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News Release

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IR-84-22

Washington, D.C.--The Internal Revenue Service today said that so-called "reimbursement," "flexible spending" and similar arrangements which purport to allow employees to pay their out-of-pocket medical, legal, dependent care or other personal expenses with "pre-tax dollars" are without substance and do not reduce employees' taxable income.

Under these arrangements, employees submit proof of expenses to their employer, who recharacterizes a portion of the employees' otherwise agreed-upon salary as "reimbursement" for such expenses. On that basis the employer treats, and advises employees to treat, the recharacterized amount as a tax-free payment and removes it from "wages" for employment tax purposes. There may be variations of this type of arrangement which are equally invalid.

The IRS said that any "reimbursement" under any such arrangements is part of the employee's income under Internal Revenue Code section 61 and is subject to federal income tax withholding and federal employment taxes. The arrangements are merely attempts to pay taxable compensation without compliance with the federal tax laws, by labeling a portion of the employee's salary as "reimbursement". In fact, no amount is paid to reimburse the employee for expenses. The employee simply receives what would have been received had no expenses been incurred. Moreover, the employer does not actually bear the cost of the expenses. In addition, the employer is not at risk as to either the amount of the employee's expenses or whether the employee has any expenses. It makes no difference if the "reimbursement" amounts are paid directly to the provider of the health care or other services or to the employee.

Employers who make tax returns on the basis that these types of arrangements are effective will be liable for payment of employment taxes and income and employment tax withholding on the amount of any alleged "reimbursement", as well as for interest and applicable penalties.

Employees who file their federal income tax returns on such a basis will be liable for additional tax, interest and applicable penalties.

Code section 125 does not change these results. Under that section "no amount shall be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan". However, section 125 does not exclude salary or amounts expended to, or on behalf, of an employee if the amounts are "reimbursements" under such arrangements.

The IRS concluded that today's announcement addresses only the arrangements described. These arrangements and all invalid variations of such arrangements are to be distinguished from valid cafeteria plans in which the employee can make a one-time election before the beginning of the year between cash and

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eligibility for reimbursement of certain expenses for the year up to a stated amount. Under these plans, if the employee elects reimbursement, but incurs such expenses during the year in an amount less than the limitation, the employee receives no further benefits or payments of any kind. The IRS believes that there are numerous variations of all such arrangements--valid and invalid--and it does not intend this announcement to deal with or distinguish among all such variations. This announcement is not to be construed by inference as approving other arrangements under relevant Code sections.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[EE-16-79]

Tax Treatment of Cafeteria Plans

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the tax treatment of cafeteria plans. Changes to the applicable tax law were made by the Revenue Act of 1978, by the Technical Corrections Act of 1979 and by the Miscellaneous Revenue Act of 1980. The proposed regulations would provide the public with the guidance needed to comply with those Acts and would affect employees who participate in cafeteria plans.

DATES: Written comments and requests for a public hearing must be delivered or mailed by July 6, 1984. The regulations are generally proposed to be effective for plan years beginning after December 31, 1978, except with respect to certain provisions set forth in Q&A-21 which would be effective as of September 4, 1984. In addition, transitional relief is provided with respect to employer contributions made before June 1, 1984, pursuant to certain "flexible spending arrangements" that satisfy specified conditions. Also, the provision relating to qualified cash or deferred arrangements would be effective for plan years beginning after December 31, 1980.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (EE-16-79), Washington, D.C. 20224.

FOR FURTHER INFORMATION CONTACT: Harry Beker of the Employee Plans and Exempt Organizations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, D.C. 20224 (Attention: CC:EE) (202-566-6212) (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed Income Tax Regulations (26 CFR Part 1) under section 125 of the Internal Revenue Code of 1954. These proposed regulations are to be issued pursuant to section 134 of the Revenue Act of 1978 (92 Stat. 2763), section 101 of the Technical Corrections Act of 1979 (92 Stat. 2227), section 226 of the Miscellaneous Revenue Act of 1980 (94 Stat. 3526), and under the authority contained in section 7805 of the Code (68A Stat. 917, 26 U.S.C. 7805).

Format

These proposed regulations are presented in the form of questions and answers. The questions and answers do not address various issues regarding the application of the discrimination standards under section 125. Written comments are requested specifically with respect to the application of these discrimination standards. In particular, comments are requested regarding tests that a plan may use to determine whether it is nondiscriminatory, methods by which to value benefits, appropriate safe harbors from discrimination, and tests to assure that the pricing of benefits under a cafeteria plan is not discriminatory.

The guidance provided by these questions and answers may be relied upon to comply with provisions of section 125 and will be applied by the Internal Revenue Service in resolving issues arising under cafeteria plans and related Code sections. However, pending the issuance of final regulations, advance determinations and rulings regarding whether a cafeteria plan is or is not discriminatory will not be issued. Determinations regarding discrimination will be made only on audit.

If final regulations are more restrictive than the guidance in this Notice, the regulations will not be applied retroactively. No inference, however, should be drawn regarding issues not expressly raised that may be suggested by a particular question or answer or by the inclusion or exclusion of certain questions.

Nonapplicability of Executive Order 12291

The Treasury Department has determined that this Regulation is not subject to review under Executive Order 12291 or the Treasury and Office of Management and Budget Implementation of the Order dated April 29, 1983.

Regulatory Flexibility Act

Although this document is a notice of proposed rulemaking which solicits public comments, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

Comments and Requests for a Public Hearing

Before adopting these proposed regulations consideration will be given to any written comments that are submitted (preferably seven copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held on a date announced in the notice of public hearing appearing elsewhere in this Federal Register.

Drafting Information

The principal author of these proposed regulations is Harry Beker of the Employee Plans and Exempt Organizations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

List of Subjects in 26 CFR Parts 1.61-1–1.281-4

Income taxes, Taxable income.

PART 1—[AMENDED]

Proposed Amendments to the Regulations

Accordingly, it is proposed to amend the Income Tax Regulations, 26 CFR Part 1, by adding the following new section:

§ 1.125-1 Questions and answers relating to cafeteria plans.

Q-1: What does section 125 of the Internal Revenue Code provide?

A-1: Section 125 provides that a participant in a nondiscriminatory cafeteria plan will not be treated as having received the taxable benefits offered under the plan solely because the participant has the opportunity, before the benefits become currently available to the participant, to choose among the taxable and nontaxable benefits offered under the plan.

Q-2: What is a "cafeteria plan" under section 125?

A-2: A "cafeteria plan" is a separate written benefit plan maintained by an employer for the benefit of its employees under which all participants are employees and each participant has the opportunity to select the particular benefits that he desires. A cafeteria plan may offer participants the opportunity to select among various taxable benefits and nontaxable benefits, but a plan must offer at least one taxable benefit and at least one nontaxable benefit. For example, if participants are given the opportunity to elect only among two or more nontaxable benefits, the plan is not a cafeteria plan.

Q-3: What must the written cafeteria plan document contain?

A-3: The written document embodying a cafeteria plan must contain at least the following information: (i) A specific description of each of the benefits available under the plan, Page Denied

[…]ding the periods during which the [bene]fits are provided (i.e., the periods of [cov]erage), (ii) the plan's eligibility rules [go]verning participation, (iii) the [pro]cedures governing participants' [ele]ctions under the plan, including the [pe]riod during which elections may be [ma]de, the extent to which elections are [irr]evocable, and the periods with [re]spect to which elections are effective, [(iv)] the manner in which employer [co]ntributions may be made under the [pl]an, such as by salary reduction [ag]reement between the participant and [th]e employer or by nonelective [em]ployer contributions to the plan, (v) [th]e maximum amount of employer [co]ntributions available to any [p]articipant under the plan, and (vi) the [p]lan year on which the cafeteria plan [o]perates.

In describing the benefits available under the cafeteria plan, the plan document need not be self-contained. For example, the plan document may include by reference benefits established under other "separate written plans," such as coverage under a qualified group legal services plan (section 120) or under a dependent care assistance program (section 129), without describing in full the benefits established under these other plans. But, [for] example, if the plan offers different [m]aximum levels of coverage under a dependent care assistance program, the descriptions must specify the available maximums. In addition, an arrangement under which a participant is provided with coverage under a dependent care assistance program for dependent care expenses incurred during the period of coverage up to a specified amount (e.g., $500) and the right to receive, either directly or indirectly in the form of cash or any other benefit, any portion of the specified amount that is not reimbursed for such expenses will be considered a single benefit and must be fully described as such in the plan document. This also is the case with other benefits, such as coverage under an accident or health plan and coverage under a qualified group legal services plan. See Q&A-17 and Q&A-18 regarding the taxability of such benefit arrangements.

Q-4: What does the term "employees" mean under section 125?

A-4: The term "employees" includes present and former employees of the employer. All employees who are treated as employed by a single employer under subsections (b), (c), or (m) of section 414 are treated as employed by a single employer for purposes of section 125. The term "employees" does not, however, include self-employed individuals described in section 401(c) of the Code. Even though former employees generally are treated as employees, a cafeteria plan may not be established predominantly for the benefit of former employees of the employer.

In addition, even though the spouses and other beneficiaries of participants may not be participants in a cafeteria plan, a plan may provide benefits to spouses and beneficiaries of participants. For example, the spouse of a participant may not be permitted to participate actively in a cafeteria plan (i.e., the spouse may not be given the opportunity to select or purchase benefits offered by the plan), but the spouse of a participant may benefit from the participant's selection of family medical insurance coverage or of coverage under a dependent care assistance program. A participant's spouse will not be treated as actively participating in a cafeteria plan merely because the spouse has the right, upon the death of the participant, to select among various settlement options available with respect to a death benefit selected by the participant under the cafeteria plan or to elect among permissible distribution options with respect to the deceased participant's benefits under a cash or deferred arrangement that is part of the cafeteria plan.

Q-5: What benefits may be offered to participants under a cafeteria plan?

A-5: With the exception of benefits that defer the receipt of compensation (see Q&A-7), a cafeteria plan may offer participants the opportunity to select among certain taxable benefits and nontaxable benefits described in the plan document. The term "taxable benefit" means cash, property, or other benefits attributable to employer contributions that are currently taxable to the participant under the Internal Revenue Code upon receipt by the participant. The term "nontaxable benefit" means any benefit attributable to employer contributions to the extent that such benefit is not currently taxable to the participant under the Internal Revenue Code upon receipt of the benefit. Thus, a cafeteria plan may offer participants the following benefits, which will be nontaxable when provided in accordance with the applicable provisions of the Internal Revenue Code: group-term life insurance up to $50,000 (section 79), coverage under an accident or health plan (section 106), coverage under a qualified group legal services plan (section 120), and coverage under a dependent care assistance program (section 129). Also, amounts received by participants under one of these benefits may or may not be taxable depending upon whether such amounts qualify for an exclusion from gross income. See Q&A-17 and Q&A-18 regarding the inclusion of an accident or health plan, dependent care assistance program, or qualified group legal services plan in a cafeteria plan. Also, see Q&A-7 regarding the inclusion of deferred compensation benefits in a cafeteria plan.

