the easiest to apply but will generally only apply when the employer has one plan or a group of plans that can be tested together. If the employer's plan or plans cannot pass the 80 percent nondiscrimination test, two alternatives are available: the employer can increase benefits, eligibility and/or contributions for the NHCEs (as noted in the last example), or the employer can test the plan or plans under the second nondiscrimination test comprised of two eligibility tests and one benefits test discussed below. If neither alternative is chosen, the employer must include the value of the HCEs' health coverage on a timely filed Form W-2. Failure to do so would result in an excise tax of 28 percent of the value of the coverage provided to HCEs and possibly penalties for failure to withhold and underreport. However, to determine the value of the discriminatory excess health coverage, the employer must perform the eligibility and benefits tests.

**CALCULATION - ELIGIBILITY AND BENEFITS TESTS**

In order to be nondiscriminatory under these rules, the employer must satisfy two eligibility, one benefits, and one subjective discrimination test. This combination of tests is necessary to accommodate various plans offered by an employer and test for discrimination with respect to both eligibility and coverage.

The average benefits test requires that the average benefit actually provided to NHCEs be at least 75 percent as valuable as the average benefit provided to HCEs. All health benefits are aggregated for purposes of this test, including those provided through a flexible benefit plan.

EXAMPLE 4: Assume the employer has the following employee group and provides two health plans which cannot be tested together. PLAN A is valued at \$1,500 and PLAN B is valued at \$2,000. Sworn statements are not obtained and no employee is eligible for a plan other than the coverage provided.

	<u>EMPLOYEES</u>	<u>PLAN A</u>	<u>PLAN B</u>	<u>NO COVERAGE</u>
HCE	20	15	5	--
NHCE	80	15	45	20

The benefits test will be passed if the average employer-provided benefit for NHCEs is 75 percent of the average employer-provided benefit for HCEs. The average employer-provided benefit for the HCEs is \$1,625 ((15 employees x \$1,500 + 5 employees x \$2,000) divided by 20 employees). The average employer-provided benefit for NHCEs is \$1,406.25 ((15 employees x \$1,500 + 45 employees x \$2,000) divided by 80 employees). This test is passed because \$1,406.25 is greater than 75 percent of \$1,625 or \$1,218.75.

There are two eligibility tests which must be satisfied to pass the nondiscrimination tests. The first test ensures that a substantial number of NHCEs receive a benefit that is not significantly less valuable than the benefit available to HCEs. Ninety percent of the NHCEs must have available to them a benefit equal to at least 50 percent of the largest benefit available to any HCE. For this test, all health plans are treated as one plan. However, employee and spouse/dependent coverage can be tested separately by utilizing the sworn statement procedure previously discussed.

The second test ensures that no one plan is available primarily to HCEs. To pass this test at least 50 percent of the employees to whom a plan is available must be NHCEs. This test can also be satisfied if the percentage of HCEs who are eligible to participate is not greater than the percentage of NHCEs who are eligible to participate.

The final test is a subjective test. Some forms of discrimination are not detectable by objective tests, such as in the case of a plan that covers only a rare condition to which only the owner of the employer is subject. There is a subjective nondiscrimination rule to prohibit this unusual type of discrimination.

The above eligibility tests, based on the preceding example, can be illustrated as follows.

EXAMPLE 5: Assume neither plan has nondiscriminatory items. The next test requires each plan to be equally available to NHCEs and HCEs. This test is satisfied. One half of the employees eligible for Plan A are NHCEs and 90 percent of the employees eligible for Plan B are NHCEs. The final test requires that 72 NHCEs (90 percent of 80 employees) have available a benefit of at least \$1,000 (50 percent of \$2,000). This test is failed because only 60 employees have this coverage available. The employer will either have to expand coverage to 12 NHCEs or include part of the value of the health benefits provided to HCEs as income on a timely filed Form W-2. If this is not done, the employer will be subject to a nondeductible tax equal to 28 percent of the value of the coverage (or benefits, if an uninsured plan).

EMPLOYEE'S SWORN STATEMENT

The below signed does hereby swear that the following statements are true:

- 1. I (have) (do not have) a spouse. (circle the applicable one)
- 2. I have \_\_\_\_\_ dependents (not including spouse, if any).
- 3. The name of the other employer, if any, of mine, my spouse, my dependent or my parent, providing me with health benefits is:

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and coverage provided is described as follows:

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- 4. The name of the other employer, if any, of mine, my spouse, my dependent or my parent, providing my spouse and dependents, if any, with health benefits is:

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and coverage provided is described as follows:

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Under the penalties of perjury, I declare to the best of my knowledge and belief that this statement is true, correct, and complete.

\_\_\_\_\_  
(Signature of employee)

\_\_\_\_\_  
(Date)

**SAMPLE LETTER TO EMPLOYER REGARDING NONDISCRIMINATION  
REQUIREMENTS OF Section 89**

(CPA Firm Letterhead)

(Name and Address)

Dear M \_\_\_\_\_ :

As you are probably aware, the Tax Reform Act of 1986 established comprehensive nondiscrimination and qualification rules covering certain employee benefit plans under a new Section 89 of the Internal Revenue Code. The complex new rules deal primarily with the issue of health and life insurance plans that discriminate in favor of highly compensated employees, and specify certain areas of uniform treatment of these employee benefits.

