

Internal Revenue Service Regulation Sec.125

Cafeteria Plans

Sec. 125 CAFETERIA PLANS

125(a) Sec. 125 [1986 Code]. **GENERAL RULE.**—Except as provided in subsection (b), no amount shall be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan.

125(b) **EXCEPTION FOR HIGHLY COMPENSATED PARTICIPANTS AND KEY EMPLOYEES.**—

125(b)(1) **HIGHLY COMPENSATED PARTICIPANTS.**—In the case of a highly compensated participant, subsection (a) shall not apply to any benefit attributable to a plan year for which the plan discriminates in favor of—

125(b)(1)(A) highly compensated individuals as to eligibility to participate, or

125(b)(1)(B) highly compensated participants as to contributions and benefits.

125(b)(2) **KEY EMPLOYEES.**—In the case of a key employee (within the meaning of section 416(i)(1)), subsection (a) shall not apply to any benefit attributable to a plan [year] 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. For purposes of the preceding sentence, statutory nontaxable benefits shall be determined without regard to the last sentence of subsection (f).

125(b)(3) **YEAR OF INCLUSION.**—For purposes of determining the taxable year of inclusion, any benefit described in paragraph (1) or (2) shall be treated as received or accrued in the taxable year of the participant or key employee in which the plan year ends.

125(c) **DISCRIMINATION AS TO BENEFITS OR CONTRIBUTIONS.**—For purposes of subparagraph (B) of subsection (b)(1), a cafeteria plan does not discriminate where qualified benefits and total benefits (or employer contributions allocable to statutory nontaxable benefits and employer contributions for total benefits) do not discriminate in favor of highly compensated participants.

125(d) **CAFETERIA PLAN DEFINED.**—For purposes of this section—

125(d)(1) **IN GENERAL.**—The term “cafeteria plan” means a written plan under which—

125(d)(1)(A) all participants are employees, and

125(d)(1)(B) the participants may choose among 2 or more benefits consisting of cash and qualified benefits.

125(d)(2) **DEFERRED COMPENSATION PLANS EXCLUDED.**—

125(d)(2)(A) **IN GENERAL.**—The term “cafeteria plan” does not include any plan which provides for deferred compensation.

125(d)(2)(B) **EXCEPTION FOR CASH AND DEFERRED ARRANGEMENTS.**—Subparagraph (A) shall not apply to a profit-sharing or stock bonus plan or rural cooperative plan (within the meaning of section 401(k)(7)) which includes a qualified cash or deferred arrangement (as defined in section 401(k)(2)) to the extent of amounts which a covered employee may elect to have the employer pay as contributions to a trust under such plan on behalf of the employee.

125(d)(2)(C) EXCEPTION FOR CERTAIN PLANS MAINTAINED BY EDUCATIONAL INSTITUTIONS.—Subparagraph (A) shall not apply to a plan maintained by an educational organization described in section 170(b)(1)(A)(ii) to the extent of amounts which a covered employee may elect to have the employer pay as contributions for post-retirement group life insurance if—

125(d)(2)(C)(i) all contributions for such insurance must be made before retirement, and

125(d)(2)(C)(ii) such life insurance does not have a cash surrender value at any time.

For purposes of section 79, any life insurance described in the preceding sentence shall be treated as group-term life insurance.

125(e) HIGHLY COMPENSATED PARTICIPANT AND INDIVIDUAL DEFINED.—For purposes of this section—

125(e)(1) HIGHLY COMPENSATED PARTICIPANT.—The term “highly compensated participant” means a participant who is—

125(e)(1)(A) an officer,

125(e)(1)(B) a shareholder owning more than 5 percent of the voting power or value of all classes of stock of the employer,

125(e)(1)(C) highly compensated, or

125(e)(1)(D) a spouse or dependent (within the meaning of section 152) of an individual described in subparagraph (A), (B), or (C).

125(e)(2) HIGHLY COMPENSATED INDIVIDUAL.—The term “highly compensated individual” means an individual who is described in subparagraph (A), (B), (C), or (D) of paragraph (1).

125(f) QUALIFIED BENEFITS DEFINED.—For purposes of this section, the term “qualified benefit” means any benefit which, with the application of subsection (a), is not includible in the gross income of the employee by reason of an express provision of this chapter (other than section 106(b), 117, 127, or 132). Such term includes any group term life insurance which is includible in gross income only because it exceeds the dollar limitation of section 79 and such term includes any other benefit permitted under regulations. Such term shall not include any product which is advertised, marketed, or offered as long-term care insurance.

