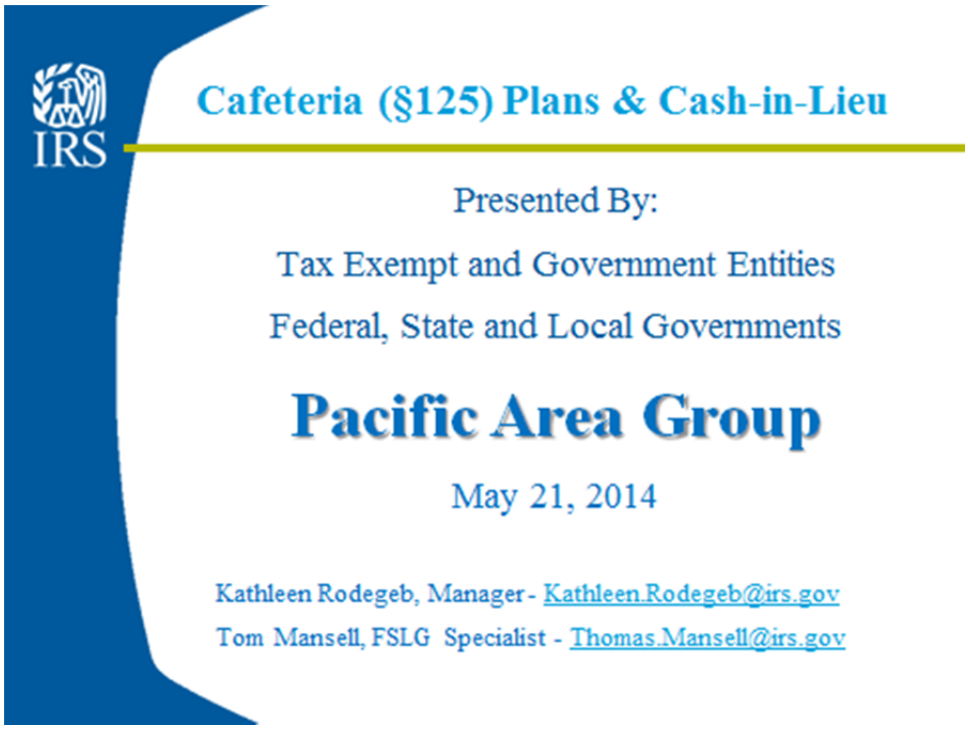
SLIDE 1

If you would like to be added to our distribution list for notifications of future presentation, please send an email to Kathleen.Rodegeb@irs.gov with your request to be added.

