Cafeteria Plans in Transition

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I. Introduction.

Cafeteria plans, one of the most exciting and attractive employee benefit programs of the 1980's, are in transition. This is true in a literal way, for they are now subject to the transition rules enacted by Congress as part of the Tax Reform Act of 1984, Public Law 98-369. It is also true in a more general way, for, although cafeteria plans have been permissible since 1978, the real shape of the law that will govern them is only now emerging, and it is reasonable to anticipate additional, significant changes.

This article will describe cafeteria plans generally, examine the provisions of the TRA that affect cafeteria plans, especially the transition rules, analyze the proposed Treasury regulations dealing with cafeteria plans, and outline two major problems not addressed by either the regulations or the legislation. The analysis of the proposed regulations will go substantially beyond mere description. The basic thesis of this article is that the Treasury and the Internal Revenue Service (“IRS”) are seeking, without statutory authority, to alter fundamental legal concepts that govern this area. In order to see that this is so, it will be necessary to examine at length the doctrine of constructive receipt embedded in the proposed regulations. Significant attention will also be paid to the notion of “deferred compensation” that is advanced in the proposed regulations, and the dubious “use it or lose it” doctrine upon which they also depend. The extent to which Congress has endorsed or adopted these doubtful theories in the TRA is problematical, and additional legislative attention seems both likely and appropriate. In short, cafeteria plans, and the treatment of them proposed by the IRS and Treasury, raise important issues of tax and employee benefits policy, and deserve closer and more thoughtful attention by the Congress.

II. Overview of Cafeteria Plans.

A. Definition and General Explanation.

Section 125 of the Code1 defines a cafeteria plan as a written plan under which all participants are employees and participants may choose among two or more benefits, which may be nontaxable benefits, cash, property, or other taxable benefits. Although the legislative history indicates that the term “employee” includes former employees and beneficiaries of present and former employees, S. Rep. No. 1263, 95th Cong., 2d Sess. 75 (1978), self-employed individuals or partners in a partnership cannot be participants.

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1 All Code citations are to the Internal Revenue Code of 1954, as amended.

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under a cafeteria plan.

The basic purpose and benefit of a cafeteria plan is clear. A cafeteria plan allows a participant to choose the types and amounts of fringe or welfare benefits he will receive from the employer, and he will be taxable only to the extent of the value of any taxable benefits selected. From the employee's point of view, this means that he can choose cash rather than coverage under a fringe or welfare benefit plan that is of no interest or utility to him. From the employer's point of view, cafeteria plans offer the possibility that fringe or welfare benefits can be more efficiently selected and delivered to employees, thereby minimizing the purchase of unneeded or unwanted benefits. When employer provided medical protection is placed partially on a cafeteria plan basis, there is significant potential for medical cost containment.

The cafeteria plan rules do not apply unless participants are afforded an opportunity to select benefits under the plan. PLR 8052090 (October 1, 1980). Also, the cafeteria plan rules do not apply if the only benefits that can be selected are nontaxable benefits. Since all benefits under such a plan would, by definition, be nontaxable, participants under such a plan do not need the exclusionary rule of Code § 125. PLR 7922011 (February 28, 1979).

As originally enacted, Code § 125 did not state which nontaxable benefits could be included under a cafeteria plan. The legislative history, though, indicated that among the permissible benefits were the first $50,000 of group term life insurance, see Code § 79, disability benefits, see Code §§ 105(c) & (d), accident and health benefits, see Code §§ 105(e) & (b), and group legal services benefits. See Code § 120. There has been general agreement that dependent care assistance benefits may also be included in a cafeteria plan, see Code § 129, and a number of cafeteria plans have also included such nonstatutory benefits as employee discounts, employer-paid parking, and employer-paid membership in professional, health, or recreational organizations. Code § 125(d) (2) specifically proscribes the inclusion of deferred compensation among the options available under a cafeteria plan, but this provision was amended to allow inclusion of elective contributions to a qualified cash or deferred arrangement that meets the requirements of Code § 401(k).

B. Tax Consequences to Participants.

Under Code § 125(a), a participant under a cafeteria plan will not recognize taxable income solely because he may choose among the taxable or nontaxable benefits provided by the plan. If the plan discriminates in favor of highly compensated employees, either as to eligibility or as to contributions or benefits, however, amounts contributed to the plan on behalf of a highly compensated employee will be included in such individual's gross income. Code § 125(b) (2). Amounts required to be included in the income of highly compensated employees under a discriminatory plan are treated as received or accrued in the participant's taxable year in which the plan year ends. Code
§ 125(b) (2). Participants who are not highly compensated suffer no adverse tax consequences under a discriminatory cafeteria plan. If a plan fails to be a cafeteria plan at all, however, such as by providing prohibited deferred compensation, then the position of the IRS and Treasury is that each participant, including each rank and file participant, is taxable on all benefits available to him under the plan, regardless of whether he had selected and received taxable or (otherwise) nontaxable benefits.

For purposes of Code § 125, a highly compensated participant is an employee who is either an officer, a shareholder owning more than five percent of the voting power or value of all classes of stock of the employer, a highly compensated person, or a spouse or dependent of any of these three categories. See Code § 125(e) (1). The phrase “highly compensated” is not defined, and there are no attribution rules for stock ownership under Code § 125.

C. Discrimination.

A cafeteria plan will not be treated as discriminatory with respect to eligibility to participate if (i) it benefits a classification of employees which satisfies the coverage requirements of Code § 410(b) (1) (B), (ii) not more than three years of employment with the employer maintaining the plan are required as a condition of participation in the plan, and (iii) each eligible employee commences participation on the first day of the plan year following the satisfaction of the employment requirement. Code § 125(g) (3). The Service regards the requirement of Code § 410(b) (1) (B) as satisfied only if a plan covers a “fair cross section” of employees. See Revenue Ruling 83-58, 1983-1 C.B 95; but see Federal Land Bank Ass'n of Ashville, North Carolina, 74 T.C. 82 (1980); Robert D. Sutherland, 78 T.C. 395 (1982).

Unlike a pension plan, a cafeteria plan will not be regarded as nondiscriminatory simply because, consistent with Code § 410(b) (1) (A), it covers seventy percent of all employees, or, if eighty percent or more of employees are eligible, seventy percent of those eligible actually participate. See Code § 125(g) (3). It is important to note that the requirements for eligibility for a cafeteria plan are measured in terms of years of employment, and not years of service, as is eligibility for a pension plan. Id. This means, for example, that an employee who is employed continuously for three years but who works less than 1,000 hours a year, cannot be excluded from a cafeteria plan. On the other hand, it would appear to be permissible under a cafeteria plan to disregard any period of employment that was prior to an interruption in employment.

Under Code § 125(c), a cafeteria plan will not be discriminatory with respect to contributions or benefits if the nontaxable benefits and total benefits (or employer contributions allocable to nontaxable benefits and employer contributions for total benefits) do not discriminate in favor of highly compensated participants. It should be noted especially that a cafeteria plan is not required to be nondiscriminatory with respect to both contributions and
benefits, and that this antidiscrimination rule is tested by looking at aggregate benefits rather than on a benefit-by-benefit basis. Further, the legislative history indicates that this test is to be applied in proportion to compensation:

A plan will not be discriminatory if total benefits and nontaxable benefits attributable to highly compensated employees, measured as a percentage of compensation, are not significantly greater than the total benefits and nontaxable benefits attributable to other employees (measured on the same basis), provided the plan is not otherwise discriminatory under the standards of the bill. [Senate Report No. 95-1263, 95th Cong., 2d Sess. 75 (1978).]

Code § 125(g) (2) contains a special rule under which a cafeteria plan that provides health benefits will not be considered discriminatory if contributions on behalf of all participants include an amount which either (i) equals 100 percent of the cost of health coverage of the majority of highly compensated participants similarly situated, or (ii) equals or exceeds 75 percent of the cost of the health benefit coverage of any similarly situated plan participant having the highest cost health benefit coverage under the plan. In addition, contributions or benefits other than for health benefits must bear a uniform relationship to compensation. Code § 125(g) (2). The legislative history indicates that plan participants that have the same family size will be treated as similarly situated, S. Rep. No. 95-1263, 95th Cong., 2d Sess. 76 (1978), but is not clear whether being similar in age will be treated as being "similarly situated." Presumably the "cost" of health benefits coverage for purposes of this special rule means the health insurance coverage provided under the plan rather than the actual amount of expenses reimbursed. This provision is clearly drafted as a safe harbor, so that meeting it would make it unnecessary to satisfy the general rule of Code § 125(c). There has been some indication, though, that the Treasury and IRS may seek to require all plans providing health insurance to meet the special rule of Code § 125(g) (2). If this special rule were applied by looking to the value of benefits or coverage actually elected by participants, rather than to the value of benefits available under a plan, it is doubtful whether any plan could qualify as nondiscriminatory. That is, so long as one participant chose cash instead of coverage, it would seem impossible to meet either the "100 percent" or the "75 percent" test on a coverage or utilization basis, rather than an availability basis.