125(g) SPECIAL RULES.—

125(g)(1) COLLECTIVELY BARGAINED PLAN NOT CONSIDERED DISCRIMINATORY.—For purposes of this section, a plan shall not be treated as discriminatory if the plan is maintained under an agreement which the Secretary finds to be a collective bargaining agreement between employee representatives and one or more employers.

125(g)(2) HEALTH BENEFITS.—For purposes of subparagraph (B) of subsection (b)(1), a cafeteria plan which provides health benefits shall not be treated as discriminatory if—

125(g)(2)(A) contributions under the plan on behalf of each participant include an amount which—

125(g)(2)(A)(i) equals 100 percent of the cost of the health benefit coverage under the plan of the majority of the highly compensated participants similarly situated, or

125(g)(2)(A)(ii) equals or exceeds 75 percent of the cost of the health benefit coverage of the participant (similarly situated) having the highest cost health benefit coverage under the plan, and

125(g)(2)(B) contributions or benefits under the plan in excess of those described in subparagraph (A) bear a uniform relationship to compensation.

125(g)(3) CERTAIN PARTICIPATION ELIGIBILITY RULES NOT TREATED AS DISCRIMINATORY.—For purposes of subparagraph (A) of subsection (b)(1), a classification shall not be treated as discriminatory if the plan—

125(g)(3)(A) benefits a group of employees described in section 410(b)(2)(A)(i), and

125(g)(3)(B) meets the requirements of clauses (i) and (ii):

125(g)(3)(B)(i) No employee is required to complete more than 3 years of employment with the employer or employers maintaining the plan as a condition of participation in the plan, and the employment requirement for each employee is the same.

125(g)(3)(B)(ii) Any employee who has satisfied the employment requirement of clause (i) and who is otherwise entitled to participate in the plan commences participation no later than the first day of the first plan year beginning after the date the employment requirement was satisfied unless the employee was separated from service before the first day of that plan year.

125(g)(4) CERTAIN CONTROLLED GROUPS, ETC.—All employees who are treated as employed by a single employer under subsection (b), (c), or (m) of section 414 shall be treated as employed by a single employer for purposes of this section.

125(h) CROSS REFERENCE.—

For reporting and recordkeeping requirements, see section 6039D.

125(i) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the provisions of this section.

.01 Added by P.L. 95-600. Amended by P.L. 104-191, P.L. 101-508, P.L. 101-140, P.L. 100-647, P.L. 99-514, P.L. 98-612, P.L. 98-611, P.L. 98-369, P.L. 96-613, P.L. 96-605 and P.L. 96-222. For details, see Code Volume I.

COM-RPT, 2002FED ¶7320.0129, **Committee Reports on P.L. 104-191 (Health Insurance Portability and Accountability Act of 1996)**

Committee Reports on P.L. 104-191 (Health Insurance Portability and Accountability Act of 1996)

.0129 Exclusion for employer-provided long-term care coverage.—A plan of an employer providing coverage under a long-term care insurance contract generally is treated as an accident and health plan. Employer-provided coverage under a long-term care insurance contract is not, however, excludable by an employee if provided through a cafeteria plan; similarly, expenses for long-term care services cannot be reimbursed under an FSA. ⁵ * * *—**House Committee Report.**

Conference agreement.—The conference agreement generally follows the House bill.—**Conference Committee Report.**

See also ¶6800.06 and 43,966.80.

Committee Reports on 100-647 (Technical and Miscellaneous Revenue Act of 1988)

.014 Definition of a cafeteria plan.—The bill amends the definition of a cafeteria plan so that a choice only between nontaxable benefits is not a cafeteria plan. The inclusion of a choice between nontaxable benefits as a cafeteria plan would require, to make the provision effective as a practical matter, additional amendments not intended by Congress. For example, under present law, a choice between nontaxable benefits, one of which constituted deferred compensation, generally would not be a cafeteria plan in light of the prohibition on deferred compensation in a cafeteria plan. Thus, an employer could simply add to any choice between nontaxable current benefits the choice of a nominal nontaxable deferred benefit; this would at least arguably remove the arrangement from the definition of a cafeteria plan. Although this and other problems with the new definition could have been individually addressed with additional rules, such rules would have added complexity not contemplated by Congress.