SLIDE 2

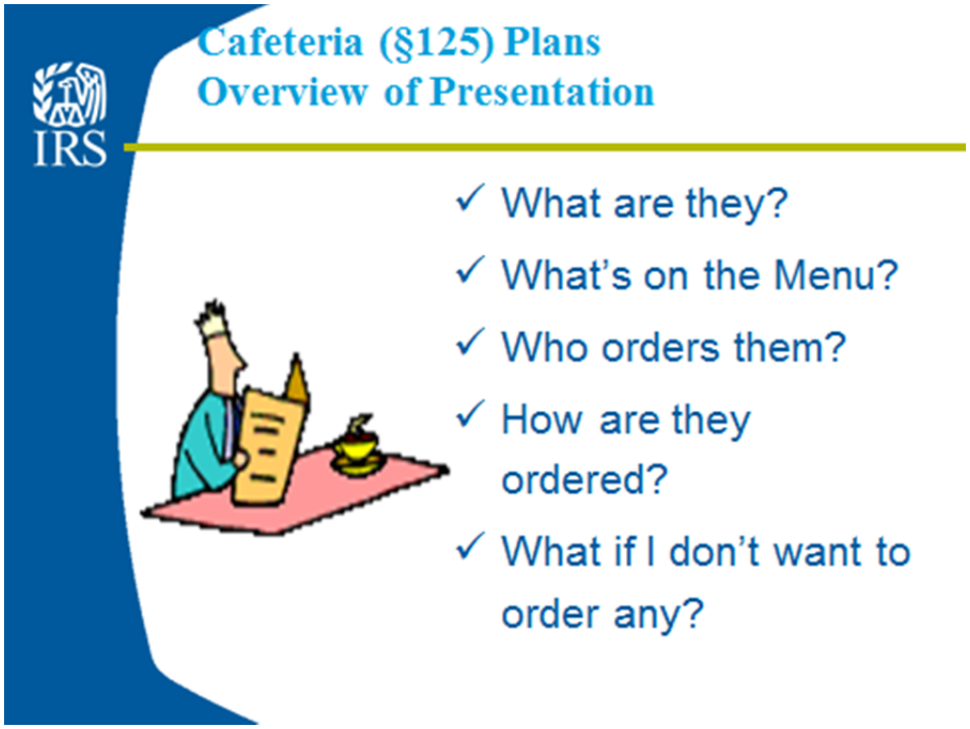


During this presentation, we will provide an overview of the basic requirements for Cafeteria Plans. With the invitation to this presentation, we sent two handouts; one of which is titled Quick Links for Government Entities, a tool that contains a list of important telephone numbers and email addresses, as well as a summary of and links to a variety of resources on the FSLG web site. We hope you find it useful. At the end of the presentation, we will provide a list of the resources we mentioned, all of which are available on the IRS web site at www.irs.gov or in the Internal Revenue Code and Treasury Regulations.

SLIDE 3

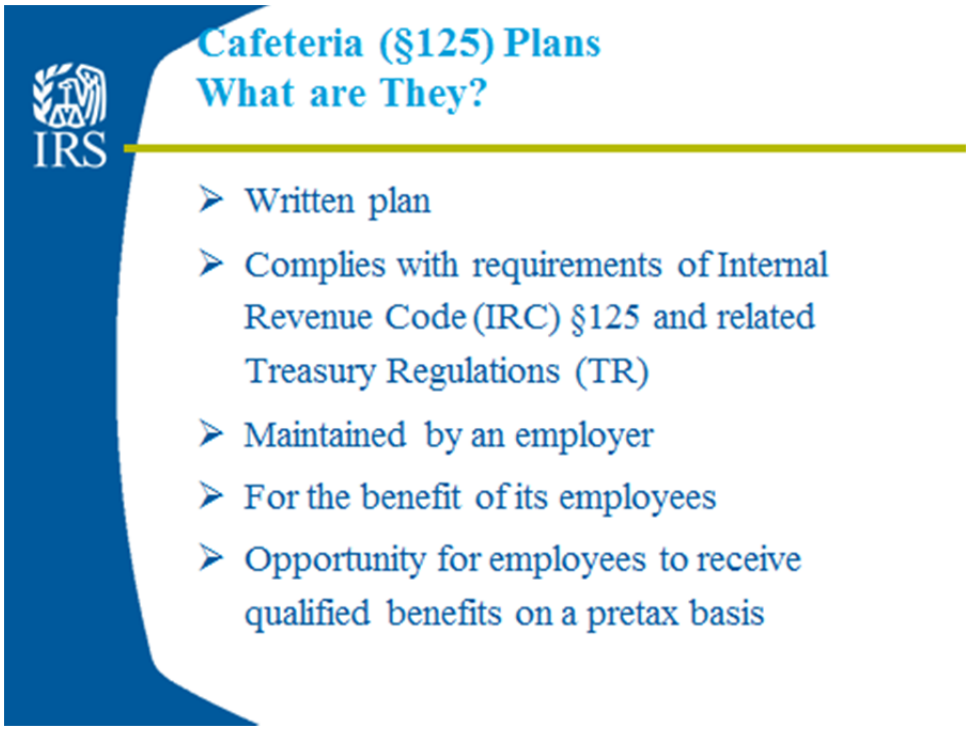
Cafeteria Plan: Qualified benefit (non-taxable) or Cash (taxable)?

SLIDE 4



Definition; what types of benefits can be offered; who can participate in the plans; how to participate in the plans; and what to do when an employee chooses not to participate in an employer's Cafeteria Plan.