Under Code § 125(g) (4), the aggregation rules of Code §§ 414(b), (c) and (m) apply, with the result that discrimination for both eligibility and benefits or contributions must be determined on a controlled group or affiliated service group basis. A collectively bargained cafeteria plan is automatically treated as nondiscriminatory if the plan is maintained under an agreement that the Secretary of the Treasury finds to be a collective bargaining agreement between employee representatives and one or more employers. Code §
The provisions of Code § 125 do not indicate, however, whether employees covered under a collective bargaining agreement can be excluded in determining whether a separate plan limited to nonrepresented employees satisfies the nondiscriminatory eligibility requirements.

It is important to note that, in addition to the complex and rather uncertain discrimination rules imposed under section 125 of the Code, benefits provided under a cafeteria plan may also be subject to the special nondiscrimination rules of other sections of the Code. For example, self-insured medical expense reimbursement benefits must satisfy the nondiscrimination provisions of Code § 105(h) of the Code as well as the provisions of Code § 125. Similarly, group legal service benefits under Code § 120 and dependent care assistance benefits under Code § 129 must satisfy the antidiscrimination rules of those provisions as well as the provisions of Code § 125. In addition, if a cafeteria plan offers group term life insurance benefits, the antidiscrimination rules of Code § 79(d) will apply as well as the antidiscrimination rules of Code § 125.

For all such benefits, in other words, it is necessary to do a two-level analysis: First, it is necessary to determine whether the, say, dependent care benefits satisfy the antidiscrimination requirements of Code § 129. Second, it is necessary to determine whether those dependent care benefits, when added to the other taxable and nontaxable benefits provided under the cafeteria plan permitting the election of Code § 129 benefits, satisfy the antidiscrimination requirements of Code § 125. In any given case, it is possible to fail the antidiscrimination rules at one level even though they are satisfied at the other level. If, for example, benefits under a cafeteria plan include dependent care assistance benefits, and the dependent care program does not satisfy the antidiscrimination rules of Code § 129(d) (2), then all of the dependent care assistance benefits, including those provided to rank and file employees, would be currently taxable. The discrimination in favor of the highly paid which caused these dependent care assistance benefits to be currently taxable, might also cause the cafeteria plan under which they are offered to be discriminatory. If this were the case, all of the nontaxable benefits provided under the plan, including non-Code § 129 benefits, would be taxable to the highly compensated participants under the plan, whereas rank and file participants in the plan would be taxed only upon the dependent care assistance benefits, if any, which they had actually received.

Detailed analysis of the Code provisions regulating the underlying benefits which may be offered under a cafeteria plan, such as group term life, medical reimbursement, dependent care, and group legal, including the special discrimination rules which apply to them, are beyond the scope of this article.


A. Permissible Benefits.

The Tax Reform Act of 1984 ("TRA") amended Code § 125(d) (1), the
definition of a cafeteria plan to restrict it to plans which allow participants to choose among two or more benefits consisting of cash and "statutory nontaxable benefits." Code § 125(f) defines "statutory nontaxable benefits" to mean any benefits which, when provided under the cafeteria plan, are not includible in the gross income of an employee by reason of an express provision of chapter 1 of the Internal Revenue Code other than Code § 117 (dealing with employer-paid food and lodging), Code § 124 (dealing with van-pooling), Code § 127 (dealing with employer-provided educational assistance, or Code §132 (the new exclusion for certain employer-provided fringe benefits). The term also includes any group term life insurance that is includible in gross income only because it exceeds the dollar limitation of Code § 79.

By its very definition, the term "statutory nontaxable benefits" is a misnomer, for not all benefits that are not taxable under the provisions of the Code are included in the term "statutory nontaxable benefits," and some of the items that are included under that term are not nontaxable because of a statutory provision. What is clear, though, is that the term covers the following benefits, which, accordingly, can continue to be offered under a cafeteria plan:

1. Employer-provided group term life insurance, both the first $50,000, which is nontaxable, and all amounts in excess thereof, which are taxable.
2. Disability benefits under Code §§ 105(c) and (d).
3. Accident and health benefits under Code §§ 105(e) and (b).
4. Qualified group legal services benefits under Code § 120, and
5. Qualified dependent care assistance benefits under Code § 129.

This statutory change makes it clear that such things as employer-provided parking may no longer be provided under a cafeteria plan, if they ever could. Two particular items remain in doubt. Although the new definition added to Code § 125(f) would not by its literal terms embrace group term life insurance benefits for dependents, which is tax-free up to $2,000 by virtue of the regulations under Code § 61, Reg. § 1.61-2(b), or vacation days (not pay), under the House bill each of these benefits was intended to be included in the term statutory nontaxable benefits. See H.R. Rep. 98-861, 98th Cong., 2d Sess. 1174 (1984). The Conference Committee report says that the final statute follows the House bill, but neither the Conference Report itself nor the statute states that the two benefits are included. See TRA § 531(b); id. at 1174-77. The proposed regulations under Code § 125, which could appear at any time, may clarify the question of whether dependent group life and vacation days can be included in the cafeteria plan.

B. The 25 Percent Rule.

Section 531(b) of the TRA amends Code § 125(b) to add a rule
that the exclusion from income provided under Code § 125(a) is not available with respect to any benefit attributable to a plan for which the statutory nontaxable benefits provided to key employees exceed 25 percent of the aggregate of such benefits provided for all employees under the plan. This rule, very similar to the special discrimination rules found in Code §§ 120(c) (3) and 129(d) (4), is in addition to the general rule that the benefits and contributions under a cafeteria plan may not discriminate in favor of highly compensated participants. In applying this rule, 25 percent of statutory nontaxable benefits is determined without regard to group term life insurance benefits in excess of $50,000, which in fact are taxable benefits under a cafeteria plan. Key employees are officers, owners, and highly compensated individuals, as defined under Code § 416(i) (1), the new top-heavy provisions generally applicable to pension plans.

This new provision, effectively precluding key employees from receiving more than 25 percent of the nontaxable benefits under a cafeteria plan, will have the practical effect of making cafeteria plans unsuitable for small employers. The small business or professional corporation is unlikely to sponsor a cafeteria plan unless the owners and top people can benefit significantly from it, but many organizations, including even those with a total number of employees over 50 or more, will find it difficult to provide substantial benefits to key employees without violating this 25 percent rule.

C. Reporting Requirements.

Under new Code § 125(h) (1), each employer maintaining a cafeteria plan during any taxable year after 1984 will have to file a special return with the IRS stating the number of employees of the employer, the number of employees participating in the plan, the total cost of the plan, and basic data about the employer. All employers will be required to maintain records necessary to determine whether the requirements of Code § 125 are met. In addition, the Conference Report directs the Secretary, and the Code authorizes him, to require a select and statistically significant group of employers maintaining cafeteria plans to file detailed additional information on the operation of their cafeteria plans. H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 1175 (1984). This information is to be used in evaluating the adequacy of the statutory provisions. The Tax Reform Act also directs the Secretary of Health and Human Services, in cooperation with the Secretary of the Treasury, to study the effects of cafeteria plans on the containment of health care costs and to submit a report to the Ways and Means and Finance Committees no later than April 1, 1985. TRA § 531(b) (6).

D. Transition Rules.

Far and away the most significant and perplexing provisions of the Tax Reform Act dealing with cafeteria plans, however, are the general and special transition rules. The general rule by its terms prevents the application of
the proposed regulations to plans and benefits provided prior to the end of 1984, or, if earlier, the effective date of any plan modification to increase benefits after February 10, 1984. The special transition rule covers the next six months. Under it, if a benefit is provided before July 1, 1985, and also before any post-February 10, 1984, modification increasing benefits, and if that benefit fails to satisfy the proposed Treasury regulations dealing with cafeteria plans solely because cashouts and carryovers are permitted, then that benefit will not fail to be a nontaxable benefit solely because of that failure. These provisions raise at least as many questions as they answer.