Sanctions.—The bill also clarifies that, in the case of a cafeteria plan that fails the cafeteria plan nondiscrimination test (sec. 125(b)(1)), only highly compensated employees are taxable on the available taxable benefits. In the case of a cafeteria plan that fails the key employee concentration test (sec. 125(b)(2)), the bill clarifies that only key employees are taxable on the available taxable benefits.

Qualified benefits.—In addition, the bill modifies the definition of qualified benefits. Under the bill, the term “qualified benefits” includes benefits that would be qualified benefits but for the fact that they are includible in an employee’s income under section 89(a). Thus, if, for example, there is a discriminatory excess with respect to a health plan offered under a cafeteria plan, such discriminatory excess will not cause the cafeteria plan to cease to be a cafeteria plan.

The bill also modifies the special definition of qualified benefits used for purposes of determining whether under the key employee concentration test (sec. 125(b)(2)), the qualified benefits provided to key employees under a cafeteria plan exceed 25 percent of the aggregate of such benefits provided to all employees under the plan. For this purpose, benefits that are includible in income (without regard to the key employee concentration test of sec. 125(b)(2)) are disregarded.—**Senate Committee Report.**

Conference Agreement.—Pensions; Employee Benefits.—The conference agreement follows the Senate amendment * * *.—**Conference Committee Report.**

For additional Committee Reports, see ¶7240.013.

Committee Reports on P.L. 99-514 (Tax Reform Act of 1986)

Senate Committee Report

.015 Cafeteria plans: Explanation of provision.—Under the bill, the definition of permissible cafeteria plan benefits is clarified. The effect of the provision, which changes the reference in section 125 from nontaxable benefits to qualified benefits is to (1) eliminate any possible implication that a taxable benefit provided through a cafeteria plan is nontaxable, and (2) clarify that certain taxable benefits, as permitted under Treasury regulations, can be provided in a cafeteria plan.

The bill makes two changes to the transition relief provided to certain cafeteria plans under section 531(b) of the Tax Reform Act of 1984. The first change provides that a cafeteria plan, in existence on February 10, 1984,

maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers will be granted relief under the transition rules until the expiration of the last collective bargaining agreement relating to the cafeteria plan. When a collective bargaining agreement terminates is determined without regard to any extension of the agreement agreed to after July 18, 1984. Also, if a cafeteria plan is amended to conform with either the requirements of the Act or the requirements of any cafeteria plan regulations, the amendment is not treated as a termination of the agreement.

Second, the bill provides that a cafeteria plan which suspended a type or amount of benefit after February 10, 1984, and subsequently reactivated the benefit is eligible for transition relief under either the general or special transition relief provision.—**Senate Committee Report.**

COM-RPT, 2002FED ¶7320.16, **Committee Report on P.L. 96-605 (Miscellaneous Revenue Act of 1980)**

Committee Report on P.L. 96-605 (Miscellaneous Revenue Act of 1980)

.16 Cafeteria plans permitted to provide deferred compensation under rules applicable to cash or deferred profit-sharing and stock bonus plans

A cafeteria plan is an employee benefit plan under which a participant may choose between taxable benefits and one or more nontaxable fringe benefits. Under present law, cafeteria plans are not permitted to provide deferred compensation.

Both cafeteria plans and cash or deferred profit-sharing plans allow employees to choose between current compensation and other benefits. The committee believes that present law is too restrictive because it does not permit employees to choose among currently taxable compensation, deferred compensation, and fringe benefits under a single plan.

Under the provision, benefits under a cafeteria plan could include amounts which an employee covered by a profit-sharing or stock bonus plan with a qualified cash or deferred arrangement can elect to have the employer pay as a contribution to a trust under a profit-sharing or stock bonus plan. Amounts contributed by the employer, pursuant to the employee's election, will be treated as nontaxable benefits for purposes of the "cafeteria" plan rules.

The provision is effective for taxable years beginning after December 31, 1980.—**Senate Finance Committee Report.**

COM-RPT, 2002FED ¶7320.17, **Committee Report on P.L. 96-222 (Technical Corrections Act of 1979)**

Committee Report on P.L. 96-222 (Technical Corrections Act of 1979)

.17 Prior to the Revenue Act of 1978, if a cafeteria plan was in existence on June 27, 1974, a participant in the plan was taxable only to the extent the participant elected taxable benefits under the plan. The 1978 Act made this favorable tax treatment applicable to all cafeteria plans meeting certain nondiscrimination standards, including a standard regarding the maximum number of years of employment which may be required as a condition of plan participation.