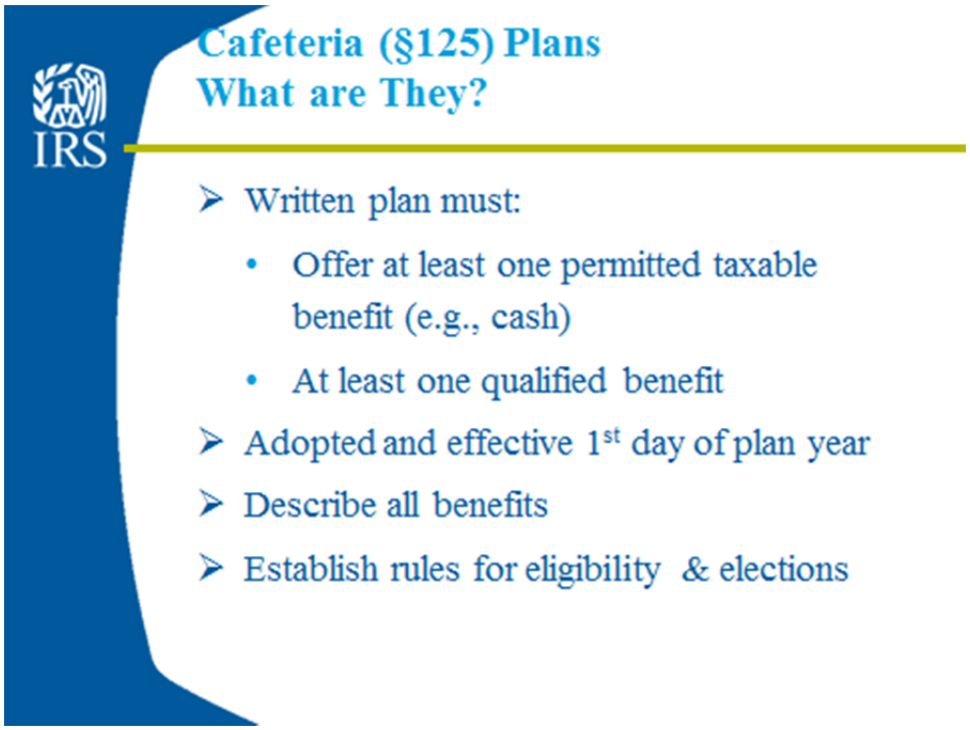
SLIDE 5



Cafeteria Plans provide options for employees to elect to receive pre-tax benefits, such as the cost of health care premiums, cash or a cash equivalent. They are the exclusive means for an employer to offer employees an election between taxable and nontaxable benefits, without the election itself resulting in the inclusion in the gross income of the employees.

Treasury Regulations section 1.125-1 defines a cafeteria plan as a separate written plan that complies with the requirements of Internal Revenue Code section 125 and related Treasury Regulations and that is maintained by an employer for the benefit of its employees. Non-employees cannot participate in an employer's Cafeteria Plan.

SLIDE 6



Cafeteria Plans must be written and must offer at least one permitted taxable benefit and at least one qualified benefit.

The taxable benefit will generally be cash, or its equivalent. The term *Cash* includes cash compensation (including salary reductions), payments for annual leave, sick leave, or other paid time off and severance pay. A distribution from a trust described in section 401(a) is not cash for purposes of section 125.

If employees are given the opportunity to elect only among two or more non-taxable benefits, the plan is not a cafeteria plan. Similarly, a plan that only offers an election among permitted taxable benefits, such as salary, paid time off or other taxable benefits, is not a cafeteria plan.

