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26 CFR Part 1
Tax Treatment of Cafeteria Plans

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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 nontxable 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, including the periods during which the benefits are provided (i.e., the periods of coverage), (ii) the plan's eligibility rules governing participation, (iii) the procedures governing participants' elections under the plan, including the period during which elections may be made, the extent to which elections are irrevocable, and the periods with respect to which elections are effective, (iv) the manner in which employer contributions may be made under the plan, such as by salary reduction agreement between the participant and the employer or by nonelective employer contributions to the plan, (v) the maximum amount of employer contributions available to any participant under the plan, and (vi) the plan year on which the cafeteria plan operates.

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 maximum 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 empoloyee 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 event 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 $1300 from among the following: up to $300 in cash, coverage under an accident or health plan providing medical expense reimbursement (cost of $600), 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 ($600 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-8, 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 § 1.105-2. 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 105(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 incurred during a specified period of plan 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 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 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.
[FR Doc. 84-12263 Filed 5-2-84; 2:49 pm]

BILLING CODE 4830-01-M

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).

TEXT: 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. 3529) 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 28, 1982.

## 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.