These new rules are generally applicable beginning in 1989 and the possible penalties for failure to comply with the rules and regulations could be very substantial. Congress recently instructed the Internal Revenue Service to have the regulations published by November 15, 1988, which deadline they failed to meet. To further complicate the matter, the recent Technical and Miscellaneous Revenue Act of 1988, signed by the President on November 10th changed some aspects of the provisions of Section 89.

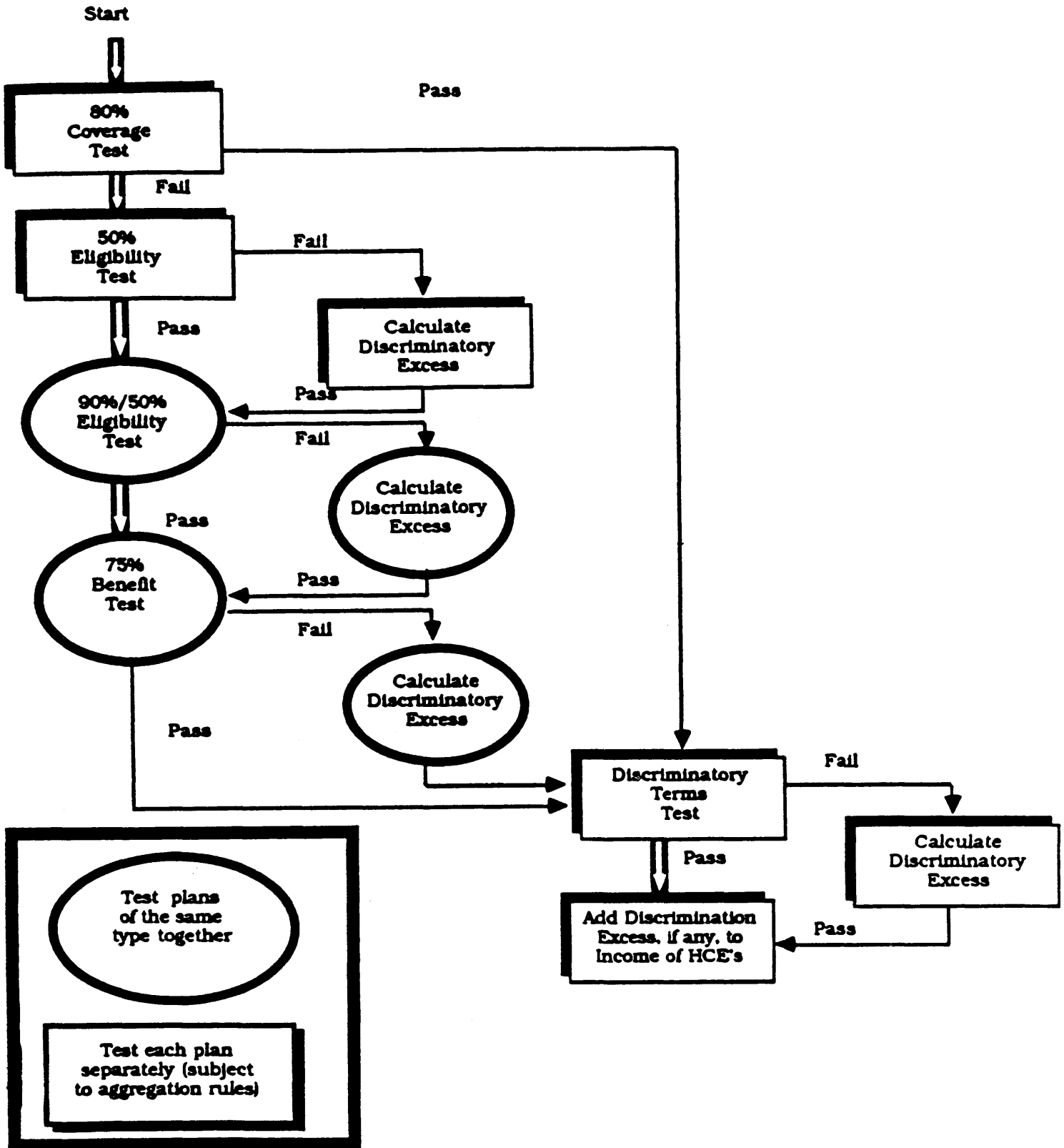
While the details of Section 89 are complex, we believe that the benefits of a timely review for compliance are sufficiently great to warrant your consideration and avoid additional costs and penalties imposed on employers who fail to comply with the requirements. If we can provide additional information concerning these requirements or assist you in determining whether your employee benefits are in compliance with Section 89, please contact us.

Sincerely,

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, CPA

# THE NONDISCRIMINATION TESTS



Test plans of the same type together

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Test each plan separately (subject to aggregation rules)



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