First, the transition rules apply only to plans that were in existence on February 10, 1985, or to which substantial implementation costs had been incurred before February 10, 1984. February 10, 1984, was the date of the Internal Revenue Service news release which first announced that so-called “zebra” plans and “flexible spending accounts” were not regarded as bona fide cafeteria plans. A flexible spending account is one that allows an employee to apply credits under the account to the provision of any available benefits during the coverage period, or to receive cash at the end of that period or, perhaps, a carryforward of benefits into the next year. A “zebra” plan, or zero-based reimbursement account, allowed an employee to provide for and obtain reimbursement for a particular expense covered by a cafeteria plan after having incurred it. Thus, having spent $100 at the dentist or for eyeglasses, the employee could reduce his next paycheck by $100 and receive that amount instead as a medical reimbursement. Under the so-called “ultimate zebra,” the employee would turn in all his claims for reimbursement only once, at the end of the year, and get a single check covering all reimbursed items.

Zebras and flexible spending accounts clearly do not satisfy the requirements of the proposed Treasury regulations, which require irrevocable advance elections and preclude cashouts or carryforwards. Under the general transition rule, any cafeteria plan which failed to satisfy the proposed Treasury regulations, and any benefit offered under such cafeteria plan which failed to meet the rules of Code §§ 105, 106, 120, or 129 under proposed Treasury regulations, does not fail to be a cafeteria plan or a nontaxable benefit under Code §§ 105, 106, 120, or 129 solely because of such failures.

One basic question in applying both transition rules is, what will constitute a “cafeteria plan,” to which alone the rules apply. Presumably the new provision of Code § 125(b) restricting cafeteria plans to those which provide a choice between cash and nonstatutory benefits will not be used to limit the class of plans to which the transition rule applies, for that provision does not become effective until January 1, 1985. TRA § 531(h). Will a plan have to satisfy the requirement of Q & A 5 of the proposed Treasury regulations, which would restrict permissible nontaxable benefits to those that are not currently taxable under the Code, and does this mean only benefits for which there is an explicit Code provision? Or, will any plan that in good faith was thought to constitute a cafeteria plan prior to the promulgation of the pro-
posed Treasury regulations be covered by the transition rules? For example, it is entirely possible that the transition rule will not be extended to "ultimate zebras" for there is sentiment at Treasury and IRS that such plans were so far beyond the pale that no one could reasonably have thought that they constituted cafeteria plans.\(^2\) Again, if a plan covered both permissible and (arguably) impermissible benefits, such as employer-paid parking, will the transition rule apply to the entirety of the plan, only to those benefits which were (under the proposed Treasury regulations) regarded as permissible benefits, or not at all?

Although the statute extends the general and special transition rules to all plans with respect to which more than $15,000 of implementation costs, or more than one-half of the total costs of implementation, had been incurred as of February 10, 1984, the Conference Report indicates that implementation costs are limited to the costs of designing and installing computer programs for operation of the plan and the costs of printing cafeteria plan brochures for employees. H.R. Rep. 98-861, 98th Cong., 2d Sess. 1177 (1984). Thus, apparently the cost of consultants or attorney's fees to design and implement a cafeteria plan cannot be counted in determining whether a plan qualifies for relief under the general transition rule.

There are other questions concerning what plans are covered by the transition rules. It is not clear whether a cafeteria plan that was amended to conform to the proposed regulations could be returned to its more flexible basis (e.g., a zebra) through the end of 1984 and still get the benefit of the transition relief. Literally read, such an amendment would not be possible, because it would amount to the addition of benefits after February 10, 1984, but it is difficult to see why plans that did their best to comply with the proposed regulations should stand worse than those which made no such efforts. The same question arises in connection with a flexible spending account or benefits bank that was frozen in the light of the proposed regulations. May such a plan be recommenced under the general transition rule, or would such recommencement constitute an amendment adding benefits, thereby denying the plan the relief provided in the transition rules? Another area of uncertainty concerns newly hired or acquired employees. Although it would probably be permissible to add new employees hired in the ordinary course to an existing cafeteria plan without risking coverage under the transition rules, it is doubtful whether the employees of an acquired company could be put into an existing grandfathered plan without risking coverage under the transition rule.

As a general matter, it seems clear what the general and special transition rules are aimed at. The general transition rule is intended to bless the generality of plans in existence through the end of this year, and the special transition rule is intended to extend the period during which cashouts and carry-

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\(^2\) Under an ultimate zebra there has been actual receipt of the entire year's income before the reimbursement election is filed, and the employer retroactively redesignates some of the compensation already received as having been cafeteria plan reimbursements for nontaxable benefits.
forwards will be allowed, but only for plans which have otherwise brought themselves into compliance with the proposed regulations. What is not clear, however, is whether any significance should be read into the fact that the general transition rule provides protection both for the plan and for the benefits provided under it, whereas the special transition rule provides protection only with respect to the benefits provided, and not the cafeteria plan itself. This difference in wording, if taken seriously, could render the special transition rule valueless. Thus, it is clear that a cafeteria plan that provides for cashouts and carryforwards during the first six months of 1985, will not meet the requirements of the proposed regulations. The mere fact that benefits provided under that plan will be treated as nontaxable benefits by virtue of the special transition rule, does not mean that those same benefits will not be regarded as taxable because provided under a plan that does not meet the proposed regulation requirements applicable under Code § 125. Although this result would render the special transition rule meaningless, presumably Congress intended some difference by making the general transition rule applicable to plans and benefits, while the special rule applies only to benefits. Presumably this and other questions concerning the transition rules will be dealt with in the Treasury regulations that are expected to be promulgated at any time.

Perhaps the greatest puzzle or uncertainty concerning the transition rules, however, relates to the very concept upon which they are founded. Although they are called “transition” rules, there is no statutory scheme spelled out in the Tax Reform Act to which we are transitioned. Moreover, the only protection that is provided is from the application of the proposed Treasury regulations. It is hornbook law that proposed regulations have no effect as law. Transition rules which only serve to protect us from that which has no effect in the first instance, however, seems pointless and silly. Presumably what Congress intended is that no valid interpretation of the provisions of Code § 125, or the underlying benefit provisions, such as Code §§ 79, 105, 106, 120 and 129, which is reflected in the proposed Treasury regulations, will be applied adversely to affect a cafeteria plan, or benefits provided under it, if the requirements of the transition rules are satisfied.

The larger conclusion to which these considerations tend to lead is that Congress, by enacting the transition rules in the Tax Reform Act, has implicitly endorsed the substance of the proposed Treasury regulations. Indeed, the Conference Report explicitly states that, “The conference agreement does not prevent the application of the proposed Treasury regulations after ....” the expiration of the transition rules with respect to any particular plan. Id. at 1175.

This reading of the transition rules is bolstered by the unwritten legislative history. It is widely known that the conferees chose these transition rules rather than adopting the compromise proposed by Senator Packwood and Congressman Conable. Under that proposal, zebras and flexible spending accounts would have been allowed, but a cap of $2,000 would have been
applied to all benefits under the plan other than dependent care assistance, for which a separate cap would have been permitted of $2,400 in the case of one dependent and $4,800 in the case of two or more dependents. This clearly substantive rule was rejected in favor of the transition rules, thus indicating the substantive intent of those rules themselves. It is quite likely, however, that Congress will revisit this issue in 1985 or 1986. One reason for this is that, although the Treasury approach rules out zebras and flexible spending accounts, it does not restrict the dollar amounts that can be excluded from income under these provisions. In an era when revenue loss is a serious concern, it is possible that Congress will wind up preferring strict dollar caps on cafeteria plan benefits in return for greater flexibility in how they may operate.

IV. Proposed Treasury Regulations.

For five years the Treasury and the IRS were silent on their views on the proper interpretation of section 125 of the Code. In fact, the IRS consistently refused to issue rulings or provide other guidance. Then, on May 2, 1984, the IRS proposed regulations for the tax treatment of cafeteria plans which are revolutionary in concept and result. Although presaged by the news release of February 10, 1984, these regulations go well beyond anything that even the most conservative members of the employee benefits bar had anticipated. They are comprehensive, dealing not only with key questions under Code § 125, but also with related issues under Code §§ 105, 106, 120, and 129. These regulations are ingenious in concept and sweeping in application. If unchanged in final form, and upheld in the courts, they will materially alter the law in this area.

The three concepts which are key to the proposed regulations, and whose adoption is necessary in order to strike down flexible spending accounts and zebras, are the special concepts of constructive receipt, use it or lost it, and deferred compensation advanced in these regulations. There are other difficulties with these regulations, which are dealt with in the next section, but this section of the article focuses on the broader questions of the validity of each of these three doctrines.