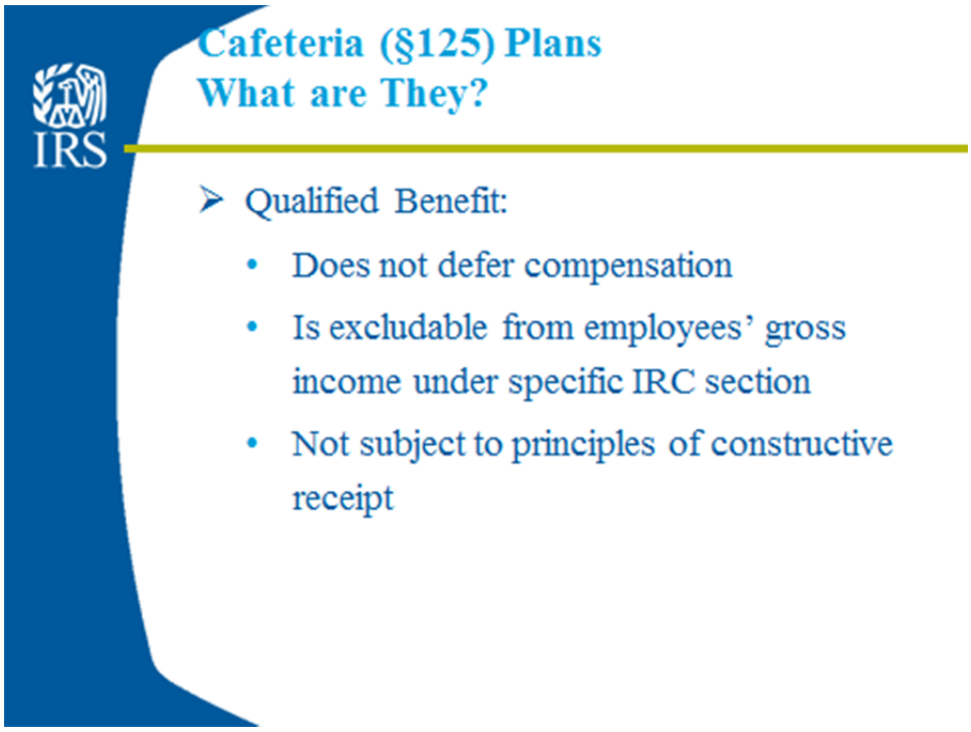
The plan must be adopted and effective on or before the first day of the plan year and must apply uniformly to all participants.

The plan document(s) must contain all of the following information:

- Description of benefits available
- Plan rules governing participation
- Requirement that participants be employees
- Procedures governing employees' elections, including periods that elections may be made; periods to which elections are effective; provide that elections are irrevocable (except for optional change in status rules)
- The manner in which contributions may be made (for example, through salary reduction)
- Maximum amount of employer contributions available through the plan
- Plan year
- If paid time off, required ordering rules for non-elective and elective paid time off
- If flexible spending arrangements, provisions for complying with requirements
- If grace period, provisions for complying
- If distributions from health Flexible Spending Arrangements to employees' Heath Savings Accounts, provisions for complying

If there is <u>no written plan</u>, if the written plan <u>fails to satisfy any of the requirements</u>, or if the plan <u>fails to operate according to the written plan</u>, then the plan <u>is not</u> a cafeteria plan and employees' elections between taxable and nontaxable benefits result in gross income to the employees.

SLIDE 7



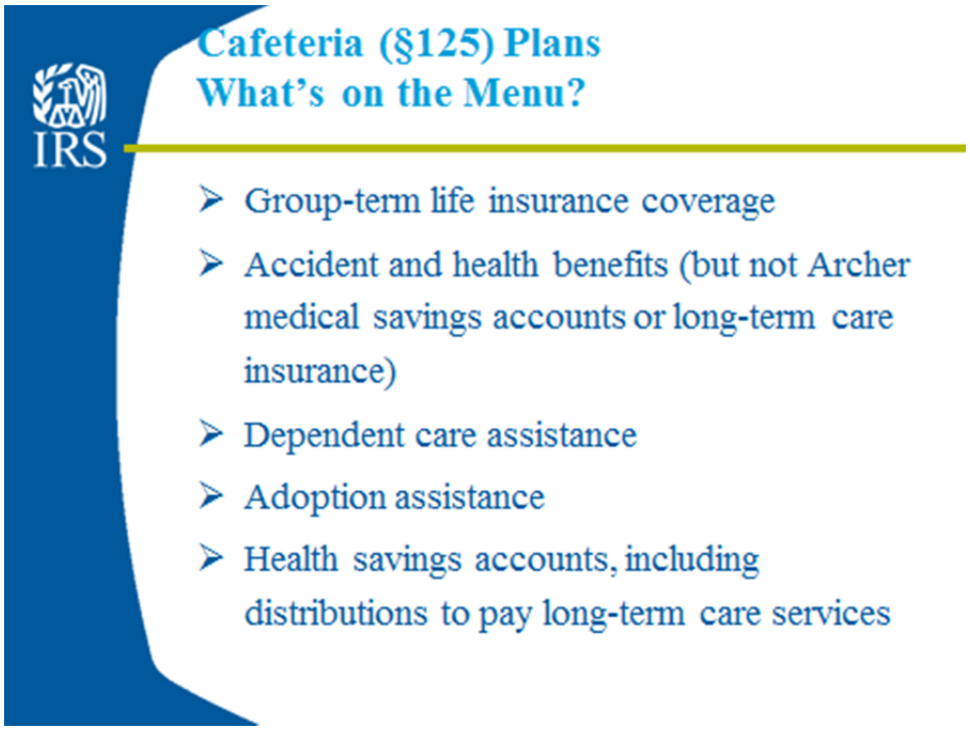
A Cafeteria Plan must not provide for the deferral of compensation, except as specifically permitted, such as contributions to a section 401(k) plan and a plan maintained by an educational organization described in section 170(b)(1)(A)(ii) for post-retirement group life insurance.