In addition, a cafeteria plan may offer benefits that are nontaxable because they are attributable to after-tax employee contributions. For example, a cafeteria plan may offer participants the opportunity to purchase, with after-tax employee contributions, coverage under an accident or health plan providing for the payment of disability benefits. A participant's receipt of coverage under such an accident or health plan would not trigger taxable income because the coverage would be purchased with after-tax employee contributions. Similarly, any amounts paid to a participant under such an accident or health plan on account of disability incurred during the year of coverage may be nontaxable under section 104(a)(3).

Q-6: May employer contributions to a cafeteria plan be made pursuant to a salary reduction agreement between the participant and employer?

A-6: Yes. The term "employer contributions" means amounts that have not been actually or constructively received (after taking section 125 into account) by the participant and have been specified in the plan document as available to a participant for the purpose of selecting or "purchasing" benefits under the plan. A plan document may provide that the employer will make employer contributions, in whole or in part, pursuant to salary reduction agreements under which participants elect to reduce their compensation or to forgo increases in compensation and to have such amounts contributed, as employer contributions, by the employer on their behalf. A salary reduction agreement will have the effect of causing the amounts contributed thereunder to be treated as employer contributions under a cafeteria plan only to the extent the agreement relates to compensation that has not been actually or constructively received by the participant as of the date of the agreement (after taking section 125 into account) and, subsequently, does not become currently available to the participant. In addition, a plan document also may provide that the employer will make employer contributions on behalf of participants equal to specified amounts (or specified percentages of compensation) and that such nonelective contributions will be available to participants for the selection or purchase of benefits under the plan.

Q-7. May a cafeteria plan offer a benefit that defers the receipt of compensation?

A-7. No. A cafeteria plan does not include any plan that offers a benefit that defers the receipt of compensation, with the exception of the opportunity for participants to make elective contributions under a qualified cash or deferred arrangement defined in section 401(k). Thus, employer contributions made at a participant's election to a profit-sharing plan containing a qualified cash or deferred arrangement will be treated as nontaxable benefits under a cafeteria plan.

In addition, a cafeteria plan does not include a plan that operates in a manner that enables participants to defer the receipt of compensation. Generally, a plan that permits participants to carry over unused benefits or contributions from one plan year to a subsequent plan year operates to enable participants to defer the receipt of compensation. This is the case regardless of whether the plan permits participants to convert the unused contributions or benefits into another benefit in the subsequent plan year. For example, a plan that offers participants the opportunity to purchase vacation days (or to receive cash or other benefits under the plan in lieu of vacation days) will not be a cafeteria plan if participants who purchase the vacation days for a plan year are allowed to use any unused days in a subsequent plan year. This is the case even though the plan does not permit the participant to convert, in the subsequent plan year, the unused vacation days into any other benefit. In determining whether a plan permits participants to carry over unused vacation days, a participant will be deemed to have used his nonelective vacation days (i.e., the vacation days with respect to which the participant had no election under the plan) before his elective vacation days. For example, assume that an employer provides a participant with three weeks of vacation for a year and, under the plan, the participant is permitted to receive cash or other benefits in lieu of one of these three weeks. Assume that the participant elects not to exchange the one elective week of vacation for another benefit. If the participant uses two weeks of vacation during the year, he will be treated as having used the two nonelective weeks of vacation. Thus, if the participant is permitted to carry the one unused week over to the next year, the plan will be treated as operating to enable participants to defer the receipt of compensation. Thus, the plan will fail to be a cafeteria plan and the section 125 exception to the constructive receipt rules will not apply.

In addition, a plan that allows participants to use employer contributions for one plan year to purchase a benefit that will be provided in a subsequent plan year operates to enable participants to defer the receipt of compensation.

Q-8. What requirements apply to participants' elections under a cafeteria plan?

A-8. A plan is not a cafeteria plan unless the plan requires that participants make elections among the benefits offered under the plan. A plan may provide that elections may be made at any time. However, benefit elections under a cafeteria plan should be made in accordance with certain guidelines (see Q&A-15) in order for participants to qualify for the protections of the section 125 exception to the constructive receipt rules. An election will not be deemed to have been made if, after a participant has elected and begun to receive a benefit under the plan, the participant is permitted to revoke the election, even if the revocation relates only to that portion of the benefit that has not yet been provided to the participant. For example, a plan that permits a participant to revoke his election of coverage under a dependent care assistance program or of coverage under an accident or health plan after the period of coverage has commenced will not be a cafeteria plan. However, a cafeteria plan may permit a participant to revoke a benefit election after the period of coverage has commenced and to make a new election with respect to the remainder of the period of coverage if both the revocation and new election are on account of and consistent with a change in family status (e.g., marriage, divorce, death of spouse or child, birth or adoption of child, and termination of employment of spouse).

Q-9. What is the tax treatment of benefits offered under a nondiscriminatory cafeteria plan?

A-9. A participant in a nondiscriminatory cafeteria plan will not be treated as having received taxable benefits offered under the plan and thus will not be required to include the benefits in gross income solely because the plan offers the participants the opportunity, before the benefits become currently available to the participant, to elect to receive or not to receive the benefits. Section 125 thus provides an exception to the constructive receipt rules that apply with respect to employee elections among nontaxable and taxable benefits (including cash). These constructive receipt rules generally provide that an individual will be required to include in gross income the taxable benefits that he could have elected to receive if the individual had the opportunity to elect to receive or not to receive the benefits, even though both the opportunity to make this election occurs and the actual election is made before the benefits become currently available to the individual. Section 125 does not, however, alter the application of the constructive receipt rules to a situation in which benefits become currently available to an individual even though the individual elects not to receive and does not actually receive the benefits. Thus, if taxable benefits become currently available to a participant in a nondiscriminatory cafeteria plan, the participant will be taxable on the benefits, even though the participant has elected or subsequently elects not to receive the benefits and does not actually receive the benefits.

Q-10. What is the tax treatment of benefits offered under a discriminatory cafeteria plan?

A-10. The section 125 exception to the constructive receipt rules is not available to the highly compensated participants in a cafeteria plan that is discriminatory for a plan year. Thus, a highly compensated participant in a cafeteria plan that is discriminatory for a plan year will be taxable on the combination of the taxable benefits with the greatest aggregate value that he could have selected for the plan year. The section 125 exception to the constructive receipt rules remains available to participants who are not highly compensated without regard to whether the cafeteria plan is discriminatory.

Q-11. How are the amounts taxable to a highly compensated participant because a cafeteria plan is discriminatory for a plan year to be allocated among the benefits actually selected by the participant for the plan year?

A-11. A highly compensated participant in a discriminatory cafeteria plan is taxable on the maximum taxable benefits that he could have selected for the plan year. For example, assume that a cafeteria plan provides a highly compensated participant with the opportunity to select, for a plan year, benefits costing $1,300 from among the following: up to $300 in cash, coverage under an accident or health plan providing medical expense reimbursement (cost of $800), coverage under an accident or health plan providing disability benefits (cost of $200), coverage under a qualified legal services plan (cost of $400), and coverage under a dependent care assistance program (cost of $400). For the plan year in question, the participant elects to receive $100 in cash, coverage under both of the accident or health plans ($800 and $200), and coverage under the dependent care assistance program ($400). If the cafeteria plan is discriminatory for the plan year, the participant will be taxable on the $100 cash benefit actually selected and on the $200 cash benefit that the participant could have selected. This $300 will be allocated, first, to the taxable benefits actually selected by the participant and second, on a pro rata basis to the nontaxable benefits actually selected by the participant. Thus $100 is allocated to the $100 cash benefit actually received and the $200 is allocated as employee contributions among the nontaxable benefits actually selected as follows: $100 to coverage under the accident or health plan for medical care, $33.33 to the coverage under the accident or health plan for disability benefits, and $66.67 to the coverage under the dependent care assistance program. This allocation would not affect the nontaxable status of any of these benefits—the purchase of coverage under any of these plans with employee contributions would not trigger taxable income—but it may affect the taxability of amounts received under any of the plans. In addition, depending upon whether other conditions are satisfied, the participant may be able to deduct under section 213 some or all of the employee cost of the coverage under the accident or health plan for medical care. Thus, reimbursements received by the participant for medical care expenses incurred during the year of coverage may be nontaxable under either section 104(a)(3) or section 105(b), depending upon whether the reimbursements are attributable to after-tax employee or pre-tax employer contributions. Also, if the participant became disabled during the year of coverage, benefits provided under the accident or health plan would be nontaxable to the participant under section 104(a)(3) to the extent that the benefits were attributable to the portion of the coverage purchased with the after-tax employee contributions. Finally, any reimbursements received under the dependent care assistance program for the year of coverage will be nontaxable under section 129 if the requirements of that section are satisfied.

Q-12: When must a highly compensated participant in a discriminatory cafeteria plan include in gross income amounts attributable to the taxable benefits that the participants could have selected, but did not in fact select?

A-12: Amounts required to be included in gross income by a highly compensated participant because a cafeteria plan does not satisfy the applicable nondiscrimination standards for a plan year will be treated as received or accrued in the participant's taxable year within which ends the plan year with respect to which an election was or could have been made.

Q-13: Who are highly compensated participants under section 125?

A-13: The term "highly compensated participant" means a participant who is an officer, a shareholder owning more than 5 percent of the voting power or value of all classes of stock of the employer, or highly compensated. The classification of a participant as highly compensated for this purpose will be made on the basis of the facts and circumstances of each case. A spouse or a dependent (within the meaning of section 152) of any such "highly compensated participant" will be treated as highly compensated.

Q-14: When will a benefit be treated as currently available to a participant in a cafeteria plan?

A-14: A benefit is treated as currently available to a participant if the participant is free to receive the benefit currently at his discretion or the participant could receive the benefit currently if an election or notice of an intent to receive the benefit were given. A benefit will not be treated as not currently available merely because of a requirement that the participant must elect or give notice of intent to receive the benefit in advance of receipt of the benefit. However, a benefit is not currently available to a participant if there is a substantial limitation or restriction on the participant's receipt of the benefit. A benefit will not be treated as currently available if the participant may under no circumstances receive the benefit before a particular time in the future and there is a substantial risk that, if the participant does not fulfill specified conditions during the period preceding this time, the participant will not receive the benefit.

Q-15: What procedures with respect to benefit elections should a cafeteria plan adopt in order to assure that participants are not subject to tax, under the constructive receipt rules, on taxable benefits that the participants have elected not to receive?

A-15: Generally, in order for participants to avoid constructive receipt with respect to taxable benefits offered under a cafeteria plan, the taxable benefits must at no time become currently available to the participants. Thus, a cafeteria plan should require participants to elect the specific benefits that they will receive before the taxable benefits become currently available. A benefit will not be treated as currently available as of the time of the election if the election specifies the future period for which the benefit will be provided and the election is made before the beginning of this period.