A. Constructive Receipt.

In order to understand the novelty and probable invalidity of the doctrine of constructive receipt embedded in the proposed cafeteria plan regulations, it is necessary to examine the key statutory, regulatory, and case law precedents.

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3 In PLR 7953021 (Oct. 3, 1979), the only known private rulings on cafeteria plans, the IRS indicated that benefits financed entirely out of employee money would not satisfy Code § 125. This ruling, however, was based on General Counsel Memorandum 38047 (Aug. 17, 1979), which was later revoked by General Counsel Memorandum 39080 (Nov. 23, 1983).
1. Law Prior to 1972.

Prior to the publication on December 6, 1972, of a proposed amendment to Treasury Reg. § 1.402(a)-1(a), it was a well established principle of tax law that the mere availability to an employee of an election under which the employee could receive future compensation either in the form of cash or in the form of contributions by his employer to a qualified plan did not result in a recognition of income by the employee at the time the election was made or at the time the services were rendered. Rather, participants would only be taxed when amounts were “distributed or made available,” in accordance with section 402(a) of the Code. The contribution by the employer to the qualified plan was not taxable to the employee under Treas. Reg. § 1.402(a)-1(a) (1) (i).

In Revenue Ruling 56-497, 1956-2 C.B. 284, the Service had ruled that a profit-sharing plan would be qualified if it met the usual nondiscrimination requirements of The Code, even though employees could choose, by prior irrevocable election, to have their share of the current year’s profits received in cash or contributed to the plan. In Revenue Ruling 63-180, 1963-2 C.B. 189, the Service held that, under such a plan, “the employer’s contribution on behalf of an employee is not includible in the employee’s gross income at the time the contribution is made, but the employee must include in gross income the amount distributed or made available to him as provided for in section 402(a) of the Code.” Thus, to the extent that an employee elected to have the employer make contributions to the profit-sharing plan rather than to receive cash, the availability of the election itself did not result in income to the employee. In so ruling, the Service distinguished and confined strictly to its facts the holding in Hicks v. United States, 314 F.2d 180 (4th Cir. 1963). The result reached in Revenue Ruling 63-180 was reaffirmed by Revenue Ruling 68-69, 168-1 C.B. 402.

The principle illustrated by Revenue Ruling 63-180 in the qualified plan area was applied by the Service to elections involving unfunded, nonqualified plans as well. In Revenue Ruling 69-650, 1969-2 C.B. 106, for example, an employer allowed certain of its employees to elect, prior to the beginning of the year, to defer a portion of such year’s scheduled salaries. Deferred amounts were to be distributed to each electing employee in installments over the 10-year period following the date of termination of employment. After noting that “income is not constructively received if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions,” the Service held that the deferred portion of the employee’s salary was not includible in income in the year earned but was only includible in the later taxable years in which it was actually received by, or otherwise made available to, the employee. Revenue Ruling 71-419, 1971-2 C.B. 220, is to the same effect. See also Rev. Rul. 68-86. 1968-1 C.B. 184; Rev. Rul. 60-31, 1960-1 C.B. 174, modified by Rev. Rul. 64-279, 1964-2 C.B. 121; Rev. Rul. 70-435, 1970-2 C.B. 100; and Rev. Proc. 71-19, 1971-1 C.B. 698.

In addition, the Service has acquiesced in judicial decisions giving effect
for tax purposes to contractual agreements deferring receipt of compensation for services even when it was clear that such provisions were entirely attributable to the desires of the individuals rendering the services and that such individuals could have chosen to receive their compensation on a current basis. See Ray S. Robinson, 44 T.C. 20 (1965), acq. 1970-2 C.B. xxi, 1976-2 C.B. 2; Commissioner v. Oates, 207 F.2d 711 (7th Cir. 1953), aff'g 18 T.C. 570 (1952), acq. 1960-1 C.B. 5. See also Howard Veit, 8 T.C. 809 (1947), acq. 1947-2 C.B. 4; Howard Veit, 8 T.C. Mem. 919 (1949).

2. The 1972 Proposed Regulations.

The amendment to Treas. Reg. § 1.402(a)-1(a), that was proposed in late 1972, provided in pertinent part as follows:

An amount contributed to an exempt trust will, except as otherwise provided in this subdivision, be considered to be contributed by the employee if at his individual option such amount was so contributed in return for a reduction in his basic regular compensation or in lieu of an increase in such compensation.

The proposed regulation constituted an attempt to change well established law, and its validity was accordingly challenged. Congressional awareness that the proposed regulation was intended to change existing law is evidenced by the legislative history of section 2006 of ERISA—a statutory provision which brought that attempt to a halt. See H.R. Rep. No. 93-1280, 93rd Cong., 2d Sess. 355.

3. Section 2006 of ERISA.

Section 2006 of ERISA, enacted in 1974, had a very broad reach. It dealt with elective salary reduction arrangements involving qualified pension and profit-sharing plans as well as nonqualified plans. It also dealt explicitly with cafeteria arrangements under which employees were entitled to choose between taxable and nontaxable forms of current compensation.

With respect to arrangements in existence on June 27, 1974, section 2006 froze the law as of January 1, 1972 (specifically referring to Revenue Rulings 56-497, 63-180, and 68-89, supra), and further provided that no final salary reduction regulations could be issued prior to January 1, 1977. Plans or arrangements which were not in existence on June 27, 1974, were the subject of section 2006(a), which declared that:

[A] contribution made before January 1, 1977, to [a qualified] employees' trust . . . or under [a covered type of] arrangement . . . shall be treated as a contribution made by an employee if the contribution is made under an arrangement under which
the contribution will be made only if the employee elects to receive a reduction in his compensation or to forego an increase in his compensation.

The Conference Report explained the rationale for the treatment of post-June 27, 1974 plans as follows: "This will prevent a situation where a new plan might begin in reliance on pre-1972 law while Congress has not yet determined what the law should be in the future." H.R. Rep. No. 93-1280, 93rd Cong., 2d Sess. 355. This Conference Report language makes it clear that it was to be for Congress, not the Treasury, to decide whether the law should be changed from that which existed prior to 1972.

Section 2006(a) was twice amended to extend the period of its application. After the second amendment, it applied to contributions "made before January 1, 1980." See Pub. L. 95-615, § 5; Pub. L. 94-455, § 1506. Section 2006(a) was not subsequently amended and ceased to apply to contributions made to new plans or arrangements on or after January 1, 1980.


The proposed section 402(a) regulations, which were a major stimulus to the enactment of Section 2006 of ERISA, were withdrawn, but the IRS said that it would continue to follow the principles of that proposed regulation. This was made clear in the proposed Treas. Reg. § 1.61-16 regulation that was promulgated on February 3, 1978. This proposed regulation provided that, if compensation could, at the taxpayer's individual option, be deferred to a later year, the compensation would be treated as received by the taxpayer in the year in which it would have been paid but for the deferral. The notice of proposed rulemaking accompanying the proposed regulation acknowledged that the regulation would constitute a change in the position of the Internal Revenue Service, would require that a large number of revenue rulings be no longer applied or that they be reconsidered, and would necessitate the reconsideration of the acquiescences in the Oates and Robinson cases, cited above.

In response to this proposed regulation, which was aimed at nonqualified deferred compensation, as well as to deal with the cafeteria plan, cash or deferred plan, and other questions involved in section 2006 or ERISA, Congress adopted a number of provisions in the Revenue Act of 1978, P.L. 95-600. Section 132 of that statute, which is not contained in the Internal Revenue Code but which is a permanent and important tax provision, provides that the taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan shall be determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978. Although the legislative history indicates that section 132 was not intended to restrict judicial interpretations or determinations, the unmistakable intention of section 132 was to preclude further attempts by the Treasury

The law applicable to deferred compensation and salary reduction type arrangements on February 1, 1978, was no different from that which existed on January 1, 1972, to which section 2006 of ERISA applied. The decisions and rulings which constituted, and continue to constitute, that law make clear that an employee who elects not to receive a portion of his or her current compensation that has not yet been earned does not currently recognize income simply because he could instead have received cash and has chosen instead to receive nontaxable current benefits or taxable compensation on a deferred basis. The proposition reflected in the proposed regulations under Code § sections 61 and 402—namely, that an employee is taxable when he could have received cash income if he had an election to receive the cash or not—was clearly inconsistent with the settled, traditional law of constructive receipt. It was, moreover, inconsistent with other key provisions of the Revenue Act of 1978.

