APPEALS

INDUSTRY SPECIALIZATION PROGRAM

SETTLEMENT GUIDELINES

INDUSTRY: All Industries

ISSUE: Cafeteria Plan/Qualified Retirement Plan Hybrid Arrangement

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CAFETERIA PLAN/QUALIFIED RETIREMENT PLAN HYBRID ARRANGEMENT

IRC 125

ISSUE

Whether a participant-retiree in a qualified plan under section 401(a) of the Internal Revenue Code (the Code) who uses distributions from the plan to pay for benefits in the former employer's section 125 cafeteria plan, must include the distributions in income pursuant to section 402(a).

EXAMINATION DIVISION POSITION

Amounts distributed from a section 401(a) qualified employee plan and used to pay for benefits in a former employer's section 125 cafeteria plan, must be included in the participant-retiree's income pursuant to section 402(a) and may not be treated as tax free salary reductions under section 125.

STATEMENT OF FACTS:

Certain entities have marketed an arrangement that purports to allow retirees who participate in a qualified retirement plan to use their distributions from the plan to purchase employer-provided accident and health coverage through the former employer's cafeteria plan. This is done in an attempt to avoid including the distributions in income. The qualified plan distributions are reported on Form 1099R net of the cost of the accident and health coverage. As a result, under this arrangement, it is argued that qualified plan contributions that gave rise to an immediate employer deduction and accumulated tax-free for years, escape taxation entirely.

An impetus for the use of the cafeteria plan/qualified retirement plan hybrid arrangement stems from the issuance of Financial Accounting Standards Board Statement 106, Employers' Accounting for Post-retirement Benefits Other Than Pensions. This statement creates incentives to explore alternative approaches for providing accident and health benefits to retirees in order to offset retiree health obligations on the employers' financial statements and to reduce the escalating costs of accident and health coverage.

LAW & ANALYSIS

Section 125(d)(1) of the Code provides that a cafeteria plan is a plan under which all participants are employees, and the participants may choose among two or more benefits consisting of cash and qualified benefits (i.e., benefits that are excludable from gross income because of an express provision of the Code). The normal rules of constructive receipt do not apply to benefits that are received under a cafeteria plan and if an employee is allowed to choose between accident and health coverage or compensation, the employee will be able to exclude from gross income, under section 106, the amounts used to purchase the accident and health coverage. However, the federal income tax treatment of qualified retirement plans, and specifically, the taxation of qualified plan distributions is governed by an entirely different statutory arrangement.

Section 402(a) of the Code describes the rule applicable to distributions from a qualified retirement plan. This section states that, except as otherwise provided in this section, any amount actually distributed to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under section 72 of the Code (relating to annuities). There are only two exceptions under section 402 to the general rule of includability of distributions in gross income.[1]

The first exception to this rule is in section 402(e)(1)(A), which provides that if a distribution is made to a spouse or former spouse of a participant under the terms of a qualified domestic relations order, the spouse or former spouse, rather than the participant, will be taxed on the distribution. See section 414(p) for specific requirements that must be satisfied in order for a distribution to be considered a valid qualified domestic relations order. The second exception to the rule is provided in section 402(c). This section sets forth the rules applicable to rollovers from exempt trusts and provides that if an employee receives an eligible rollover distribution and transfers any portion of it to an eligible retirement plan within 60 days, then that distribution (to the extent so transferred) shall not be includable in gross income for the taxable year in which paid.

Neither of these exceptions allows a participant to exclude from gross income amounts distributed from a qualified plan to purchase benefits through the former employer's cafeteria plan. Because the "except as otherwise provided in this section" language in section 402(a) does not encompass section 125, the general rule of section 402(a) applies and the distribution is includable in the participant-retiree's gross income.

This position is consistent with two longstanding revenue rulings. Rev. Rul. 61-164, 1961-2 C.B. 99, considered whether a profit-sharing plan is permitted, under the qualification rules, to use trust funds to purchase accident and health coverage. The ruling states that while the purchase of the accident and health insurance would not prevent the qualification of the plan, the use of trust funds to pay the cost of major medical insurance for an employee or his beneficiaries is a distribution within the meaning of section 402 of the Code. Similarly, Rev. Rul. 69-141, 1969-1 C.B. 48 concluded that distributions made from a qualified profit-sharing trust to pay for medical care expenses of the employee-participant are not accident and health benefits excludable under section 105(b) of the Code but are taxable under section 402(a) as previously earned deferred compensation.

[1] The distributions referred to are assumed to be employer contributions for which the employee has no basis. If the employee has basis in any qualified plan contributions, under section 72, the employee would only be taxed on amounts in excess of basis.