In addition, after the beginning of the specified period for which the benefits are provided, the taxable benefits must not become currently available to the participants. After the commencement of this period, taxable benefits will be treated as currently available if participants have the right to revoke their elections of nontaxable benefits and instead to receive the taxable benefits for such period, without regard to whether the participants actually revoke their elections. For example, assume that a cafeteria plan offers each participant the opportunity to elect, for a plan year, between coverage under a dependent care assistance program for up to $2000 of the dependent care expenses incurred by the participant during the plan year or a cash benefit of $2000 for the year. If the plan requires participants to elect between these benefits before the beginning of the plan year and, after the year has commenced, the participants are prohibited from revoking their elections, participants who elected coverage under the dependent care assistance program will not be taxable on the cash benefit of $2000. But if, after the beginning of the plan year, participants have the right to revoke their elections of coverage under the dependent care assistance program and thereby to receive the cash benefit, the participants will be treated as having received the $2000 in cash even though they do not revoke their elections. The same result would obtain even though the cash benefit is not payable until the end of the plan year. See Q&A-6, however, regarding the revocation of elections on account of changes in family status.

Q-16: Do the rules of section 125 affect whether any particular benefit offered under a cafeteria plan is a taxable or nontaxable benefit?

A-16: Generally, no. A benefit that is nontaxable under its Internal Revenue

Code when offered separately is treated as a nontaxable benefit under a cafeteria plan only if the rules providing for the exclusion of the benefit from gross income continue to be satisfied when the benefit is offered under the cafeteria plan. For example, if $50,000 in group-term life insurance is offered under a cafeteria plan and the rules under section 79(a) governing the exclusion of the cost of this benefit from gross income are satisfied, the rules of section 79(d) still apply to determine the status of the benefit as taxable or nontaxable for key employees who participate in the plan. See Q&A-17 and Q&A-18, however, regarding the inclusion of coverage under an accident or health plan, dependent care assistance program, or qualified group legal services plan in a cafeteria plan.

Similarly, if a cafeteria plan offers benefits that are nontaxable under the Internal Revenue Code when offered outside of a cafeteria plan, but are prohibited from inclusion in a cafeteria plan, the benefits will be treated as taxable benefits under the cafeteria plan. Thus, coverage under a qualified transportation plan (section 124) and coverage under an educational assistance program (section 127) will be treated as taxable benefits if offered under a cafeteria plan. Also, any benefits (either reimbursement for expenses or in kind benefits) received by a participant under a qualified transportation plan or an educational assistance program will be taxable if the benefits are provided under a cafeteria plan.

Finally, if a benefit that is taxable under the Internal Revenue Code when offered separately is offered under a cafeteria plan, the benefit will continue to be a taxable benefit under the cafeteria plan. For example, if a cafeteria plan offers a participant the opportunity to direct the employer to make charitable contributions or contributions to an individual retirement account on behalf of the participant, such contributions must be included in the participant's gross income for income and employment tax purposes without regard to whether the plan satisfies section 125 and without regard to whether the contributions are deductible by the participant.

Q-17. How are the specific rules of section 105, providing an income exclusion for amounts received as reimbursement for medical care expenses under an accident or health plan, to be applied when coverage under an accident or health plan is offered as a benefit under a cafeteria plan?

A-17. Section 105(b) provides an exclusion from gross income for amounts that are paid to an employee under an employer-funded accident or health plan specifically to reimburse the employee for certain medical care expenses incurred by the employee during the period for which the benefit is provided to the employee, i.e., the period during which the employee is covered under the accident or health plan. Section 105(h) provides that the exclusion provided by section 105(b) is not available with respect to certain amounts received by a highly compensated individual (as defined in section 105(h)(5)) under a discriminatory self-insured medical reimbursement plan. Several rules are of particular importance when coverage under an accident or health plan is a benefit offered under a cafeteria plan.

First, in order for medical care reimbursements paid to a participant under a cafeteria plan to be treated as nontaxable under section 105(b), the reimbursements must be paid pursuant to an employer-funded "accident or health plan" as defined in section 105(e) and § 1.105-5. This means that although the reimbursements need not be provided under a commercial insurance contract, the reimbursements must be provided under a benefit that exhibits the risk-shifting and risk-distribution characteristics of insurance. A benefit will not exhibit the required risk-shifting and risk-distribution characteristics, even though the benefit is provided under a commercial insurance contract, if the ordinary actuarial risk of the insurer is negated either under the terms of the benefit or by any related benefit or arrangement (including arrangements formally outside of the cafeteria plan).

Second, a cafeteria plan benefit under which a participant will receive reimbursements of medical expenses is a benefit within sections 106 and 105(b) only if, under the benefit, reimbursements are paid specifically to reimburse the participant for medical expenses incurred during the period of coverage. Amounts paid to a participant as reimbursement are not treated as paid specifically to reimburse the participant for medical expenses if, under the benefit, the participant is entitled to the amounts, in the form of cash (e.g., routine payment of salary) or any other taxable or nontaxable benefit, irrespective of whether or not he incurs medical expenses during the period of coverage, even if the participant will not receive the amounts not used for expense reimbursement until the end of the period. A benefit under which participants will receive reimbursement for medical expenses up to a specified amount and, if they incur no expenses, will receive cash or any other benefit in lieu of the reimbursements is not a benefit that qualifies for the exclusions under sections 106 and 105(b). See § 1.106-1. This is the case without regard to whether the benefit was purchased with contributions made at the employer's discretion, at the participant's discretion (such as pursuant to a salary reduction agreement), or pursuant to a collective bargaining agreement. For example, if a cafeteria plan offers participants coverage under an employer-funded plan that provides for the reimbursement of medical expenses incurred during the plan year up to a specified amount (e.g., $1,000) and the participants are entitled to receive, in the form of any other taxable or nontaxable benefits (including deferrals under a cash or deferred arrangement), any portion of the specified amount that is not paid as reimbursement for medical expenses, the employer contributions used to purchase the coverage will not qualify for the section 106 exclusion and any reimbursements paid to participants for expenses incurred during the year of coverage will not be eligible for the section 106(b) exception. Arrangements formally outside of the cafeteria plan that provide for the adjustment of a participant's compensation or a participant's receipt of any other benefits on the basis of the expenses incurred or reimbursements received by the participant will be considered in determining whether the reimbursements are provided under a benefit eligible for the exclusions under sections 106 and 105(b).

Third, the medical expenses that are reimbursed under an accident or health plan must have been incurred during the period for which the participant is actually covered by the accident or health plan in order for the reimbursements to be excluded from gross income under section 105(b). For purposes of this rule, expenses are treated as having been incurred when the participant is provided with the medical care that gives rise to the medical expenses, and not when the participant is formally billed, charged for, or pays for the medical care. Also, for purposes of this rule, medical expenses that are incurred before the later of the date the plan is in existence and the date the participant is enrolled in the plan will not be treated as having been incurred during the period for which the participant is covered by the plan. Thus, in order for reimbursements to be excluded from gross income under section 105(b), the accident or health plan must provide a participant the right to reimbursement for medical expenses under an accident or health plan, a dependent care assistance program, or a qualified group legal services plan only for periods during which the participant expects to receive medical care, dependent care, or legal services (Q&A-17 and Q&A-18), such benefit will not be deemed solely on account of such failure to have failed to satisfy the statutory rules providing for the income exclusion of such coverage or of any benefits provided thereunder, if, by September 4, 1984, the cafeteria plan is amended to operate in accordance with such election of coverage rule. A cafeteria plan may treat the portion of its current plan year remaining after September 4, 1984 as a new period of coverage and as an initial plan year for purposes of satisfying the rule prohibiting a plan from operating to enable participants to elect coverage under an accident or health plan, dependent care assistance program, or qualified group legal services plan only for periods during which they expect to receive medial care, dependent care, or legal services (Q&A-17 and Q&A-18).

In addition, if the conditions set forth below are satisfied, employer contributions (including elective and nonelective contributions) made before June 1, 1984 under an arrangement described in the next sentence which is part of a cafeteria plan, will not be treated as having been made to an accident or health plan, dependent care assistance program, or qualified group legal services plan that fails to satisfy the rules contained in the second and third paragraphs of Q&A-17 and the first paragraph of Q&A-18 merely because, for a plan year, a participant was entitled to receive, in the form of cash or any other taxable or nontaxable benefit, amounts available for reimbursement under the arrangement without regard to whether covered expenses are incurred. An arrangement is described in this sentence only if, under the arrangement,

(i) An account was actually established on behalf of the participant by the employer, by an entry on the employer's books or in similar fashion, prior to the beginning of the plan year (or prior to the date on which an individual first becomes eligible to participate under the arrangement in the case of an individual who first becomes eligible to participate on account of years of employment during the plan year);

(ii) The amount (or specific rate) of contributions to the account under the arrangement was fixed prior to the beginning of the plan year,

(iii) Neither the participant nor the employer possessed the right to increase or decrease contributions to the account during the plan year (but a plan may provide that contributions could be terminated during the year on account of the participant's (a) separation from service or (b) cessation of participation under the arrangement for the remainder of the plan year);

(iv) Contributions were actually deposited in or credited to the account before being made available for reimbursement, and

(v) Distributions were not available for reasons other than reimbursement of covered expenses until the end of the plan year (but a plan may provide that a single distribution of the unreimbursed balance may be made on account of the participant's (a) separation from service or (b) cessation of participation under the arrangement for the remainder of the plan year).

A cafeteria plan may operate on a plan year other than the calendar year for purposes of this transitional rule, so long as terms of the plan permit contributions to a plan to be fixed only once during, and a distribution of the unreimbursed amount to be received, only once for any plan year, provided that contributions may be fixed for a short plan year of the plan's first period of operation. This transitional rule does not affect or alter the requirement of Q&A-17 and 18 that expenses that are reimbursed under an arrangement must have been incurred during the period for which the participant actually is covered by the arrangement.

Roscoe L. Egger, Jr.,

Commissioner of Internal Revenue.

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during the period of coverage on account of changes in family status.

Finally, if coverage under a dependent care assistance program is a benefit offered under a cafeteria plan, the rules of section 129 will determine the status of the benefit as a taxable or nontaxable benefit. As a result, coverage under a dependent care assistance program in a cafeteria plan will be nontaxable for a plan year only if, among other requirements, the principal shareholder and owner discrimination test contained in section 129(d)(4) is satisfied with respect to employer contributions actually used to provide participants with dependent care assistance during the plan year. In addition, amounts paid or incurred by the employer under a dependent care assistance program are excludable from gross income only to the extent that these amounts do not exceed the lesser of the participant's earned income or the participant's spouse's earned income.

Rules similar to the rules applicable to dependent care assistance program apply with respect to coverage under a qualified group legal services plan (section 120) offered as a benefit under a cafeteria plan.

Q-19. What are the rules governing whether a cafeteria plan is discriminatory?

A-19. The applicable discrimination rules under section 125 provide that, in order to be treated as nondiscriminatory for a plan year, a cafeteria plan must not discriminate in favor of highly compensated participants as to benefits and contributions for that plan year. Generally, this discrimination determination will be made on the basis of the facts and circumstances of each case. Section 125(c) provides that a cafeteria plan does not discriminate where either (i) total nontaxable benefits and total benefits or (ii) employer contributions allocable to total nontaxable benefits and employer contributions allocable to total benefits do not discriminate in favor of highly compensated participants. A cafeteria plan must satisfy section 125(c) with respect to both benefit availability and benefit selection. Thus, a plan must give each participant an equal opportunity to select nontaxable benefits, and the actual selection of nontaxable benefits under the plan must not be discriminatory, i.e., highly compensated participants do not disproportionately select nontaxable benefits while other participants select taxable benefits.