Just as section 132 of the Revenue Act preserved prior law for nonqualified deferred compensation, section 457 of the Code, as added by the Revenue Act of 1978, established that an employee of a unit of state or local government would not be subject to current taxation merely because he made an election, within certain limits, to receive part of his compensation on a deferred rather than a current basis. The Revenue Act of 1978 also added sections 401(k) and 402(a) (8) to the Code. The former provided that a profit-sharing plan would not be disqualified merely because it included a qualified cash or deferred arrangement. The latter provided that contributions made to a profit-sharing or stock bonus plan pursuant to a qualified cash or deferred arrangement shall not be treated as distributed or made available to the employee nor as contributions made to the plan by the employee. As is commonly known, cash or deferred arrangements under Code § 401(k) have been widely adopted and are perhaps the most exciting retirement benefit of the 1980's. They are made possible by the explicit provision of the Revenue Act of 1978, which rejected the IRS and Treasury view that an employee would be currently taxable if he had an election to receive or defer items of compensation.

It is important to point out that the language of Code § 402(a) (8) cannot be interpreted to mean that constructive receipt does occur when Code § 402(a) (8) does not apply—namely, in the case of a cash or deferred arrangement which is not qualified under Code § 401(k). There is no indication in the legislative history of Code § 402(a) (8) that Congress intended to cause employees constructively to receive income in circumstances in which there would have been no constructive receipt under established caselaw, and the statutory language itself clearly does not produce any such result. In fact, the effect of the language of Code §402(a) (8) is just the opposite—namely, to restrict rather than expand the scope of the constructive receipt doctrine. It
has always been clear under the case law that an employee who has already performed services entitling him to immediate payment compensation may not avoid current taxation of that compensation by, at that point, electing to defer receipt of the compensation. See generally Metzer, “Constructive Receipt, Economic Benefits and Assignment of Income: A Case Study in Deferred Compensation.” 29 Tax Law Rev. 525, 542-3 (1974). Code § 402(a) (8) changes this rule in the case of qualified cash or deferred arrangements: an employee may elect deferral even after he has earned the right to immediate payments of compensation.

5. Constructive Receipt Under Section 125.

Like Code §§ 457 and 401(k), and section 132 of the Revenue Act of 1978 itself, Code § 125 was enacted by the Revenue Act of 1978. It was intended to make it clear that the law of constructive receipt has no application with respect to elections made under a cafeteria plan as defined in Code § 125. Despite the fact that the legislative history clearly demonstrates that Congress enacted these provisions in order to protect taxpayers against the overreaching constructive receipt theories of the IRS and Treasury, those agencies are now proposing a doctrine of constructive receipt which assumes that Congress accepted, rather than rejected, its theories. In proposed Treas. Reg. § 1.402(a)-1(d) (1), it is provided that, except with respect to a qualified cash or deferred arrangement as defined in section 401(k), any amount contributed to a qualified plan will be treated as contributed by the employee if such amount was so contributed at the employee’s individual option. Under this rule, such amounts would be taxable to the electing employee in the period during which he might otherwise have received the income.

In the proposed regulations under section 125, 49 F.R. 193321 (May 7, 1984), the IRS and Treasury go even further. Here, they propose a rule according to which not only would all elections other than under a Code § 125 cafeteria plan be taxed when the employee might otherwise have received the amount, but also, elections under a Code § 125 cafeteria plan will be valid only if and to the extent that they comply with the IRS’ ever more restrictive notions of what constructive receipt requires. For example, in Q & A 8 of the proposed regulations, id. at 19324, it is stated that, “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.” To the extent that this rule is thought by the IRS to derive from the doctrine of constructive receipt, it is simply wrong. For example, under its own regulations dealing with the doctrine of constructive receipt for salary reduction contributions to Code § 403(b) annuities, the IRS has clearly provided that an election to make salary reduction contributions to such a tax deferred annuity program may be revoked at any time. Treas. Reg. § 1.403(b)-1(b) (3) (i).

In Q & A 9, 49 F.R. at 19324, the proposed cafeteria plan regulations
"the constructive receipt rules that apply with respect to employee elections among nontaxable and taxable benefits (including cash) . . . 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 (sic.) though both the opportunity to make this election occurs and the actual election is made before the benefits become currently available to the individual.

Again, this assertion that an election exercisable prior to the rendering of services triggers constructive receipt is simply wrong. The authorities cited above, and confirmed by the enactment of section 132 of the Revenue Act of 1978, confirm that a binding and irrevocable election made by an individual prior to the time when he was entitled to receive taxable benefits will effectively preclude him from being currently taxable on them. The assertion in the proposed regulations seems simply to be wrong, and has no greater validity than the theory which the Treasury has thrice now put forward in proposed regulations, without statutory or judicial support.

The IRS, of course, has authority under Code § 7805(a) to issue interpretative regulations. It does not, however, have the authority to make or change the rules of tax law, unless such authority has been specifically delegated to it by Congress. E.G., Code § 1502. No such delegation has occurred in this area.

In Q & A 14, 49 F.R. at 19325, the following statement occurs:

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. (Emphasis added.)

This statement erroneously conjoins two independent rules forming part of the traditional doctrine of constructive receipt. If an individual makes a binding and irrevocable election prior to the period of rendering services to defer receipt of compensation, he will not be taxable on that compensation, even though there is no risk of forfeiture. See the authorities cited above. On the other hand, an individual will not be in constructive receipt of income even though it is immediately available to him, or would be so if he gave notice of intent to receive it, provided that his right to receive it is subject to substantial limitations or restrictions or he would incur a significant penalty through the
receipt of it. Treas. Reg. § 1.451-2(a); Rev. Rul. 68-482, 1968-2 C.B. 186; see also, Code §§ 83(a) (2) & 402(b). These doctrines are independent. Constructive receipt, in other words, is precluded either by a prior binding agreement or a current substantial risk of forfeiture or penalty. Q & A 14 erroneously conjoins them into a single proposition, thereby suggesting that both conditions must be satisfied to prevent constructive receipt. Again, there is no basis for this assertion.

The proposed Code § 125 regs are suffused with two separate errors. One is the supposition that the rules of constructive receipt apply at all in this area. The legislative history of the Revenue Act of 1978 in general, and of Code § 125 in particular, confirm that the provisions permitting the elective employee benefits enacted by that statute were intended to permit such elections to operate without regard to the application of the doctrine of constructive receipt. Secondly, even if constructive receipt doctrines still applied in this area, there is no basis for the IRS and Treasury view that an election triggers constructive receipt even if made irrevocably and prior to the period of services. This view, as is conceded in the preamble to Treas. Reg. § 1.61-16, involves a rejection and alteration of established and settled legal principles. And now the Code § 125 proposed regulations have gone even further. In addition to adopting the erroneous notion that the existence of an elective right triggers constructive receipt, these regulations suggest that an election will trigger constructive receipt if it is revocable and is additionally subject to a substantial risk of forfeiture. There is no basis for either of these contentions.

In sum, the constructive receipt doctrine embedded in the proposed Code § 125 regulations is even more out of line with established authority than were the prior proposals under Code §§ 61 and 402. It may well be that proposed cafeteria plan regulations could not achieve the desired result of shutting down flexible spending accounts and zebra plans without adopting this novel and unprecedented theory of constructive receipt. Here, as elsewhere, however, wishing does not make it so, and fidelity to the legislative history of the Revenue Act of 1978 and the traditional law of constructive receipt leads ineluctably to the conclusion that the IRS and Treasury theory of constructive receipt for cafeteria plans is invalid.

B. Use It or Lose It.

The phrase "use it or lose it" is such a catchy one that, like many such phrases, it obscures as much as it clarifies. This key requirement, as intended by IRS and the Treasury, is satisfied if either (1) there is real insurance involved, (2) there is real employer risk, or (3) there is real employee risk. In order for there to be real insurance, there must be a shifting of risk to the insurance company, as there is in a typical medical insurance policy where the insurance company undertakes to pay all claims up to a certain amount without knowing in advance the extent or nature of those claims. Similarly, there is real employer risk when the employer self-insures actual risks, as is
the case with a typical self-insured medical plan. The third requirement, that there be real employee risk, is satisfied if the employee is not assured of getting the full value of the cash compensation otherwise available to him if it is not fully utilized for the benefit selected. Thus, if an employee can receive back in cash the balance of any unused credits under a cafeteria plan, carry them over, or use them for other benefits, then the employee has not incurred any real risk. The phrase “use it or lose it” describes this latter element rather well, but at the cost of omitting the prior two. To repeat, the real requirement of the proposed regulations is satisfied if there is either employee risk, employer risk, or real insurance. Given this broader context, it is possible, even under the proposed regulations, to design and implement valuable and workable cafeteria plans. First, however, it is important to explore the weaknesses of the position taken in the proposed regulations.