A Cafeteria Plan also must not provide for retirement health benefits for current employees beyond the current plan year or group-term life insurance with a permanent benefit.

The amount of salary foregone in order to receive the benefit is not subject to the principles of constructive receipt. That is, employees are not considered to have received that income, so the benefits provided to employees through Cafeteria Plans are excluded from gross income.

So, what types of benefits may be offered through Cafeteria Plans? First, we'll have a polling question for you to check your memory on what we've discussed so far, and then we'll have a look at the types of benefits that may be offered through a Cafeteria Plan.

SLIDE 8



The types of benefits that may be offered through a Cafeteria Plan include group-term life insurance; accident and health benefits; dependent care assistance; adoption assistance; and health savings accounts, including distributions to pay for long-term care services.

SLIDE 9

IRC section 79 – GTLI: Note that group-term life insurance can be provided by an employer to its employees without the cost being taxable to the employees, up to a maximum of $50,000 of coverage. The imputed cost of coverage in excess of $50,000, reduced by the amount the employee paid toward the insurance, is subject to social security and Medicare tax, but not income tax withholding, even when provided as a qualified benefit in a Cafeteria Plan. Table 2.2, in Publication 15-B, or the table in Treasury Regulations section 1.79-3(d)(2) should be used to compute the value of coverage in excess of $50,000 to be included in employees' wages.

IRC sections 105 and 106 – Medical and Health Care: Contributions to the cost of accident or health insurance, except for long-term care benefits provided through a flexible spending or similar arrangement, made directly or indirectly to an employee, are generally not subject to income, social security or Medicare taxes.

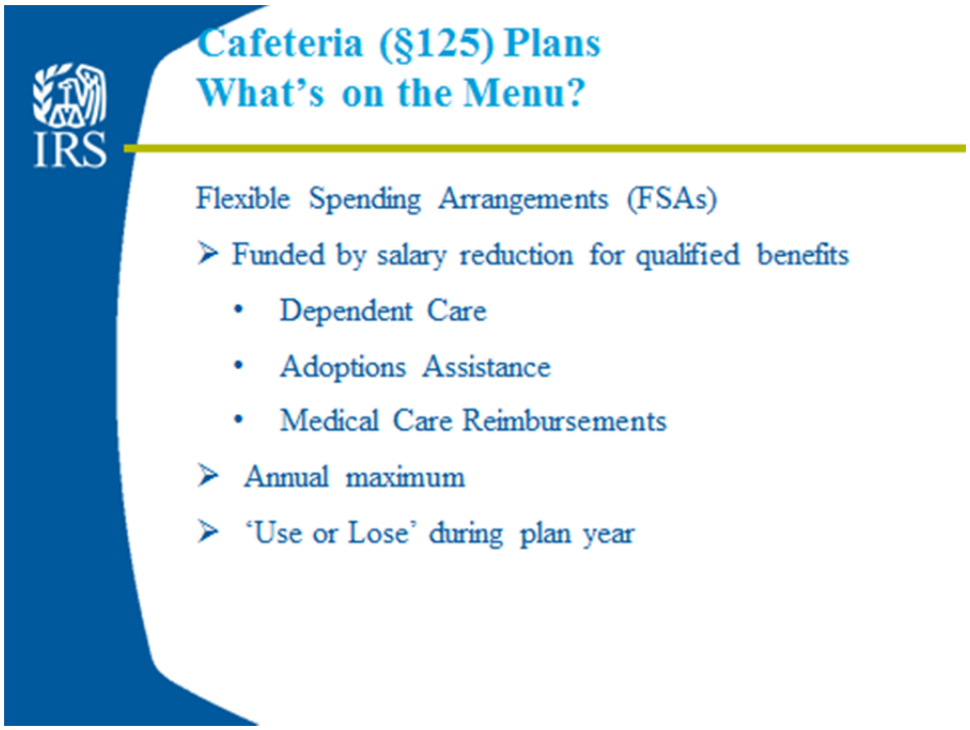
IRC section 125(d)(2)(C) – Certain plans maintained by educational organizations: This section allows an educational organization to maintain post-retirement group life insurance for its employees, provided that all contributions for the insurance are made before retirement and the life insurance does not have a cash surrender value at any time.