In addition to not discriminating as to either benefit availability or benefit selection, a cafeteria plan must not discriminate in favor of highly compensated participants in actual operation. A plan may be discriminatory in actual operation if the duration of the plan (or of a particular nontaxable benefit offered under the plan) coincides with the period during which highly compensated participants utilize the plan (or the benefit).

Q-20. May nontaxable benefits provided under a cafeteria plan be counted as "compensation" under section 401(a)(5) for purposes of determining whether a qualified pension, profit-sharing, or stock bonus plan discriminates under section 401(a)(4), or under section 415 for purposes of the limitations contained in that section?

A-20. A qualified pension, profit-sharing, or stock bonus plan will not be treated as discriminatory within the meaning of section 401(a)(4) merely because, for purposes of allocating contributions to the participant or calculating the participant's benefit under the plan, the plan considers nontaxable benefits provided to a participant as compensation. For example, if a participant in a cafeteria plan elects coverage under an accident or health plan, the value of such coverage may be considered as compensation under a qualified plan for purposes of calculating the participant's allocation or benefit under the qualified plan. Nontaxable reimbursements under the accident or health plan, however, generally may not be treated as compensation under a qualified plan. Similarly, the value of coverage under a dependent care assistance program may be counted as compensation under a qualified plan for allocation and benefit purposes, but nontaxable reimbursements of dependent care expenses under the program generally may not be treated as compensation for these purposes. On the other hand, a qualified plan will not be treated as discriminatory under section 401(a)(4) merely because the plan does not consider nontaxable benefits, such as coverage under an accident or health plan or coverage under a dependent care assistance program, as compensation for allocation or benefit purposes under the plan.

For purposes of section 415, "compensation" does not include amounts that are excluded from gross income, such as premiums for group-term life insurance under section 79 or employer contributions to an accident or health plan excluded under section 106.

Q-21. What are the effective dates of the rules contained in these questions and answers?

A-21. These rules contained in questions and answers relating to section 125 generally shall apply to plan years of cafeteria plans beginning after December 31, 1978. However, a cafeteria plan that failed to satisfy one or more of the following rules for plan years beginning before May 7, 1984 will not be deemed thereby to have failed to satisfy section 125 for such plan years if, by September 4, 1984, the plan is amended to operate in accordance with these rules: (i) the rules requiring certain information to be included in the cafeteria plan document (Q&A-3), (ii) the rules governing the active participation of a participant's spouse in a cafeteria plan (Q&A-4), (iii) only in the case of a plan under which participants were permitted neither to carry over unused benefits for more than one plan year nor to convert, into any other benefits, any unused benefits that had been carried over to a subsequent plan year, the rules prohibiting the carryover of any unused contribution or benefit from one plan year to a subsequent plan year (Q&A-7), and (iv) the rules limiting the revocability of benefit elections (Q&A-8). A cafeteria plan may treat the portion of its current plan year remaining after September 4, 1984 as a new period of coverage for purposes of satisfying the rules governing benefit elections (Q&A-8). Also, a benefit offering participants the opportunity to make elective contributions under a qualified cash or deferred arrangement may be included in a cafeteria plan only in plan years beginning after December 31, 1980.

The rules contained in Q&A-17 governing the taxability of coverage and benefits under an accident or health plan relate specifically to sections 105 and 106 and thus generally are effective with respect to all taxable years beginning after December 31, 1953. The rules contained in Q&A-18 governing the taxability of coverage and benefits under a dependent care assistance program relate specifically to section 129 and thus generally are effective with respect to all taxable years beginning after December 31, 1981. The rules contained in Q&A-18 governing the taxability of coverage and benefits under a qualified group legal services plan relate specifically to section 120 and thus generally are effective with respect to all taxable years beginning after December 31, 1976. However, if coverage under an accident or health plan, dependent care assistance program, or qualified group legal services plan was offered as a benefit under a cafeteria plan and such benefit failed to satisfy, before May 7, 1984, the rule prohibiting a plan from operating to enable a participant to elect coverage rred during a specified period of coverage. Reimbursements of expenses incurred prior to or after the specified period of coverage will not be excluded under section 105(b). However, the actual reimbursement of covered medical care expenses may be made after the applicable period of coverage.

Fourth, in order for reimbursements under an accident or health plan to qualify for the section 105(b) exclusion, the cafeteria plan may not operate in a manner that enables participants to purchase coverage under the accident or health plan only for periods during which the participants expect to incur medical care. For example, if a cafeteria plan permits participants to purchase coverage under an accident or health plan on a month-by-month or an expense-by-expense basis, reimbursements under the accident or health plan will not qualify for the section 105(b) exclusion. If, however, the period of coverage under an accident or health plan offered in a cafeteria plan is twelve months (or, in the case of a cafeteria plan's initial plan year, at least equal to the plan year) and the plan does not permit a participant to select specific amounts of coverage, reimbursement, or salary reduction for less than twelve months, the cafeteria plan will be deemed not to operate to enable participants to purchase coverage only for periods during which medical care will be incurred. See Q&A-8 regarding the revocation of elections during a period of coverage on account of changes in family status.

Fifth, in order for reimbursements to a highly compensated individual under a self-insured accident or health plan to be treated as nontaxable under a cafeteria plan, the discrimination rules of section 105(h) must be satisfied. For purposes of these rules, coverage under a self-insured accident or health plan offered by a cafeteria plan will be treated as an optional benefit (even if only one level and type of coverage is offered) and, for purposes of the optional benefit rule in § 1.105-11(c)(3)(i), employer contributions will be treated as employee contributions to the extent that taxable benefits are offered by the plan. In addition, the accident or health plan offered by the cafeteria plan must provide for the nondiscriminatory reimbursement of expenses on a per capita basis, rather than as a proportion of compensation.

Q-18 How are the specific rules of section 129 providing an income exclusion for dependent care assistance provided under a dependent care assistance program, to be applied when coverage under a dependent care assistance program is offered as a benefit under a cafeteria plan?

A-18 Section 129(a) provides an employee with an exclusion from gross income both for employer-funded coverage under a dependent care assistance program and for amounts paid or incurred by the employer for dependent care assistance provided to the employee if the amounts are paid or incurred under a dependent care assistance program. A program under which participants receive reimbursements of dependent care expenses up to a specified amount and are entitled to receive, in the form of any other taxable or nontaxable benefits, any portion of the specified amount not used for reimbursement is to be treated as a single benefit that is not a dependent care assistance program within the scope of section 129. Thus, dependent care assistance provided under a cafeteria plan will be treated as provided under a dependent care assistance program only if, after the participant has elected coverage under the program and the period of coverage has commenced, the participant does not have the right to receive amounts under the program other than as reimbursements for dependent care expenses. This is the case without regard to whether coverage under the program was purchased with contributions made at the employer's discretion, at the participant's discretion, or pursuant to a collective bargaining agreement. For example, assume a cafeteria plan allows participants to elect to receive, for a particular plan year, either the right to reimbursements of dependent care expenses incurred during the year up to $2000 or a cash benefit of $2000. If the participant elects the right to receive reimbursements of dependent care expenses, the reimbursements will not be treated as made under a dependent care assistance program if, after the period of coverage has commenced, the participant has the right to revoke his election of this benefit and instead to receive the cash or if, under the terms of the program itself, the participant is entitled to receive, in the form of cash (e.g., routine payment of salary) or any other benefit, any amounts not reimbursed for dependent care provided during the period of coverage. Arrangements formally outside of the cafeteria plan that provide for the adjustment of a participant's compensation or a participant's receipt of any other benefits on the basis of the assistance or reimbursements received by the participant will be considered in determining whether a dependent care benefit is a dependent care assistance program under section 129.

Moreover, in order for dependent care assistance to be treated as provided under a dependent care assistance program eligible for the section 129 exclusion, the care must be provided to or on behalf of the participant during the period for which the participant is covered by the program. For example, if a participant elects coverage for a plan year under a dependent care assistance program that provides for the reimbursement of dependent care expenses, only reimbursements for dependent care expenses incurred during that plan year will be treated as having been provided under a dependent care assistance program within the scope of section 129. For purposes of this rule, dependent care expenses will be treated as having been incurred when the dependent care is provided, and not when the participant is formally billed, charged for, or pays for the dependent care. Also, for purposes of this rule, expenses that are incurred before the later of the date the program is in existence and the date the participant is enrolled in the program will not be treated as having been incurred during the period for which the participant is covered by the program. Similarly, if the dependent care assistance program furnishes the dependent care in kind (e.g., under an employer-maintained child care facility), only dependent care provided during the plan year of coverage will be treated as having been provided under an dependent care assistance program within the scope of section 129.

In addition, in order for dependent care assistance under a cafeteria plan to be treated as provided under a dependent care assistance program eligible for the section 129 exclusion, the plan may not operate in a manner that enables participants to purchase coverage under the program only for periods during which the participants expect to receive dependent care assistance. If the period of coverage under a dependent care assistance program offered by a cafeteria plan is twelve months (or, in the case of a cafeteria plan's initial plan year, at least equal to the plan year) and the plan does not permit a participant to select specific amounts of coverage, reimbursement, or salary reduction for less than twelve months, the plan will be deemed not to operate to enable participants to purchase coverage only for periods during which dependent care assistance will be received. See Q&A-8 regarding the revocation of elections

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[EE-16-79]

Tax Treatment of Cafeteria Plans (Transition Rules); Notice of Proposed Rulemaking

AGENCY: Internal Revenue Service, Treasury.

ACTION: Amendment of notice of proposed rulemaking

SUMMARY: This document contains proposed amendments to a notice of proposed rulemaking which was published in the Federal Register on May 7, 1984 (49 FR 19321). That notice contained proposed regulations relating to the tax treatment of cafeteria plans. Changes to the applicable tax law necessitating the proposed amendments were made by section 531(b)(5) of the Tax Reform Act of 1984. The proposed amendments relate to general and special transition relief under the proposed regulations and provide the public with the guidance needed to comply with that Act.

DATE: Written comments and requests for a public hearing must be delivered or mailed by January 30, 1985. The proposed regulations are generally to be effective for plan years beginning after December 31, 1978, but are subject to the general and special transition rules.

ADDRESS: Send comments and requests for a public hearing to Commissioner of Internal Revenue, Attention: CC:LR:T (EE-16-79), Washington, D.C. 20224.

FOR FURTHER INFORMATION CONTACT: Harry Beker of the Employee Plans and Exempt Organizations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:EE) (202-[illegible]) (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the notice of proposed rulemaking under section 125 of the Internal Revenue Code of 1954. On May 7, 1984 the Federal Register published proposed regulations relating to the tax treatment of cafeteria plans (49 FR 19321). The regulations in this document are being proposed in order to replace portions of those earlier proposed regulations which have been rendered obsolete by section 531(b)(5) of the Tax Reform Act of 1984 (98 Stat. 494). The proposed regulations are issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 26 U.S.C. 7805).