1. Medical Benefits.

The two most significant benefits permissible under a cafeteria plan, in terms of dollar value, are medical benefits and dependent care assistance benefits. If it can be shown that in neither one of these cases is there a basis for the principle of use it or lost it, then that principle clearly cannot be justified as a general requirement for cafeteria plans.

Code § 105(b) states that amounts paid, directly or indirectly, to the taxpayer for expenses incurred by him for the medical care of himself, his spouse, or his dependents are excludable from gross income if received through “accident or health insurance for personal injuries or sickness.” Code § 105(e) (1) states that, for purposes of Code § 105, “amounts received under an accident or health plan for employees” shall be treated as amounts received through “accident or health insurance.” To interpret Code § 105(e) (1) as consistent with the requirement that a medical reimbursement plan exhibit “the risk shifting and risk distribution characteristics of insurance,” as does Q & A 17, 49 F.R. at 19326, is to misread and distort the language and legislative history of that provision.

It was clear, prior to the addition of Code § 105(e) (1) in the 1954 Code, that self-insured medical plans maintained by employers were within the ambit of Code § 105(b). See Epmeier v. United States, 199 F.2d 508 (7th Cir. 1952). The reason that Code § 105(e) (1) was added to the Code was to eliminate the difficulty of determining on a case-by-case basis whether a particular accident or health plan contained sufficient indicia of insurance to qualify as “accident or health insurance.” See H.R. Report No. 1337, 83rd Cong., 2d Sess. 15, 1954. The purpose of the provision, in short, was to clarify that non-insured accident or health plans would qualify for treatment under Code § 105(b), just as would insured or self-insured plans. For example, the Senate Finance Committee Report states:

The House bill would grant the same treatment to sickness and accident benefits financed by employers whether paid under insured or non-insured
plans. Your Committee approves in principle of the general objectives of the House provision in equalizing the tax treatment of insured and non-insured sickness and accident benefits.


Q & A 17 also states that, if an employee is entitled to a specific amount of medical reimbursement and may receive unused amounts in the form of cash or another benefit, then the reimbursements actually received for medical expenses will not be treated as reimbursements paid specifically to reimburse the participant for medical expenses. The cited authority for this proposition is Treas. Reg. § 1,105.2, which states, inter alia, that "thus, Code § 105(b) does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether or not he incurs expenses for medical care." This regulation was adopted prior to the enactment of Code § 125 and without consideration of cafeteria plans. So long as an employee receives any cash pursuant to an election governed by Code § 125, its non-taxability would seem governed exclusively by that provision, thereby rendering this regulation inapplicable.

In any event, the courts have not followed this regulation in cases involving Code § 105 as such. Three cases have considered the question whether an employee who has been disabled and is entitled to a distribution from a profit-sharing plan on account of disability is entitled to exclude the distribution from gross income as a disability distribution covered by section 105(c) of the Code. In Wood v. United States, 590 F.2d 321 (9th Cir. 1979), the Service conceded that contributions to the profit-sharing plan that had not vested could be distributed tax-free under Code § 105(c). However, on grounds that vested contributions would eventually be distributed to the employee in any event, the Service argued that they could not qualify as payments for disability under Code § 105(c). The Court of Appeals disagreed and held that, so long as a plan had the purpose of providing accident or health benefits, a payment that was actually distributed for disability could qualify for exclusion under Code § 105(c).

In Masterson v. United States, 478 F. Supp 454 (N.D. Ill. 1979), the court reached the same conclusion as in the Wood case, without even any special inquiry into whether the plan had the purpose of providing accident or health benefits. In Caplin v. United States, 83-2 U.S.T.C. 9615 (2d Cir. 1983), the profit-sharing plan was held not to qualify as a plan for disability. The court was clear, however, in stating that plan distributions would qualify for exclu-

4 The decision in Masterson v. United States, 478 F. Supp 454 (N.D. Ill. 1979), states that an accident or health plan under Code § 105(b) must contain "indicia of insurance." The authorities cited for this proposition, however, are Sidman v. United States, 336 F. Supp. 474 (S.D.N.Y. 1971), which relied in turn for this proposition upon Epmeier, supra, and Haynes v. United States, 353 U.S. 81 (1957). The decisions in both Epmeier and Haynes were rendered under the 1939 Code, before the addition of section 105(e) (1), and thus are not authority for the conclusion erroneously reached in Sidman and Masterson.
sion under Code § 105(c) if the plan specified that its purpose was to qualify as an accident or health plan or if the plan referred to specific injuries or illnesses as grounds for distributions.

These three decisions seriously undermine any significance that might be seen in Treas. Reg. § 1.105-2. This is so because they unanimously state that a plan can be an accident or health plan even if amounts not distributed specifically to reimburse an employee for medical expenses will eventually be distributed to him for some other purpose. This position is consistent with example 2 under Treas. Reg. 1.72-15(f), which concludes that a participant in a profit-sharing plan who will receive a weekly payment from his account under the plan in the event of personal injury or sickness may exclude such amounts under Code § 105(d). See also General Counsel Memorandum 36900 (October 29, 1976); Rev. Rul. 77-123, 1977-1 C.B. 28.

In conclusion, it seems clear from the statute, its legislative history, regulations, rulings, and decided cases that there is no adequate basis for the premise of the proposed cafeteria plan regulations that the exclusion provided under Code § 105 is limited to situations where the amount involved cannot be received in some other form if not provided as medical benefits—i.e., Code § 105 does not embody or require the “use it or lose it” principle.

2. Dependent Care Assistance Benefits.

With respect to dependent care assistance benefits under Code § 129, there is no mention in the statute of a requirement for insurance, and thus the Treasury and IRS have had to hang their hat on a different hook. Although not spelled out in the proposed regulations, the basis for the position that under Code § 129 there must be a real assumption or shifting of risks is apparently derived from the requirement in Code § 129(d) (1) that there be a “separate” written plan that provides for dependent care assistance benefits. This requirement certainly means that a Code § 129 plan cannot provide for any other kind of benefits. From this truism, the Government reasons that a plan that provides a participant with cash as an alternative to dependent care assistance benefits would violate this requirement and thus not satisfy the Code § 129 requirements for exclusion from gross income.

This reasoning is fallacious. The choice of cash is provided at the cafeteria plan level, not at the Code § 129 level. Furthermore, it is clear that Congress did not intend by the provision mandating a “separate” plan that there be no cash alternative. When Congress has intended this result, it has known precisely how to achieve it. In Code § 127, which deals with educational assistance benefits, Congress specifically provided, in addition to a requirement for a “separate” written plan, that “a program must not provide eligible employees with a choice between educational assistance and other remuneration includable in gross income.” Code § 127(b) (4); see Code § 127(b) (1).

Code § 127 provides clear proof, therefore, that the “separate plan” requirement of Code § 129 has nothing to do with whether cash may be a permissible alternative to dependent care assistance. And, in any event, under
a cafeteria plan the cash option is provided at the cafeteria plan level, and not under the dependent care assistance plan. Again, the conclusion seems unavoidable that there is no legal basis for the requirement that there be a real assumption or shifting of risks and that cashouts or carryforwards are consequently impermissible.

C. Deferred Compensation.

As was stated above, there are three novel concepts embedded in the proposed cafeteria plan regulations, each of which is necessary in order for the IRS and Treasury to reach the conclusion that flexible spending accounts and zebra plans are impermissible. The third of these three is the rather novel notion of deferred compensation found in these proposed regulations.

Code § 125(d)(2) clearly provides that the term "cafeteria plan" does not include any plan which provides for deferred compensation, but that this requirement does not apply in the case of elective contributions under a qualified Code § 401(k) cash or deferred arrangement. The theory of the proposed regulations is that a binding and irrevocable election to dedicate a portion of compensation that could be received currently to the provision solely of welfare benefits may violate the prohibition on deferred compensation, even though the amounts subject to the election could never be received as compensation.

For example, if an employee under a cafeteria plan elected to receive $2,000 less in compensation in order to receive $2,000 in dependent care assistance benefits, but by the end of the period covered by the election had only utilized $1,500 of the elected benefits, the proposed regulations would preclude carrying over into the next period the $500 of unused benefits, on pain of paying tax on the entire $2,000 in the year in which it would otherwise have been received. The apparent rationale for this position is that, if the $500 were not allowed to be carried forward, the employee would have to reduce his or her compensation for that ensuing period of coverage by $500 in order to get equivalent dependent care benefits during that period. Accordingly, to allow a carryforward of the $500 unused balance would be the equivalent of making $500 more available in compensation during that subsequent period than would otherwise have been the case.