IRC section 129 – Dependent Care Assistance: The cost of dependent care assistance, up to $5,000 (or $2,500 for a married employee filing a separate return), is exempt from income, social security and Medicare taxes.

IRC section 137 – Adoption Assistance: Adoption assistance benefits provided in a cafeteria plan are subject to social security and Medicare taxes, but not to income tax withholding.

IRC section 223 – Health Savings Accounts (HSAs): HSA accounts for qualified individuals are exempt from income, social security and Medicare taxes up to the HSA contribution limits.

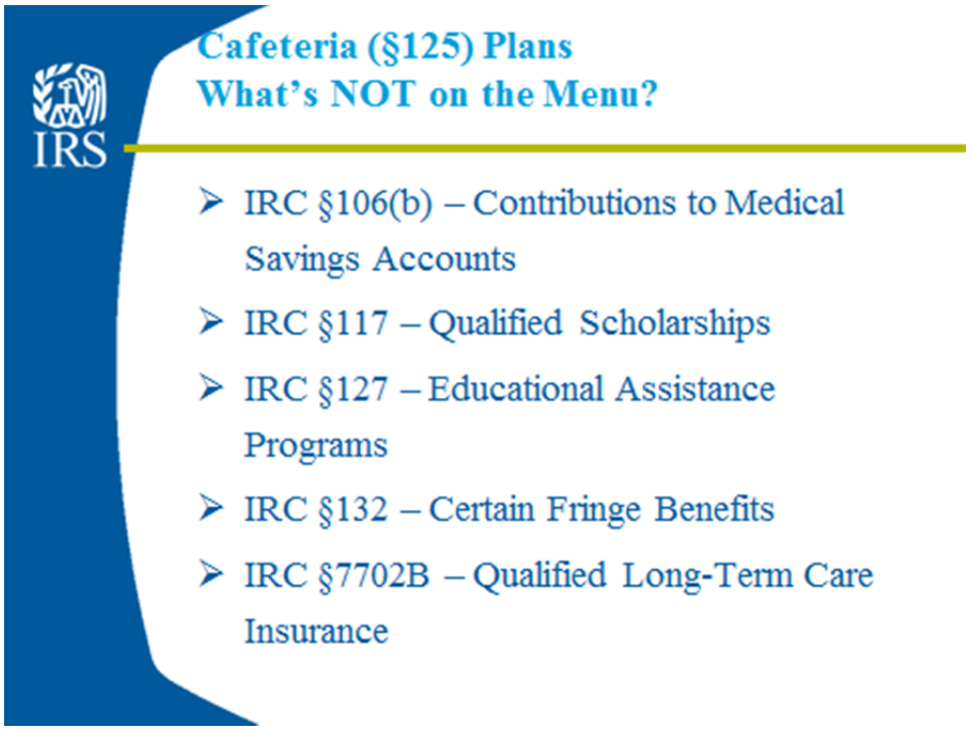
SLIDE 10



Flexible Spending Arrangements, or FSAs, may also be offered through Cafeteria Plans. A FSA is a form of cafeteria plan benefit, funded by salary reduction that reimburses employees for expenses incurred for certain qualified benefits.