On February 10, 1984, the Internal Revenue Service issued a news release (IR-84-22) which stated that so-called "flexible spending arrangements" do not provide employees with nontaxable benefits under the Code because, under such arrangements, employees are assured of receiving the benefit of what they would have received had no covered expenses been incurred.

On May 7, 1984, proposed regulations in question and answer form were published in the Federal Register. Q & A-21 provided that the proposed regulations were generally to be effective for cafeteria plan years beginning after December 31, 1978. However, as to particular rules in the proposed regulations, a cafeteria plan could be amended by September 4, 1984 to meet those particular rules and thus the requirements of the proposed regulations. In addition, as to benefits provided under a flexible spending arrangement which was part of a cafeteria plan, if such arrangement met specified conditions, the benefits (funded by employer contributions made before June 1, 1984) qualified for the statutory exclusion notwithstanding that a cash-out of unused contributions was available at the end of the plan year.

General Rules

The Tax Reform Act of 1984 renders Q&A-21 obsolete and provides both general and special transition relief from certain of the rules in the proposed regulations for certain cafeteria plans and flexible spending arrangements. First, as to plans and arrangements which were in existence on or before February 10, 1984 (or for which substantial implementation costs had been incurred before such date) and which failed on or before such date and

...ntinued to fail thereafter to satisfy the [pro]posed regulations, general transition [reli]ef is provided until January 1, 1985, [p]rovided that the plans or arrangements [a]re not modified after February 10, 1984, [t]o allow additional benefits.

Second, as to flexible spending arrangements which qualify for general transition relief through December 31, 1984, under which an employee must fix the amount of contributions before the beginning of the period of coverage and under which unused contributions generally are not available to the employee before July 1, 1985, special transition relief is available until July 1, 1985, provided there are no modifications after December 31, 1984, which allow for additional benefits.

Section 7805(b) Relief For Amended and Suspended Plans and Benefits

Section 531(b)(5)(A) of the Tax Reform Act grants general transition relief only to cafeteria plans and benefits (including benefits that are provided through flexible spending arrangements) that failed on or before February 10, 1984, and "continued to fail thereafter" to satisfy the rules in the proposed regulations. In addition, general transition relief is available only until the effective date, after February 10, [19]84, "of any modification to provide [ad]ditional benefits."

A plan or benefit that has been modified (by amendment or otherwise) after February 10, 1984, so that the plan or benefit no longer continues to fail one or more of the rules of the proposed regulations (a "conforming modification") does not "continue to fail thereafter" and therefore does not meet the requirement of the statute for continued general transition relief with respect to the rule or rules in question. For example, if contributions or reimbursements (or both) under a flexible spending arrangement have been suspended, the benefit provided through the flexible spending arrangement does not satisfy the statute for continued relief. Furthermore, a modification to restore a plan or benefit to its condition before a conforming modification (e.g., a reactivation of contributions or reimbursements or both under a suspended flexible spending arrangement) would be a "modification to provide additional benefits." Therefore, as to a plan or benefit which, after February 10, 1984, was modified so that it no longer failed to satisfy one or more of the rules in the proposed regulations, general transition relief is [a]vailable only until the effective date of [th]e modification but not thereafter with [r]espect to the rule or rules in question. These statutory requirements are reflected in Q&A-28.

The Internal Revenue Service has determined, however, that participants in plans or benefits that were modified after February 10, 1984, so that they no longer fail to satisfy one or more of the rules in the proposed regulations should not be disadvantaged because of such conforming modifications. In order to limit any adverse effect upon those participants, the Internal Revenue Service has determined to grant such plans and benefits relief under section 7805(b) of the Internal Revenue Code (See Q&A-29). Accordingly, the rules delineated in Q&A-27 generally do not become effective with respect to such plans or benefits until January 1, 1985.

Pursuant to the grant of section 7805(b) relief, a plan or benefit that has been modified after February 10, 1984, so that it no longer fails to satisfy one or more of the rules in the proposed regulations may be further modified and continue in operation until December 31, 1984, but only under the same terms that applied immediately before the conforming modification. However, because such modified plans or benefits do not qualify for general transition relief through December 31, 1984, special transition relief is not available to such plans or benefits.

In addition, pursuant to the grant of section 7805(b) relief, certain relief is available, as set forth in Q&A-29, for cafeteria plans or benefits that were eligible for transition relief under the regulations proposed on May 7, 1984, but are not eligible for general transition relief under Q&A-28.

Nonapplicability of Executive Order 12291

The Treasury Department has determined that this Regulation is not subject to review under Executive Order 12291 or the Treasury and Office of Management and Budget Implementation of the Order dated April 29, 1983.

Regulatory Flexibility Act

Although this document is a notice of proposed rulemaking which solicits public comment, the Internal Revenue Service has concluded that the regulations proposed herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these proposed regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

Comments and Request for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably eight copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

Drafting Information

The principal author of these proposed regulations is Harry Beker of the Employee Plans and Exempt Organizations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

List of Subjects in 26 CFR 1.61-1—1.281-4

Income taxes, Taxable income.

Proposed Amendments to the Regulations

The proposed amendments to 26 CFR Part 1 are as follows:

Paragraph 1. Q&A-21 of proposed § 1.125-1 as published in the Federal Register on May 7, 1984 (49 FR 19322-19329) is removed.

Par. 2. New Qs & As of proposed § 1.125-1 are added to read as follows:

§ 1.125-1 Questions and Answers Relating to Cafeteria Plans

* * * * *

Q-21: What are the general effective dates of the rules in Q&A-1 through Q&A-20? A-21: The rules in Q&A-1 through Q&A-20 relating to section 125 generally apply to plan years of cafeteria plans beginning after December 31, 1978.

The rules in Q&A-17 governing the taxability of coverage and benefits received under an accident or health plan relate specifically to sections 105 and 106 and thus generally are effective with respect to all taxable years beginning after December 31, 1953. The rules in Q&A-18 governing the taxability of coverage and benefits received under a dependent care assistance program relate specifically to section 129 and thus generally are effective with respect to all taxable years beginning after December 31, 1981. The rules in Q&A-19 governing the taxability of coverage and benefits received under a qualified group legal services plan relate specifically to section 120 and thus generally are effective with respect to all taxable years beginning after December 31, 1976.

See Q&A-25 through Q&A-28 for the general and special transition rules which provide delayed effective dates with respect to certain of these rules. See also Q&A-29 for certain relief that is available for cafeteria plans or benefits that were eligible for transition relief under the regulations proposed on May 7, 1984, but are not eligible for general transition relief under Q&A-25.

Q-22: Which cafeteria plans and benefits provided under cafeteria plans are eligible for the general and special transition relief?

A-22: There are two transition rules providing delayed effective dates with respect to certain of the rules in Q&A-1 through Q&A-20. First, general transition relief, as described in Q&A-25 and Q&A-27, is provided to cafeteria plans that were in existence on or before February 10, 1984, and to benefits (including benefits that are provided through flexible spending arrangements) in existence on or before such day. Second, special transition relief, as described in Q&A-28, is provided to certain benefits (including benefits that are provided through flexible spending arrangements) that (i) were in existence on or before February 10, 1984, and (ii) qualify for general transition relief through December 31, 1984. See Q&A-23 and Q&A-24 for the rules for determining whether a cafeteria plan for a benefit was in existence on or before February 10, 1984.

Flexible spending arrangements are used to pay benefits such as medical, legal, or dependent care assistance that are intended to qualify as nontaxable under the applicable rules of the Code. Generally, under the flexible spending arrangement form of a benefit, a participant is assured of receiving, in salary, cash or some other form, amounts that are available for expense reimbursement during the period of coverage without regard to whether the participant incurs covered expenses during the period.

Plans or arrangements that are not cafeteria plans because of a failure to satisfy one or more of the rules specified in Q&A-27 will be treated as cafeteria plans solely for purposes of the transition relief set forth in Q&A-21 through Q&A-29. For example, a plan providing only a medical benefit through a flexible spending arrangement will be treated as a cafeteria plan for purposes of the transition relief only. Also, a plan under which a participant may elect among two or more benefits, each of which would be nontaxable but for the failure of one of the benefits to satisfy certain of the requirements in Q&A-17 or Q&A-18, will be treated as a cafeteria plan to determine eligibility for transition relief under Q&A-21 through Q&A-29.

Q-23: What rules apply to determine whether a cafeteria plan or a benefit was in existence on or before February 10, 1984?

A-23: A cafeteria plan will be treated as in existence on or before February 10, 1984, if on or before such day (i) the plan was reduced to writing and communicated to employees in written form and (ii) amounts were contributed with respect to benefits provided under the plan.

A cafeteria plan will be treated as having been reduced to writing if the available benefits and the operation of such plan have been fully described in written form (e.g., by summary plan description or plan brochure), even though a formal plan document may not have been written. Amounts will be treated as having been contributed with respect to benefits provided under the plan if the employer made contributions (including contributions pursuant to salary reduction agreements) to purchase or provide benefits elected under the plan.

A cafeteria plan that was not actually in existence on or before February 10, 1984, nevertheless will be treated as in existence on or before such day if the employer incurred "substantial implementation costs" with respect to that particular plan. See Q&A-24 for the discussion of the rules applicable to the "substantial implementation cost" determination.

A benefit will be treated as in existence on or before February 10, 1984, only if on or before such day (i) the benefit was part of a cafeteria plan that was in existence on or before February 10, 1984, (ii) the benefit was fully described in written form and communicated to employees in such form (e.g., as part of the summary plan description or plan brochure), and (iii) amounts were contributed with respect to the benefit under the plan. A benefit that was not actually in existence on or before February 10, 1984, is not eligible for general transition relief.

Q-24: What rules apply in determining whether an employer has incurred "substantial implementation costs" with respect to a particular plan?

A-24: A cafeteria plan that was not actually in existence on or before February 10, 1984, will be treated as in existence on or before such day only if the employer incurred "substantial implementation costs" with respect to that particular plan. An employer will be treated as having incurred "substantial implementation costs" with respect to a particular plan only if, before February 10, 1984, it incurred either more than $15,000 of implementation costs for that plan or more than one-half of the total costs of implementing that plan.

In determining when an implementation cost has been incurred, the time of the performance of the services or production of the product giving rise to the cost, rather than the formal billing or payment of the cost, shall control. Thus, if before February 10, 1984, an employer has paid for services or a product that have not been performed or produced before such day, such cost will not be treated as having been incurred before such day.

Only the costs of designing and installing computer programs and manual accounting systems for the operation of the plan and the costs of printing brochures, descriptions, and election forms for the plan are eligible for treatment as substantial implementation costs. Other cost items (e.g., amounts expended for fees or salaries for feasibility and legal opinions and for designing the plan) are not implementation costs for these purposes.