This analysis does not hold up under careful scrutiny. Quite clearly, the only compensation being received in the subsequent coverage period is compensation paid during that period for services rendered during that period. Secondly, there is no factual basis for conclusively presuming, as the proposed regulations must, that, in the absence of a carryover, each employee would necessarily and always defer an amount of compensation for the subsequent period equal in value to the benefits which might otherwise have been carried over. Any legal rule which depends for its validity upon conclusively presuming to be true facts which are, at best, uncertain and contingent, does not rest upon a solid foundation.

There is yet a third and perhaps more serious reason to doubt the validity
of the deferred compensation position taken by the proposed regulations. So far as is known, there has heretofore been a clear and careful distinction maintained between deferred compensation and deferred welfare benefits. Consider, for example, an employee who accrues an entitlement to post-retirement medical benefits during his years of employment. Such benefits, however controversial they might be for other reasons, have never been considered deferred compensation. By contrast, it has always been quite clear what is intended by the phrase “deferred compensation.” Such amounts refer to payments in for form of cash or cash equivalents, usually after retirement or upon the occurrence of a stated age or event. Welfare benefits, either current or deferred, are received only in a specified form, or upon the occurrence of precisely defined conditions or events, or both. For example, post-retirement medical benefits can be received only if and to the extent that the participant (or his spouse or other dependents) actually incurs covered medical or health expenses. Although payable only at a fixed or determinable future time, the amount and nature of deferred compensation benefits are not further dependent upon the occurrence of other facts personal to the circumstance of the individual, such as incurring an accident or illness.\(^5\)

The proposed cafeteria plan regulations wholly abandon this established distinction between deferred compensation and deferred welfare benefits. In doing so, they depart from settled precedents. Contributions to a plan of deferred compensation are deductible only if the requirements of Code § 404 are satisfied, and, when made to a non-qualified trust or on an unfunded basis, can be deducted by the employer only in the year when the recipient takes a corresponding amount into income, and then only if separate accounts were maintained for each employee. Code § 404(a) (5). By contrast, deductions are allowable under Code § 162 for obligations to provide deferred welfare benefits in the case of an accrual basis taxpayer, as soon as the all-events test is met—namely, as soon as the fact of the liability has been determined and the amount thereof can be determined with reasonable accuracy. Treas. Reg. §§ 1.162-10; In Lundy Packing Company v. United States, 302 F. Supp. 182 (E.D. N.C. 1969), aff’d per curiam 421 F.2d 850 (4th Cir. 1970), the court required that contributions purportedly made to a sick pay fund be deductible only as deferred compensation under Code § 404(a), because the amounts contributed exceeded reasonable projections for sick pay and the contributions accrued and were payable to each employee upon termination of services, without regard to days lost from work due to illness. By contrast, in Zwicker Knitting Mills v. United States, 1980 U.S.T.C. 9832 (Ct. Cl. 1980), deductions for obligations under a collectively bargained sick pay plan were allowed under Code § 162 over the Commissioner’s objection that they should be deductible only under Code § 404 because they were

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\(^5\) A frequent exception to this general rule is one that allows a participant to receive a premature distribution of deferred compensation upon the occurrence of, and in an amount necessary to meet, a financial hardship. Such hardship distributions are uniformly treated as exceptions to the general deferred compensation rules, and simply serve to highlight the distinction between deferred compensation and deferred welfare benefits.
payable at periods of time substantially later than the year for which the taxpayer sought to deduct them. The court concluded that the amounts involved were not deferred compensation, even though payable later, because payments could be made only for health care and were not payable in any event to the employees covered by the plan. This distinction, in the view of the court, set the amounts clearly aside from deferred compensation, and thus permitted the deduction under Code § 162.

To summarize, the deferred compensation position implicit in the proposed regulations defies common sense, established distinctions, and settled case law. It should be permissible under a cafeteria plan irrevocably to commit amounts which might otherwise have been received as compensation to the provision of welfare benefits. It should not matter whether the selected welfare benefits are received during the period which the compensation might otherwise have been received, or at a later time either by election of deferred welfare benefits or through carryforwards. By taking the opposite view, the proposed regulations are invalid in yet a third basic way.

V. Technical Problems Under the Proposed Regulations.

Although the regulations as proposed by Treasury are fundamentally flawed with respect to the three fundamental concepts that undergird them, there is no indication that the Treasury or the IRS intend to relent. Indeed, they have been emboldened in their views by the position taken by Congress in the Tax Reform Act of 1984. The implicit endorsement of the proposed regulations that can be read into the general and special transition rules adopted by Congress in TRA § 531(b) (5), have been taken by the Treasury and the IRS as justifying the substantive interpretations of law advanced in the proposed regulations. It is not credible, however, on the basis of the formal and informal legislative history of the transition rules, to suppose that Congress understood or thoughtfully considered the fundamental concepts upon which the proposed regulations are based. Since these concepts are key, not only to cafeteria plans, but generally in the tax law, it would be appropriate for Congress to reconsider these questions more carefully.

Moreover, in light of the fact that the IRS and Treasury position do not restrict the dollar amounts that may be exempted from taxation under a cafeteria plan, but merely impose artificially contrived restrictions upon the way in which such plans may operate, it would be appropriate for Congress to consider whether it might be more appropriate to allow flexible benefit programs, but to put dollar caps on the amounts of benefits that may be excluded. If this approach were taken, there would be no need to ban cashouts, carryforwards, or the use of amounts elected for one purpose to provide benefits of a different kind. The extreme and unsupportable views of the IRS and Treasury with respect to constructive receipt, use it or lose it, and deferred compensation would then be wholly unnecessary. The end result would be less revenue loss and less damage to the fabric of fundamental tax concepts. Finally, unless Congress more squarely confronts and
decides these issues, it seems certain that there will be litigation contesting the validity of the proposed regulations. This will hamper the long-range administration of the law, and prolong the uncertainty that has already infected this area for too great a period of time. With these considerations in mind, it is strongly recommended that Congress revisit and reconsider the rules governing cafeteria plans.

A host of separate technical considerations also require that the proposed regulations be rethought. In fact, in light of the significant technical defects in the proposed cafeteria plan regulations, as discussed in greater detail below, it seems inconceivable that Congress could have intended these rules to be the last word on the issue. Even if the general position framed in the proposed Treasury regulations is not altered, it can be hoped that the final regulations, when they appear, will address and correct these significant difficulties.\(^6\)

A. **How Many Cafeteria Plans May An Employer Maintain?**

Q & A 2, 49 F.R. at 19322, which deals with what a cafeteria plan is, does not address the question of whether an employer may simultaneously maintain more than one cafeteria plan. Assuming that all applicable nondiscrimination rules are satisfied, an employer should be permitted to maintain more than one cafeteria plan covering the same employees, or different employees, at the same time.

B. **What Is a Cafeteria Plan?**

Under Q & A 2, it is stated that a cafeteria plan must offer at least one taxable benefit and at least one nontaxable benefit. It is not clear whether this definition embraces a typical, one-benefit cafeteria plan, where, for example, employees may reduce salary in order to receive medical reimbursement. All medical reimbursements would comprise one nontaxable benefit. The salary that is subject to reduction, however, is pay that the employees would have received and paid tax on in any event. The final regulations should clarify that compensation that is taxable, but that would be received in any event, can be treated as a taxable benefit under a cafeteria plan.

C. **Do the Cafeteria Plan Rules Apply to Code § 401(k) Plans?**

As currently worded, Q & A 2 could be interpreted as providing that a free standing cash-or-deferred plan under Code § 401(k) constitutes a cafeteria plan that must meet all of the requirements of Code § 125 as well as the requirements of Code § 401(k). This interpretation is possible because a cafeteria plan is defined in Q & A 2 as any plan which offers at least one taxable benefit and at least one nontaxable benefit. A cash-or-deferred plan offers participants a choice between currently taxable cash and an employer

\(^6\) If the proposed regulations are valid because Congress has embraced them, however, it is not clear what authority Treasury and the IRS now have to correct the mistakes or defects in them through regulatory changes.
contribution to a tax qualified plan, a benefit which is not currently taxable. Under Q & A 5, 49 F.R. at 19323, a “nontaxable benefit” is a benefit which is not currently taxable.