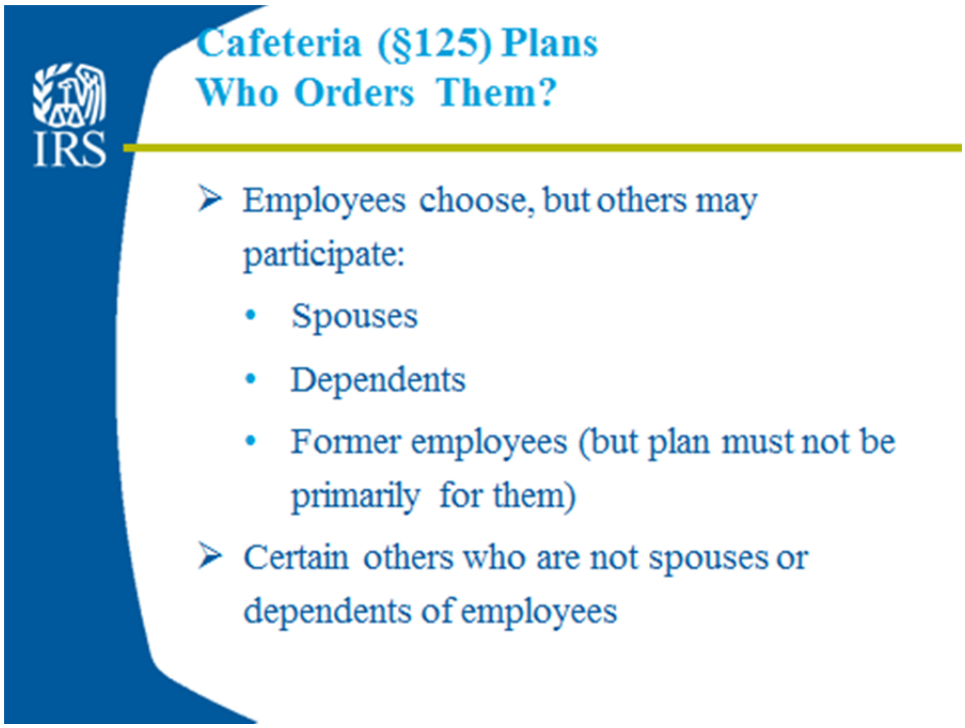
A FSA may be offered for dependent care assistance, adoption assistance and medical care reimbursements. The benefits are subject to an annual maximum and to an annual 'use-or-lose' rule. The maximum amount of reimbursement which is reasonably available to a participant for such coverage must be less than 500 percent of the value of the coverage. In the case of an insured plan, the maximum amount reasonably available must be determined on the basis of the underlying coverage. A FSA cannot provide a cumulative benefit to the employee beyond the plan year.

SLIDE 11



Some benefits that employers may offer to employees are not eligible to be offered through a Cafeteria Plan. These include Contributions to Medical Savings Accounts under IRC section 106(b); qualified scholarships under IRC section 117; educational assistance programs provided under IRC section 127; certain fringe benefits provided under IRC section 132 and qualified long-term care insurance provided for under IRC section 7702B. For additional information on the treatment of these benefits, please refer to Publication 15-A.

SLIDE 12



Cafeteria Plans are maintained by employers for employees. Treasury Regulations section 1.125-1 provides that the term employee includes any current or former employee (including any laid-off or retired employee) of the employer. It also includes:

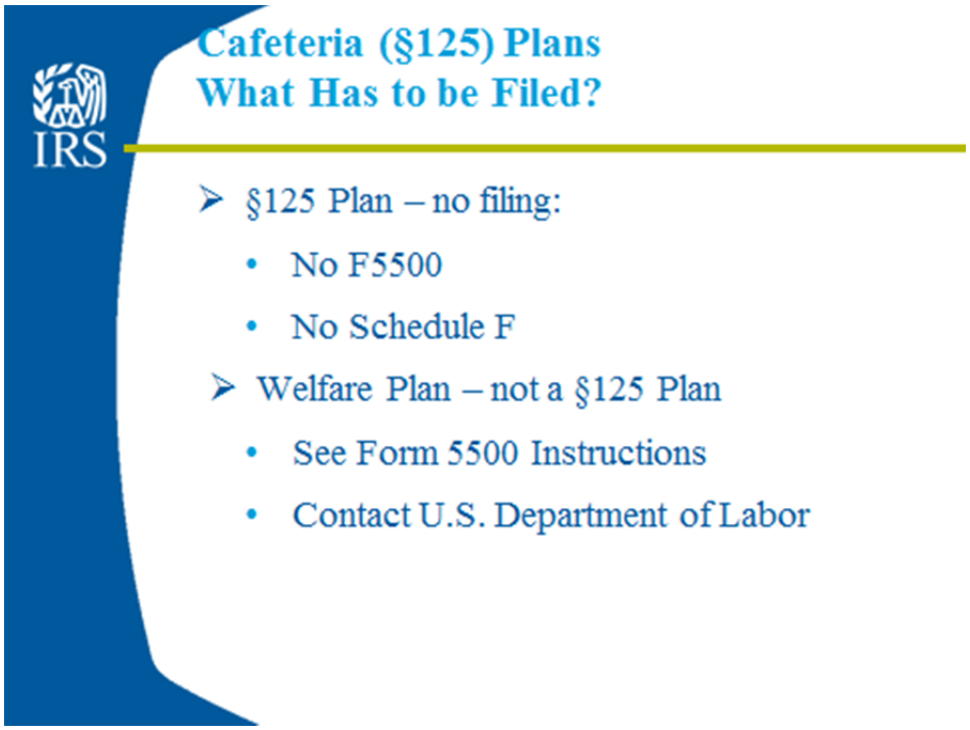
- Common law employees
- Leased employees
- Full-time life insurance salesman, and
- A current employee or former employee described in paragraphs (g)(1)(i) through (iii) of this section.