In order for costs to be treated as implementation costs with respect to a particular cafeteria plan, the costs must be specifically allocable to such plan. As a result, before February 10, 1984, an employer must have intended to establish the particular plan, and the costs in question must be directly related to that plan. An employer's intent to establish a cafeteria plan will be evidenced only if the design specifications for the plan have been developed and agreed upon by February 10, 1984. In addition, costs will not be specifically allocable to a plan if the costs would have been incurred by the employer without regard to whether the plan in question was established. For example, the cost of designing and installing a computer program will be treated as an implementation cost with respect to a particular plan only if such program was specifically designed and installed for that plan as evidenced by plan design specifications developed by February 10, 1984. However, an employer that incurred implementation costs with respect to a particular cafeteria plan may not treat such costs as implementation costs with respect to another plan that had not actually been designed when such costs were incurred.

However, if an employer incurred costs with respect to two cafeteria plans, both of which had been specifically designed and agreed-upon (but not installed) as of the time such costs were incurred, and these costs are not specifically allocable between the plans, the costs are to be allocated on the basis of the number of participants in the two plans. For example, by February 10, 1984, an employer incurred $10,000 for the design of computer programs for the administration of two cafeteria plans—Plan A and Plan B—each of which had been specifically designed as of such day. Because Plan A will cover 25 percent of the employer's workforce and Plan B will cover 75 percent of the workforce, $2,500 of the $10,000 is allocable to Plan A and $7,500 is allocable to Plan B.

Q-25. What relief is provided under the general transition rule?

A-25. In the case of a cafeteria plan or a benefit in a cafeteria plan that qualifies for general transition relief, the general effective dates in Q&A-21 do not apply with respect to the rules specified in Q&A-27. In lieu of the otherwise applicable general effective date, the effective date with respect to the application of a particular rule to a cafeteria plan or a benefit in a cafeteria plan under the general transition rule is the earliest of the following dates: (i) January 1, 1985, (ii) the effective date, after February 10, 1984, of a modification to the particular plan or benefit in question to provide an additional benefit, (iii) the effective date of the termination elimination of the particular plan or benefit in question, and (iv) the effective date, after February 10, 1984, of a modification to the particular plan or benefit in question that causes such plan or benefit no longer to fail to satisfy the particular rule in question ("conforming modification").

Modifications To Provide Additional Benefits

The addition of a new benefit to a cafeteria plan will not be treated as a modification to provide an additional benefit if, as of February 10, 1984, it was the employer's intention, as evidenced in writing and communicated to employees, that the benefit become effective under the plan as of the particular date of addition. For example, if by February 10, 1984, an employer had announced to employees, in writing, that a new medical benefit would become available to participants on November 1, 1984, the addition of the medical benefit on such day will not be treated as a modification to provide additional benefits. However, if the new medical benefit was not actually in existence on February 10, 1984, general transition relief would not be available with respect to the new benefit.

If, after February 10, 1984, an employer modifies a flexible spending arrangement under a cafeteria plan to provide employees with additional rights, such modification would be a modification to such benefit to provide an additional benefit. Examples of additional rights are the right to make additional contributions, make more frequent changes in the amount of their contributions, receive reimbursements for expenses for which reimbursements previously had not been available, receive taxable cash under the arrangement more frequently than had been permitted, and receive new or different treatment of amounts that were available but unused for expense reimbursements (e.g., a cash-out in lieu of or in addition to a carryover). Similarly, if either contributions or reimbursements (or both) with respect to a benefit provided through a flexible spending arrangement were suspended, reactivating contributions or reimbursements (even under the same terms that applied immediately before the suspension) will be treated as a modification to provide additional benefits.

A modification that permits a plan or benefit to conform to the general and special transition rules will not be treated as a modification to provide additional benefits. For example, an extension, from December 15, 1984, until January 15, 1985, of the cut off date by which expense reimbursement claims must be submitted under a flexible spending arrangement for expenses incurred during the period ending on December 31, 1984, will not be a modification to provide an additional benefit. Similarly, an alteration to a flexible spending arrangement so that a period of coverage scheduled to end on February 28, 1985, will end on December 31, 1984, and a new period will run from January 1, 1985, through June 30, 1985, will not be a modification to provide an additional benefit.

A modification, after February 10, 1984, to a plan or benefit that causes the plan or benefit to fail one or more of the rules in the regulations generally will be treated as the provision of an additional benefit. For example, if a medical benefit, which satisfies the applicable rules in sections 105 and 106 and in these regulations, is converted, on May 15, 1984, into a flexible spending arrangement, such conversion will be a modification to provide an additional benefit.

A modification, after February 10, 1984, to permit participation by employees who would not otherwise have become eligible to participate in the plan will be treated as a modification to provide an additional benefit. However, the addition of individuals who first become eligible to participate in a cafeteria plan under the eligibility and participation rules in effect on February 10, 1984, will not be treated as a modification to provide an additional benefit.

Terminations

A benefit will be treated as terminated if the plan is amended to eliminate the benefit and the amendment has taken effect. The rules delineated in Q&A-27 will become effective with respect to the benefit that has been terminated on the effective date of the termination. However, a benefit provided through a flexible spending arrangement will be treated as suspended, rather than terminated, if (i) the employer communicated to employees that either contributions or reimbursements (or both) with respect to the arrangement were being suspended, but might be permitted in the future, and (ii) amounts under the arrangement were not made available to employees during the period of suspension for reasons other than the reimbursement of covered expenses, unless such amounts were otherwise available under the terms of the arrangement in effect immediately before the suspension.

Conforming Modifications

A modification (by amendment or otherwise) that becomes effective after February 10, 1984, and causes a cafeteria plan or a benefit (including a benefit provided through a flexible spending arrangement) no longer to fail to satisfy one or more of the rules in the Q&A-1 through Q&A-20 will be treated as a "conforming modification" that cuts off general transition relief for the particular rule or rules in question; such rule or rules will become effective with respect to the particular plan or benefit on the effective date of the conforming modification. However, notwithstanding that a conforming modification has been made with respect to one or more of the rules in Q&A-1 through Q&A-20, general transition relief remains available to that particular plan or benefit with respect to the rule or rules which have not been so modified. Conforming modifications include both amendments that bring a plan or benefit into conformity with one or more of the rule in Q&A-1 through Q&A-20, and suspensions of contributions or reimbursements (or both) with respect to benefits provided through flexible spending arrangements.

But see Q&A-28 for certain additional relief that is provided to plans or benefits with respect to which conforming modifications have been made.

Q-28. What additional relief is available to cafeteria plans or benefits with respect to which conforming modifications have been made?

A-28. In the case of a plan or benefit that has been modified after February 10, 1984, so that it no longer fails to satisfy one or more of the rules in the proposed regulations, general transition relief with respect to the rule or rules in question is available only until the effective date of such conforming modification but not thereafter (although general transition relief remains available with respect to the rule or rules not so modified). However, pursuant to the authority contained in section 7805(b) of the Internal Revenue Code, the particular rule or rules in question, if delineated in Q&A-27, shall not become effective with respect to such plan or benefit until January 1, 1985.

Such a plan or benefit may therefore be further modified and continue to operation through December 31, 1984, but only under the same terms that applied immediately before the conforming modification. For example, assume that effective April 1, 1984, a flexible spending arrangement was modified by plan amendment to provide that amounts available for medical reimbursement would no longer be available to the employee without regard to whether the employee incurred medical care during the period of coverage. Assuming that such amendment is a conforming modification, the flexible spending arrangement may be further modified to continue in operation through December 31, 1984 under the same terms that applied immediately before the conforming modification.

Because such a modified plan or benefit does not qualify for general transition relief and is permitted to operate through December 31, 1984, only through a grant of section 7805(b) relief, special transition relief as set forth in Q&A-29 is not available to such plan or benefit.

Q-27. Which of the rules in Q&A-1 through Q&A-20 are subject to the general transition rule?

A-27. Relief under the general transition rule is provided with respect to both the cafeteria plan rules and with respect to the rules governing the taxability of benefits.

Cafeteria Plan Rules

The following cafeteria plan rules are subject to general transition relief: (i) the rules requiring that specific information be included in the written cafeteria plan document (Q&A-3); (ii) the rules governing the active participation of a participant's spouse in a cafeteria plan (Q&A-4); (iii) the rules governing the information that must be included in written plan document with respect to salary reduction (Q&A-6) (but the availability of salary reduction must have nevertheless been fully described in written form and communicated to employees in such form); (iv) the rules precluding a plan from operating in a manner that enables participants to defer the receipt of compensation, such as by permitting the carryover of unused benefits from one plan year to another plan year (Q&A-7); (v) the rules limiting the revocability of benefit elections (Q&A-8); and (vi) as described in the following paragraph, the rules governing the scope of the section 125 exception to the generally applicable constructive receipt rules (Q&A-8, Q&A-14, and Q&A-15).

Generally, the general transition rule does not alter the scope of the section 125 exception to the general constructive receipt rules. Thus, an employee will be taxable on taxable benefits, salary or other compensation that he has actually received or that has become currently available (as described in Q&A-14 and without regard to these general transition rules), even though the employee currently or subsequently elects not to receive and actually does not receive such taxable benefits. For example, an employee in a flexible spending arrangement under which otherwise taxable compensation actually received is recharacterized as a nontaxable expense reimbursement will be taxable on such recharacterized amount. However, for purposes of general transition relief, the section 125 exception will provide that (i) an employee will not be treated as having constructively received a taxable benefit (including cash) under a cafeteria plan merely because the employee may revoke an election of a particular benefit with respect to a future period and instead receive the taxable benefit for such period, and (ii) an employee will not be treated as having constructively received amounts that have been set aside subject to a fixed distribution or withdrawal right under an arrangement.

The cafeteria plan rules not delineated in the preceding paragraphs are effective with respect to a plan or benefit as determined under the general effective date rules in Q&A-21.

Not withstanding the application of the effective dates under the general transition rule, a plan may permit an employee to carry over unused amounts from a period of coverage or a plan year ending December 31, 1984, to a period of coverage or plan year beginning on January 1, 1985, without failing the rule precluding a cafeteria plan from operating in a manner to permit participants to defer the receipt of compensation.

Rules Governing the Taxability of Benefits

The following rules governing the taxability of a benefit are subject to the general transition relief (i) in order to qualify for the section 105(b) exclusion from gross income, medical expense reimbursements must be provided under a medical benefit that exhibits the risk-shifting and risk-distribution characteristics of insurance (Q&A-17); (ii) in order to qualify for the section 105(b), 120, or 129 exclusion from gross income, the medical, dependent care, or legal expense reimbursements must be provided under a benefit with respect to which the participant is not entitled to receive, in the form of cash or some other benefit, the amounts available for reimbursement irrespective of whether the participant incurs covered expenses during the period of coverage (Q&A-17 and Q&A-18); (iii) in order to qualify for the section 105(b), 120, or 129 exclusion from gross income, the medical, dependent care, or legal expense reimbursement must be for medical care, dependent care, or legal care incurred during the period for which the participant is actually covered by the benefit (Q&A-17 and Q&A-18); (iv) medical care, dependent care, and legal care are treated as having been incurred when the participant is provided with the care that gives rise to the covered expenses, rather than when the participant is formally billed, charged for, or pays for the care (Q&A-17 and Q&A-18); and (v) in order for medical, dependent care, or legal expense reimbursements to qualify for the section 105(b), 120, or 129 exclusion from gross income, the cafeteria plan does not operate in a manner that enables participants to purchase coverage under the benefit only for periods during which the participants expect to incur covered expenses (Q&A-17 and Q&A-18).