Because Code § 401(k) imposes its own set of antidiscrimination rules, and since Code § 402(a) (8) provides separately for the noncurrent taxability of elective contributions to a cash-or-deferred plan, such plans should not also be regarded as subject to the requirements of Code § 125. Accordingly, a free standing cash-or-deferred plan should not be subject to the requirements of Code § 125. Moreover, if a cafeteria plan does include a cash-or-deferred benefit as part of its available choices, the only effect of including the cash-or-deferred election should be to subject elections under it to the rules governing elections under cafeteria plans, as set forth in Q & A’s 8 and 15, 49 F.R. at 19324, 19325. The final regulations should also specify that the “period of coverage” for a cash-or-deferred arrangement that is included in a cafeteria plan need not be a full plan year, but may be as short as each regular payroll period utilized by the employer. Further, as is permitted under the current Code § 401(k) rules, elections to deferred contributions to a cash-or-deferred plan should be revocable at any time and for any reason.

D. Must a Cafeteria Plan Specify the Maximum Amount of Employer Contributions Available?

Clause (v), of Q & A 3, 49 F.R. at 19322-23, requires that the written document embodying a cafeteria plan must specify the maximum amount of employer contributions available to any participant under the plan. There is no authority, nor any basis in policy, for this requirement. In fact, under many cafeteria plans it would be impossible to take the maximum amount available, because it is neither known or determinable until the close of a plan year. This requirement should be deleted from the final regulations.

E. To What Extent May a Cafeteria Plan Provide Benefits For Former Employees?

Q & A 4, 49 F.R. at 19323, states that a cafeteria plan may not be established “predominantly for the benefit of former employees of the employer.” There is no authority in Code § 125 or its legislative history for this requirement. Code § 125 specifically permits a cafeteria plan to cover “employees.” This term has generally been interpreted to include former employees, and should be so interpreted here. See Code §§ 79, 120, and 401. Nothing in Code § 125 prohibits a plan from covering retirees or laid off employees exclusively, and no policy considerations dictate that such a requirement be imposed.

In fact, a key objective of Code § 125 is to impart flexibility to benefits planning. This suggests that employers be given the freedom to establish cafeteria plans in any appropriate way. Benefits needs of laid off or retired employees may be distinctly different from those of active employees. If a
cafeteria plan covers a fair cross section of laid off or retired employees, it should be deemed to meet the coverage standards of Code § 125. Similarly, if a plan exclusively for the benefit of active employees covers a fair cross section of them, it should also be deemed to meet the coverage requirements of Code § 125.

The final cafeteria plan regulations should also clarify that a plan that covers both active and retired employees may offer different benefit choices to the active and retired groups. For example, an employer should be permitted to provide that the retirees can choose among a supplemental payment plan (meeting the requirements for a welfare plan under Title I of ERISA), post-retirement medical insurance, and post-retirement life insurance, while active employees may choose from benefit options that are different in kind from those offered to retirees.

F. What Requirements Should Apply to Participant Elections Under a Cafeteria Plan?

The provisions of Q & A 8, 49 F.R. at 19324, should be modified to make clear that common administrative practices of employers are acceptable methods of complying with the election requirements of Code § 125. For example, it should be permissible to deem an employee to have elected coverage from year to year so long as he does not specifically revoke an initial election. Similarly, it should be permissible to deem an employee to have made an election if, after adequate notice and a reasonable period of time, he has failed to return an election form.

The list of permissible situations under which a participant may revoke an election, and make a new one, after the period of coverage has commenced, as provided in Q & A 8, is too narrow and eliminates a number of nonabusive situations where a change in elections can be appropriate. For example, if a company changes insurance carriers, which in turn causes a change in the scope of coverage or in the cost borne by employees, employers would normally give employees the right to drop or add coverage. Such an option should be allowed under a cafeteria plan. Also, if the coordination of benefits provision in a spouse’s health or dental plan changes, an employee should be permitted to change elections, for such an alteration may materially affect the adequacy of his coverage under the employer’s Code § 125 plan. Similarly, if a new health maintenance organization becomes available to employees, they should be allowed to switch to or add such coverage, without having to wait for a new period of coverage to begin. Finally, if a premium increase becomes effective under an insured benefit plan during a period of coverage, participants should be permitted to modify elections. The list of examples of acceptable changes in family status also should be expanded to include other common events such as relocation of the employee, employment of the spouse, death of a dependent, and changes of schools attended by dependents.
G. Terminology.

Throughout the proposed regulations confusing terminology has been used. For example, the term "benefits" is frequently used when what is actually intended is the term "coverage." Coverage, in fact, is a key concept under the proposed regulations. The basic idea of the proposed regulations is that a participant under a cafeteria plan is required to make an advance and binding, irrevocable election with respect to "coverage" for certain kinds of benefits. He may, for example, reduce his salary by a certain amount of money in return for coverage for a stated period, such as a year, with respect to medical, dependent care, group legal, or other benefits. The coverage elected—which must be limited to one kind of benefit—may result in the delivery of benefits or reimbursements to the participant of more or less than the salary reduction amount to which the participant agreed.

In a very important sense, then, the "benefit" that is elected is really the "coverage" that is chosen. However, greater clarity would be achieved if the proposed regulations were more selective in their use of these terms and referred explicitly to "coverage" when that is what is actually intended.

The terminology of the proposed regulations is also frequently misleading in speaking of "contributions" to a cafeteria plan. All that is intended, and all that should be expressed, is that a participant under a cafeteria plan may become contractually entitled to benefits of a specific kind for a specific period. In the typical cafeteria plan, no contributions are made to any trust or fund. Rather, the employer merely keeps a separate account with respect to each participant and records in each account the value of coverage elected by the participant.

VI. Conclusion.

Cafeteria plans are an attractive, flexible, and potentially important employee benefit. The regulations proposed by the IRS and Treasury, however, would drain much of the attractiveness and flexibility out of cafeteria plans, without necessarily reducing the potential revenue loss that could be caused through their utilization. As has been examined in detail above, the basic concepts upon which these proposed regulations rest are fundamentally flawed. In consequence, these proposed regulations are invalid, if judged solely by tax law concepts in force prior to the Tax Reform Act of 1984. Although it is arguable that section 531(b) of the Tax Reform Act implicitly endorsed the proposed regulations, it seems probable that Congress neither understood nor reflected carefully upon the concepts involved. Furthermore, there are significant technical defects in the proposed regulations which need to be corrected.

If cafeteria plans are to be retained as a meaningful employee benefit, Congress should review and reexamine them carefully. It may be appropriate to turn aside from the rather dubious and controversial concepts of the pro-
posed regulations, and to restore genuine flexibility to cafeteria plans. Placing dollar caps on the amount of benefit coverage permissible for each participant under a cafeteria plan would more effectively serve to prevent undue revenue loss from cafeteria plans. This approach would continue to permit cafeteria plans to be utilized for health cost containment purposes.

In addition to many difficulties and uncertainties discussed in the prior portions of this article, it should be mentioned that there is substantial uncertainty about how to apply the antidiscrimination rules of Code § 125 and the provisions governing permissible underlying benefits, such as the provisions of Code §§ 79(d), 105(h), 120, and 129. In addition, there is the very difficult problem of determining how to “cost” or “price” benefits under a cafeteria plan. If cafeteria plan benefits are permitted to be priced according to the terms of the plan, there would be substantial latitude for employer manipulation, perhaps in favor of highly paid employees. If, on the other hand, benefits were required to be prices according to their actual cost to the employer, is this to be done by reference to the group cost or the individual cost? For example, is term insurance that is available under a cafeteria plan in accordance with Code § 79 to be priced by reference to the insurance premium for the entire group, or is a separate premium to be determined for each individual, based on that individual’s age?

It does seem certain that cafeteria plan pricing should not depend upon the value of what is actually received by a participant. For example, if supplemental health insurance is offered under a cafeteria plan, what should count is the cost of the premium for the insurance coverage, not the value of benefits received by participants under such a plan. The proposed cafeteria plan regulations do indicate that questions affecting benefits, particularly questions of discrimination, are to be determined, both for Code § 125 purposes and for purposes of the underlying Code provisions, by reference to coverage that is elected, rather than benefits that are received or coverage that is available. Most of the other questions in this area, however, remain unresolved, thereby adding additional significant uncertainty to this already troubled area of the law.

The purpose of this article has been to demonstrate that the past, current, and future rules governing cafeteria plans are uncertain and unclear. Cafeteria plans are, in both the literal and the figurative senses of the word, in transition. A major task for the 99th Congress when it convenes in January 1985 should be a careful and thoughtful review of the proper tax treatment of cafeteria plans.