Although section 125 of the Code operates to protect benefits from constructive receipt and taxation under section 61, it does not operate to protect qualified plan distributions from taxation under section 402(a) of the Code. Absent explicit statutory authority, qualified plan distributions may not, under current law, be used on a pre-tax basis to purchase benefits in a cafeteria plan.[2]

INDUSTRY'S ARGUMENTS AND REBUTTAL

The industry argues that retirees are specifically contemplated as participants in cafeteria plans because the term "employee" under section 125 includes present and "former employees" of the employer. Thus, the industry argues that Congress must have contemplated that payments to "former employees" (i.e., retired beneficiaries) from retirement plans could be permitted to be used to pay for accident and health benefits on a pre-tax basis.[3]

The industry also argues that retirement payments which are "attributable to employer contributions" constitute "taxable benefits" or "cash" within the meaning of section 125(d)(1). Thus, the industry believes that participant-retirees should be permitted to reduce qualified retirement plan distributions on a pre-tax basis (i.e. like salary), to pay for the cost of benefits in a cafeteria plan.[4]

[2] Current law does, within specified limits, allow qualified plans to offer beneficiaries certain benefits other than retirement benefits. A profit-sharing plan may offer incidental life or accident and health insurance. See, section 1.401-1(b)(1)(ii) of the Income Tax Regulations and Rev. Rul. 61-164. Defined benefit plans and money purchase plans may provide benefits for sickness, accident, hospitalization, or medical expenses to retired employees and their spouses and dependents through a separate account as described in section 401(h) of the Code. See, section 1.401-1(b)(1)(i) of the regulations.

[3] Although retirees may not use retirement benefits to fund cafeteria plan benefits on a pre-tax basis, they may fund their benefits with after-tax dollars. In addition, retirees may use accumulated annual leave, sick leave and other unpaid wages to purchase retiree health insurance for the remainder of the year in which they retire, and then receive any balance in cash. Alternatively, an employer could utilize accumulated annual leave, sick leave and unpaid wages to fund health insurance for retirees without recourse to section 125 by following the approach outlined in Rev. Rul. 75-539, 1975-2 CB 45.

[4] This is similar to the argument that, because retirement benefits were determined to constitute deferred compensation for services rendered in Davis v. Michigan Dept. of Treasury, 489 U.S. 803 (1989), retirees should be able to use those amounts to fund benefits in a cafeteria plan. The decision in Davis is not relevant to the issue addressed in this paper. The issue under section 125 is not whether retirement benefits are compensation for past services (clearly they are), but whether that compensation is taxable

These arguments do not overcome the fact that section 402 of the Code contains detailed rules for determining whether a distribution from a qualified retirement plan is includable in income. Significantly, although these rules have been amended several times subsequent to the passage of section 125, there is no exception within section 402 for distributions paid through a cafeteria plan to an accident and health plan, while Congress has mandated other exceptions. Simply inferring that such an exception exists is insufficient. Further, the fact that there is a separate statutory provision, section 401(h) of the Code, which does provide employers with an opportunity to offer medical benefits to retirees within the context of a qualified plan, demonstrates that Congress has examined and addressed the issue.

when used to purchase benefits in a cafeteria plan on a pre-tax basis, an issue not addressed by the Supreme Court.

SETTLEMENT GUIDLINES

This is a legal issue. The Examination position is that amounts distributed from a section 401(a) qualified plan and used to pay for benefits under a section 125 cafeteria plan, operated by former employer of the retiree, must be included in such retiree's income pursuant to section 402(a). Such amount may not be treated as tax free salary reduction under IRC 125.

The Examination position is consistent with revenue rulings issued in 1961 and in 1969. The 1961 revenue ruling dealt with a Profit Sharing Plan and concluded that the purchase of accident and health coverage by the trust would not prevent the plan from being qualified under IRC 401(a). However, the cost of such benefit is a distribution under IRC 402.

The 1969 revenue ruling concluded that distributions made from a qualified profit sharing plan to pay for medical care expenses of the employee-participant are not accident and health benefits excludable under section 105(b) of the Code but rather taxable under section 402(a) as previously earned deferred compensation.

Section 125 of the Code operates to protect benefits from constructive receipt and taxation under section 61. However, it does not operate to expand the exceptions stated under section 402(a) of the Code dealing with taxability of distributions from a qualified plan. Absent explicit authority, distributions from a qualified plan are taxable under IRC 402(a).

The industry's argument is not supported by the Code or any judicial or regulatory determination. Current law, within specific limits, allows qualified plans to offer beneficiaries certain benefits other than retirement benefits. A profit sharing plan may offer incidental life, accident or health insurance. (section 1.401-1(b)(1)(ii) of the Income Tax Regulations and Rev. Rul. 61-164). Defined benefit plans and money purchase plans may provide benefits for sickness, accident, hospitalization, or medical expenses to retired employees and their spouses and dependents through a separate account as described in section 401(h) of the Code. IRC 125 did not expand the exceptions provided under IRC 402. Until further regulatory or judicial determinations are made, it is not clear what litigation hazards are. Until such determination, the Examination position should be sustained.

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