Notwithstanding the application of the effective dates under the general transition rule, a plan may permit an employee to carry over or receive, after December 31, 1984, a cash-out of

...ants available but unused under a ...xible spending arrangement as of December 31, 1984. Similarly, expense reimbursements under a flexible spending arrangement may be made after December 31, 1984, if such reimbursements relate to expenses incurred and contributions made on or before December 31, 1984. Finally, a plan will not be treated as operating to permit participants to elect coverage only for periods in which the participants expect to incur covered expenses merely because the period of coverage with respect to a flexible spending arrangement is terminated on December 31, 1984.

Q-28: What relief is provided under the special transition rule?

A-28: Except as provided below, for purposes of the application of the rules set forth in the following paragraph to a benefit in a cafeteria plan (including a benefit that is provided through a flexible spending arrangement) that qualifies for the general transition rule through December 31, 1984, the otherwise applicable effective dates under the general transition rule, set forth in Q&A-25, will be applied by substituting July 1, 1985, in lieu of January 1, 1985.

The special transition rule applies ...ith respect to the following rules: (i) in ...rder to qualify for the section 105(b) exclusion from gross income, medical expense reimbursements must be provided under a medical benefit that exhibits the risk-shifting and risk-distribution characteristics of insurance (Q&A-17), and (ii) in order to qualify for the section 105(b), 120, or 129 exclusion from gross income, the medical, dependent care, or legal expense reimbursements must be provided under a benefit with respect to which a participant is not entitled to receive, in the form of cash or some other benefit, amounts available for reimbursement without regard to whether the participant incurs covered expenses during the period of coverage (Q&A-17 and Q&A-18). For purposes of the special transition rule, a period of coverage from January 1, 1985, through June 30, 1985, will satisfy the rules, in Q&A-17 and Q&A-18, precluding a cafeteria plan from operating to permit participants to purchase coverage only for periods during which the participants expect to incur covered expenses.

Notwithstanding the foregoing paragraphs, the otherwise applicable effective date set forth in Q&A-25 will not be modified by substituting July 1, 1985, in lieu of January 1, 1985, unless the particular benefit in question satisfies the following conditions: (i) the amount or specific rate of employer contributions (including salary reduction contributions) to be made with respect to the benefit is fixed prior to January 1, 1985 (or, if later, prior to the date on which the individual first becomes eligible to participate under the benefit); (ii) the employer contributions are deposited in or credited to an account (including an entry on the employer's books) established on behalf of the participant by the employer before being made available for expense reimbursement; (iii) neither the participant nor the employer have the right to increase or decrease contributions to the account during the period between January 1, 1985 (or, if later, the date on which the individual first becomes eligible to participate under the benefit), and July 1, 1985 (but contributions may be terminated during this period on account of the participant's separation from the service of the employer, and contributions may be terminated or increased or decreased on account of and consistent with certain changes in family status, as set forth in Q&A-6, or with a change in employment status from full-time to part-time or from part-time to full-time); and (iv) distributions are not available with respect to contributions made after December 31, 1984, for reasons other than the reimbursement of covered expenses before the earlier of July 1, 1985, or the participant's separation from the service of the employer.

Amounts available but unused as of June 30, 1985, for reimbursement under a benefit in a cafeteria plan qualifying for special transition relief may be (i) used to reimburse covered expenses incurred before July 1, 1985, (ii) distributed in cash to participants, (iii) used to provide the participants with any other taxable or nontaxable benefits (e.g., contribution to a qualified profit-sharing plan), or (iv) made available for the reimbursement of covered expenses incurred after June 30, 1985. If amounts unused as of June 30, 1985, remain available for the reimbursement of expenses incurred before July 1, 1985, and are not made available for the reimbursement of covered expenses incurred after June 30, 1985, the post-June reimbursements of pre-July expenses will not fail to qualify for the section 105(b), 120, or 129 exclusion from gross income merely because any amounts unused for such pre-July expenses are provided in the form of cash or some other benefit, to participants before December 31, 1985. If, however, amounts unused as of June 30, 1985, for the reimbursement of covered expenses incurred before July 1, 1985, are made available for the reimbursement of expenses incurred after June 30, 1985, the rules in Q&A-17 and Q&A-18 must be satisfied with respect to such amounts.

Q-29: What relief is available for cafeteria plans or benefits that were eligible for transition relief under the regulations proposed on May 7, 1984, but are not eligible for general transition relief as set forth in Q&A-25?

A-29: Q&A-25 provides general transition relief only to those plans or benefits in existence on or before February 10, 1984. The proposed regulations originally provided transition relief for those plans or benefits in existence on or before May 7, 1984. Thus, plans or benefits which were not in existence on or before February 10, 1984, but were in existence on or before May 7, 1984, would have been eligible for transition relief under the regulations as originally proposed but are not eligible for general transition relief under Q&A-25. With respect to such plans and benefits, the following relief is provided:

Cafeteria Plan Rules

A cafeteria plan that failed to satisfy one or more of the following rules for plan years beginning on or before May 7, 1984 will not be deemed thereby to have failed to satisfy section 125 for such plans years if, by September 4, 1984, the plan was amended to operate in accordance with these rules: (i) the rules requiring certain information to be included in the cafeteria plan document (Q&A-3), (ii) the rules governing the active participation of a participant's spouse in a cafeteria plan (Q&A-4), (iii) only in the case of a plan under which participants were permitted neither to carry over unused benefits for more than one plan year nor to convert into any other benefits any unused benefits that had been carried over to a subsequent plan year, the rules prohibiting the carryover of any unused contribution or benefit from one plan year to a subsequent plan year (Q&A-7), and (iv) the rules limiting the revocability of benefit elections (Q&A-8). A cafeteria plan may treat the portion of its current plan year remaining after September 4, 1984 as a new period of coverage for purposes of satisfying the rules governing benefits elections (Q&A-8). Also, a benefit offering participants the opportunity to make elective contributions under a qualified cash or deferred arrangement may be included in a cafeteria plan only in plan years beginning after December 31, 1980.

Rules Governing the Taxability of Benefits

If the coverage under an accident or health plan, dependent care assistance program, or qualified group legal services plan was offered as a benefit under a cafeteria plan and such benefit failed to satisfy, on or before May 7, 1984, the rule prohibiting a plan from operating to enable a participant to elect coverage under an accident or health plan, a dependent care assistance program, or a qualified group legal services plan only for periods during which the participant expects to receive medical care, dependent care, or legal services (Q&A-17 and Q&A-18), such benefit will not be deemed solely on account of such failure to have failed to satisfy the statutory rules providing for the income exclusion of such coverage or of any benefits provided thereunder, if by September 4, 1984, the cafeteria plan was amended to operate in accordance with such election of coverage rule. A cafeteria plan may treat the portion of its current plan year remaining after September 4, 1984 as a new period of coverage and as an initial plan year for purposes of satisfying the rule prohibiting a plan from operating to enable participants to elect coverage under an accident or health plan, dependent care assistance program, or qualified group legal services plan only for periods during which they expect to receive medical care, dependent care, or legal services (Q&A-17 and Q&A-18).

In addition, if the conditions set forth below are satisfied, employer contributions (including elective and nonelective contributions) made before June 1, 1984, under an arrangement described in the next sentence which is part of a cafeteria plan, will not be treated as having been made to an accident or health plan, dependent care assistance program, or qualified group legal services plan that fails to satisfy the rules contained in the second and third paragraphs of Q&A-17 and the first paragraph of Q&A-18 merely because, for the period beginning with the plan year and ending no later than December 31, 1984, a participant was entitled to receive, in the form of cash or any other taxable or nontaxable benefit, amounts available for reimbursement under the arrangement without regard to whether covered expenses are incurred. An arrangement is described in this sentence only if, under the arrangement:

(i) An account was actually established on behalf of the participant by the employer, by an entry on the employer's books or in similar fashion, prior to the beginning of the plan year (or prior to the date on which an individual first becomes eligible to participate under the arrangement in the case of an individual who first becomes eligible to participate, on account of years of employment, during the plan year);

(ii) The amount (or specific rate) of contributions to the account under the arrangement was fixed prior to the beginning of the plan year;

(iii) Neither the participant nor the employer possessed the right to increase or decrease contributions to the account during the plan year (but a plan may provide that contributions could be terminated during the year on account of the participant's (a) separation from service or (b) cessation of participation under the arrangement for the remainder of the plan year);

(iv) Contributions were actually deposited in or credited to the account before being made available for reimbursement; and

(v) Distributions were not available for reasons other than reimbursement of covered expenses until the end of the plan year or until December 31, 1984, whichever is earlier (but a plan may provide that a single distribution of the unreimbursed balance may be made on account of the participant's (a) separation from service or (b) cessation of participation under the arrangement for the remainder of the plan year).

A cafeteria plan may operate on a plan year other than the calendar year for purposes of this transitional rule, so long as the terms of the plan permit contributions to a plan to be fixed only once during, and a distribution of the unreimbursed amount to be received only once for the period beginning with the plan year and ending no later than December 31, 1984, provided that contributions may be fixed for a short plan year of the plan's first period of operation. This transitional rule does not affect or alter the requirement of Q&A-17 and -18 that expenses that are reimbursed under an arrangement must have been incurred during the period for which the participant actually is covered by the arrangement.

(Sec. 531(b)(5) of the Tax Reform Act of 1984 (98 Stat. 884))

Roscoe L. Egger, Jr.,

Commissioner of Internal Revenue.

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compensation brackets utilized by a plan will be examined to determine if the brackets, or compensation groupings, result in discrimination in favor of key employees. In addition, a plan does not meet the requirements for nondiscrimination as to the type and amount of benefits available under the plan unless all types of benefits (including permanent benefits) and all terms and conditions with respect to such benefits which are available to any participant who is a key employee are also available on a nondiscriminatory basis to non-key employee participants.

Q-10 How is additional coverage purchased by employees under a plan of group-term life insurance treated for purposes of determining whether a plan of group-term life insurance is discriminatory?

A-10 (a) The extent to which employees purchase additional coverage under a plan of group-term life insurance is not taken into account for purposes of determining whether a plan of group-term life insurance is discriminatory. For example, a plan providing insurance to all employees of 1 times annual compensation, which gives all employees the option to purchase additional insurance of 1 times annual compensation at their own expense, would not be considered discriminatory as to the type and amount of benefits available, even if the group (or groups) of participants who purchase additional insurance, if tested separately, would not satisfy the requirements of section 79(d)(2)(A). Solely for this purpose, the choice of an amount of group-term life insurance as a benefit under a cafeteria plan will be treated as the purchase of group-term life insurance by an employee. If additional insurance coverage is available to any key employee that is not available on a nondiscriminatory basis to non-key employees, the plan will be considered discriminatory even if the full cost of such additional insurance coverage is paid by the employee(s) electing such benefits.