The committee believes that the use of the term "service requirement" in the cafeteria plan participation eligibility rules might lead taxpayers to believe that hours of service must be counted as they are under the qualified retirement plan participation rules (Code Sec. 410(a)).

The bill makes it clear that the cafeteria plan participation standard is based on years of employment rather than years or hours of service. The committee expects that the Treasury Department will prescribe by regulation what constitutes a year of employment.

This provision applies for plan years beginning after December 31, 1978.—**Senate Committee Report.**

COM-RPT, 2002FED ¶7320.20, **Committee Report on P.L. 95-600 (Revenue Act of 1978)**

Committee Report on P.L. 95-600 (Revenue Act of 1978)

.20 General.—Under the bill, generally, employer contributions under a written cafeteria plan which permits employees to elect between taxable and nontaxable benefits are excluded from the gross income of an employee to the extent that nontaxable benefits are elected. For this purpose, nontaxable benefits include group term life insurance up to \$50,000 coverage, disability benefits, accident and health benefits, and group legal services to the extent such benefits are excludable from gross income, but do not include deferred compensation.

The bill limits plan participation to individuals who are employees. In this regard, the committee intends that a plan may include former employees as participants and may provide benefits for beneficiaries of participants.

Under the bill, in the case of a highly compensated employee (an employee who is an officer, a more-than-5-percent shareholder, or within the highest paid group of all employees, or an employee who is a spouse or dependent of such an individual), amounts contributed under a cafeteria plan will be included in gross income for the taxable year in which the plan year ends, to the extent the individual could have elected taxable benefits unless the plan meets specified antidiscrimination standards with respect to coverage and eligibility for participation in the plan and with respect to contributions or benefits.

Coverage and eligibility.—A cafeteria plan will be considered to meet the coverage standards of the bill if it benefits a classification of employees found by the Secretary of the Treasury not to discriminate in favor of highly compensated employees. The plan will meet the eligibility standards of the bill if it (1) does not require an employee to complete more than three consecutive years of employment in order to become eligible to participate, and (2) allows an employee who is otherwise eligible to participate to enter the plan as a participant not later than the first day of the first plan year beginning after the date the employee completes three consecutive years of employment.

Contributions or benefits.—The bill provides that a cafeteria plan must not discriminate as to contributions or benefits in favor of highly compensated employees. 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 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.

In the case of a cafeteria plan which provides health benefits, the bill provides that the plan will not be treated as discriminatory if: (1) contributions on behalf of each participant include an amount which equals either 100 percent of the cost of health benefit coverage under the plan of the majority of highly compensated participants who are similarly situated (e.g., same family size), or are at least equal to 75 percent of the cost of the most expensive health benefit coverage elected by any similarly situated plan participant, and (2) the other contributions or benefits provided by the plan bear a uniform relationship to the compensation of plan participants. Of course, the committee intends that a cafeteria plan will not be considered to be discriminatory where the other contributions or benefits provided (or total contributions or benefits in the case of a plan which does not provide health benefits) for a highly compensated employee are a lower percentage of that employee's compensation than the plan provides for employees who are not highly compensated.

Under the bill, a plan is considered to meet all discrimination tests if it is maintained under an agreement which the Secretary of the Treasury finds to be a collective bargaining agreement between employee representatives and one or more employers.

In testing a cafeteria plan for discriminatory coverage of employees and discriminatory contributions or benefits, the bill provides that all employees who are employed by a commonly controlled group of businesses are

treated as if they were employed by a single employer. The rules for aggregating employees of businesses under common control are the same as the rules which are used in testing tax-qualified pension plans for discrimination (sec. 414(b) and (c)). The committee intends that, where an employer maintains two or more cafeteria plans, the employer may choose to have the plans considered as a single plan for purposes of the discrimination tests.

The amendment is effective for taxable years beginning after December 31, 1978.—**Senate Committee Report.**(20,227, 20,231)]

PROP-REG, 2002FED ¶7321, §1.125-1, **Questions and answers relating to cafeteria plans**, EE-16-79, 5/7/84 and 12/26/84, EE-130-86, 3/7/89 and REG-209461-79, 1/10/2001.