(b) If the employer bears a part of the expense of any additional coverage that is purchased by an employee under a plan of group-term life insurance, the additional insurance shall be treated, in part, as an amount of insurance provided by the employer under the plan and, in part, as an amount of insurance purchased by the employee. Except to the extent provided in subparagraph (a) above, the portion of insurance treated as an amount of insurance purchased by the employee is not taken into account for purposes of determining whether the plan is discriminatory. Whether such insurance (together with any other insurance provided by the employer under the plan) will cause the plan to be considered to discriminate in favor of participants who are key employees is determined under the rules of Q&A 9.

Q-11. What effect do the provisions of section 79(d)(1) have if a plan of group-term life insurance is discriminatory for only part of a year?

A-11. If a plan of group-term life insurance is discriminatory at any time during the key employee's taxable year, then it is a discriminatory group-term life insurance plan for that taxable year and the provisions of section 79(d)(1) will be applicable with respect to all group-term life insurance costs allocable to that employee for that year.

Q-12. Are the section 79(d) provisions independent from the requirements contained in Treas. Reg. § 1.79-1?

A-12. Yes. Treas. Reg. § 1.79-1(c)(1) provides that life insurance provided to a group of employees cannot qualify as group-term life insurance if it is provided to less than ten full-time employees unless certain requirements are satisfied. The satisfaction of these requirements does not guarantee that the plan will be nondiscriminatory, and vice versa. Treas. Reg. § 1.79-1(a)(4) provides that life insurance is not group-term life insurance unless the amount of insurance provided to each employee is computed under a formula that precludes individual selection. The mere fact that a life insurance policy is nondiscriminatory is not determinative as to whether the policy precludes individual selection, and vice versa.

Par. 4. The following section is added immediately after § 1.125-1:

§ 1.125-2T Question and answer relating to the benefits that may be offered under a cafeteria plan. (Temporary)

Q-1. What benefits may be offered to participants under a cafeteria plan?

A-1. (a) Generally, for cafeteria plan years beginning on or after January 1, 1985, a cafeteria plan is a written plan under which participants may choose among two or more benefits consisting of cash and certain other permissible benefits. In general, benefits that are excludable from the gross income of an employee under a specific section of the Internal Revenue Code may be offered under a cafeteria plan. However, scholarships and fellowships under section 117, vanpooling under section 124, educational assistance under section 127 and certain fringe benefits under section 132 may not be offered under a cafeteria plan. In addition, meals and lodging under section 119, because they are furnished for the convenience of the employer and thus are not elective in lieu of other benefits or compensation provided by the employer, may not be offered under a cafeteria plan. Thus, a cafeteria plan may offer coverage under a group-term life insurance plan of up to $50,000 (section 79), coverage under an accident or health plan (sections 105 and 106), coverage under a qualified group legal services plan (section 120), coverage under a dependent care assistance program (section 129), and participation in a qualified cash or deferred arrangement that is part of a profit-sharing or stock bonus plan (section 401(k)). In addition, a cafeteria plan may offer group-term life insurance coverage which is includable in gross income only because it is in excess of $50,000 or is on the lives of the participant's spouse and/or children. In addition, a cafeteria plan may offer participants the opportunity to purchase, with after-tax employee contributions, coverage under a group-term life insurance plan (section 79), coverage under an accident or health plan (section 105(e)), coverage under a qualified group legal services plan (section 120), or coverage under a dependent care assistance program (section 129). Finally, a cafeteria plan may offer paid vacation days if the plan precludes any participant from using, or receiving cash for, in a subsequent plan year, any of such paid vacation days remaining unused as of the end of the plan year. For purposes of the preceding sentence, elective vacation days provided under a cafeteria plan are not considered to be used until all nonelective paid vacation days have been used.

(b) Note that benefits that may be offered under a cafeteria plan may or may not be taxable depending upon whether such benefits qualify for an exclusion from gross income. However, a cafeteria plan may not offer a benefit that is taxable because such benefit fails to satisfy any applicable eligibility, coverage, or nondiscrimination requirement. Similarly, a plan may not offer a benefit for purchase with after-tax employee contributions if such benefit would fail to satisfy any eligibility, coverage, or nondiscrimination requirement that would apply if such benefit were designed to be provided on a nontaxable basis with employer contributions. Also, note that section 125(d)(2) provides that a cafeteria plan may not offer a benefit that defers the receipt of compensation (other than the opportunity to make elective contributions under a qualified cash or deferred arrangement) and may not operate in a manner that enables participants to defer the receipt of compensation.

Par. 5. The following new section is added immediately after § 1.132-1T:

§ 1.133-1T. Questions and answers relating to interest on certain loans used to acquire employer securities. (Temporary)

Q-1: What does section 133 provide?

A-1: In general, section 133 provides that certain commercial lenders may exclude from gross income fifty percent of the interest received with respect to securities acquisition loans. A securities acquisition loan is any loan to an employee stock ownership plan (ESOP) (as defined in section 4975(e)(7)) that qualifies as an exempt loan under §§ 54.4975-7 and -11 to the extent that the proceeds are used to acquire employer securities (within the meaning of section 409(l)) for the ESOP. A loan made to a corporation sponsoring an ESOP (or to a person related to such corporation under section 133(b)(2)) may also qualify as a securities acquisition loan to the extent and for the period that the proceeds are (a) loaned to the corporation's ESOP under a loan that qualifies as an exempt loan under §§ 54.4975-7 and -11 and that has substantially similar terms as the loan from the commercial lender to the sponsoring corporation, and (b) used to acquire employer securities for the ESOP. The terms of the loan between the commercial lender and the sponsoring corporation (or a related corporation) and the loan between such corporation and the ESOP shall be treated as substantially similar only if the timing and rate at which employer securities would be released from encumbrance if the loan from the commercial lender were the exempt loan under the applicable rule of § 54.4975-7(b)(8) are substantially similar to the timing and rate at which employer securities will actually be released from encumbrance in accordance with such rule. For this purpose, if the loan from the commercial lender to the sponsoring corporation states a variable rate of interest and the loan between the corporation and the ESOP states a fixed rate of interest, whether the terms of the loans are substantially similar shall be determined at the time the obligations are initially issued by taking into account the adjustment interval on the variable rate loan and the maturity of the fixed rate loan. For example, if the rate on the loan from the commercial lender to the sponsoring corporation adjusts each six months and the loan from the corporation to the ESOP has a ten year term, the initial interest rate on the variable rate loan could be compared to the rate on the fixed rate loan by comparing the yields on 6 month and ten year Treasury obligations. Similarly, if the rates on the two loans are based on different compounding assumptions, whether the terms of the loans are substantially similar shall be determined by taking into account the different compounding assumptions. A securities acquisition loan may be evidenced by any note, bond, debenture, or certificate. Also, section 133(b)(2) provides that certain loans between related persons are not securities acquisition loans. In addition, a loan from a commercial lender to an ESOP or sponsoring corporation to purchase employer securities will not be treated as a securities acquisition loan to the extent that such loan is used, either directly or indirectly, to purchase employer securities from any other qualified plan, including any other ESOP, maintained by the employer or any other corporation which is a member of the same controlled group (as defined in section 409(l)(4)).

Q-2: What lenders are eligible to receive the fifty percent interest exclusion?

A-2: Under section 133(a), a bank (within the meaning of section 581), an insurance company to which subchapter L applies, or a corporation (other than a subchapter S corporation) actively engaged in the business of lending money may exclude from gross income fifty percent of the interest received with respect to a securities acquisition loan (as defined in Q&A-1 of § 1.133-1T). For purposes of section 133(a)(3), a corporation is actively engaged in the business of lending money that lends money to the public on a regular and continuing basis (other than in connection with the purchase by the public of goods and services from the lender or a related party). A corporation is not actively engaged in the business of lending money if a predominant share of the original value of the loans it makes to unrelated parties (other than in connection with the purchase by the public of goods and services from the lender or a related party) are securities acquisition loans.

Q-3: May loans which qualify for the fifty percent interest exclusion under section 133 be syndicated to other lending institutions?

A-3: Securities acquisition loans under section 133 may be syndicated to other lending institutions provided that such lending institutions are described in section 133(a) (1), (2) or (3) and the loan was originated by a qualified holder. Subsequent holders of the debt instrument may qualify for the partial interest exclusion of section 133 if such holders satisfy the requirements of section 133 and such loan does not fail to be a securities acquisition loan under section 133(b)(2).

Q-4: When is section 133 effective?

A-4: Section 133 applies to securities acquisition loans made after July 18, 1984, and used to acquire employer securities after July 18, 1984. The provision does not apply to loans made after July 18, 1984, to the extent that such loans are renegotiations, directly or indirectly, of loans outstanding on such date. A loan extended to an ESOP or sponsoring corporation after July 18, 1984, will be treated as a renegotiation of an outstanding loan if the loan proceeds are used to refinance acquisitions of employer securities made prior to July 19, 1984. For example, if an ESOP borrowed money prior to July 19, 1984, to purchase employer securities and after July 18, 1984, borrows other funds from the same or a different commercial lender to repay the first loan, the second loan will be treated as a renegotiation of an outstanding loan to the extent of the repaid amount. Similarly, if, after July 18, 1984, an ESOP sells employer securities, uses the proceeds to retire a pre-July 19, 1984, loan and obtains a second loan to acquire replacement employer securities, the second loan will be treated as a renegotiation of an outstanding loan.

Par. 6. The following new section is added immediately after § 1.162-10.

§ 1.162-10T Questions and answers relating to the deduction of employee benefits under the Tax Reform Act of 1984; certain limits on amounts deductible. (Temporary)

Q-1: How does the amendment of section 404(b) by the Tax Reform Act of 1984 affect the deduction of employee benefits under section 162 of the Internal Revenue Code?

A-1: As amended by the Tax Reform Act of 1984, section 404(b) clarifies that section 404(a) and (d) (in the case of employees and nonemployees, respectively) shall govern the deduction of contributions paid or compensation paid or incurred under a plan, or method or arrangement, deferring the receipt of compensation or providing for deferred benefits. Section 404(a) and (d) requires that such a contribution or compensation be paid or incurred for purposes of section 162 or 212 and satisfy the requirements for deductibility under either of these sections. However, notwithstanding the above, section 404 does not apply to contributions paid or accrued with respect to a "welfare benefit fund" (as defined in section

World Equipoise Inc., San Diego, CA
Wranglers Soccer Club, Plano, TX
Youth's Hope, Northridge, CA

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)-7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

Annual Return Required for Fringe Benefit Plans

Announcement 86-20

Section 6039D of the Internal Revenue Code, which was added by Public Law 98-611 and Public Law 98-612, requires group legal services plans described in section 120, cafeteria plans described in section 125, and educational assistance programs described in section 127 to file an annual return with the Internal Revenue Service for years beginning after December 31, 1984. The Service will issue regulations soon stating that these plans should file the required return on either Form 5500, Annual Return/Report of Employee Benefit Plan; Form 5500-C, Return/Report of Employee Benefit Plan; or Form 5500-R, Registration Statement of Employee Benefit Plan.

The forms and their related instructions have been revised so that fringe benefit plans required to file need only complete specified items.

For more information, see Forms 5500, 5500-C, and 5500-R and instructions, which are now available.