If an individual is an employee of an employer and also provides services to that employer as an independent contractor, the individual is eligible to participate in the plan solely in his or her capacity as an employee. The term employee does not include self-employed individuals.

Although former employees are treated as employees for purposes of section 125, a cafeteria plan may not be established or maintained predominantly for their benefit. Such a plan is not a cafeteria plan.

Spouses, domestic partners and dependents may not be participants in a cafeteria plan because they are not employees, but the plan may provide benefits to them.

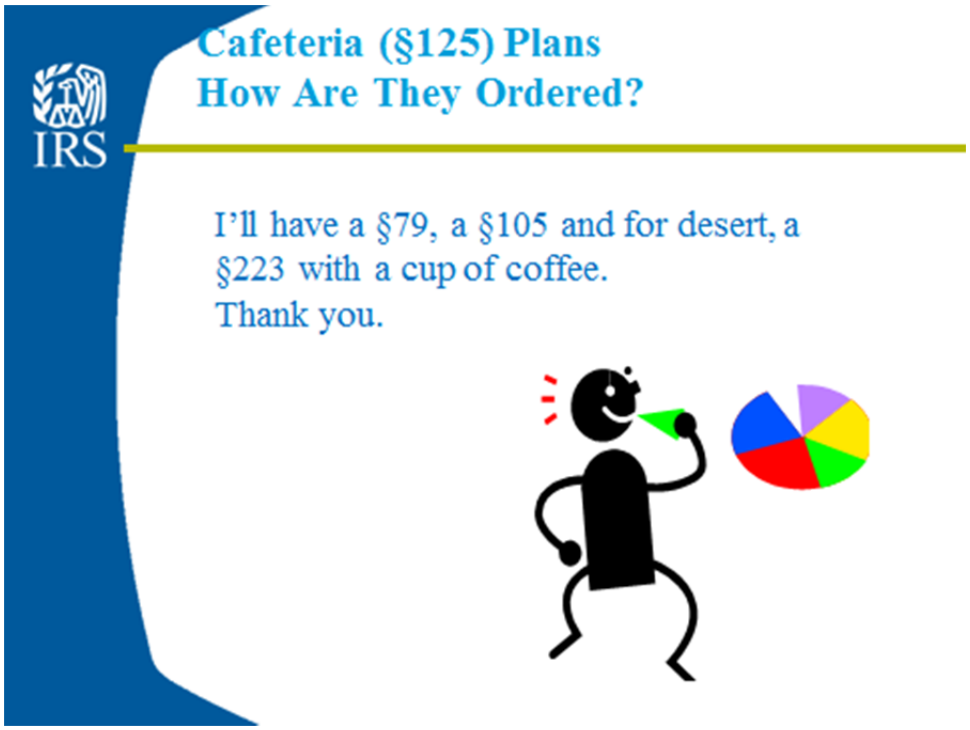
SLIDE 13



In order to be a qualified Cafeteria Plan, the plan must be in writing. However, there is no requirement to file tax or information returns relative to the plan with the IRS.

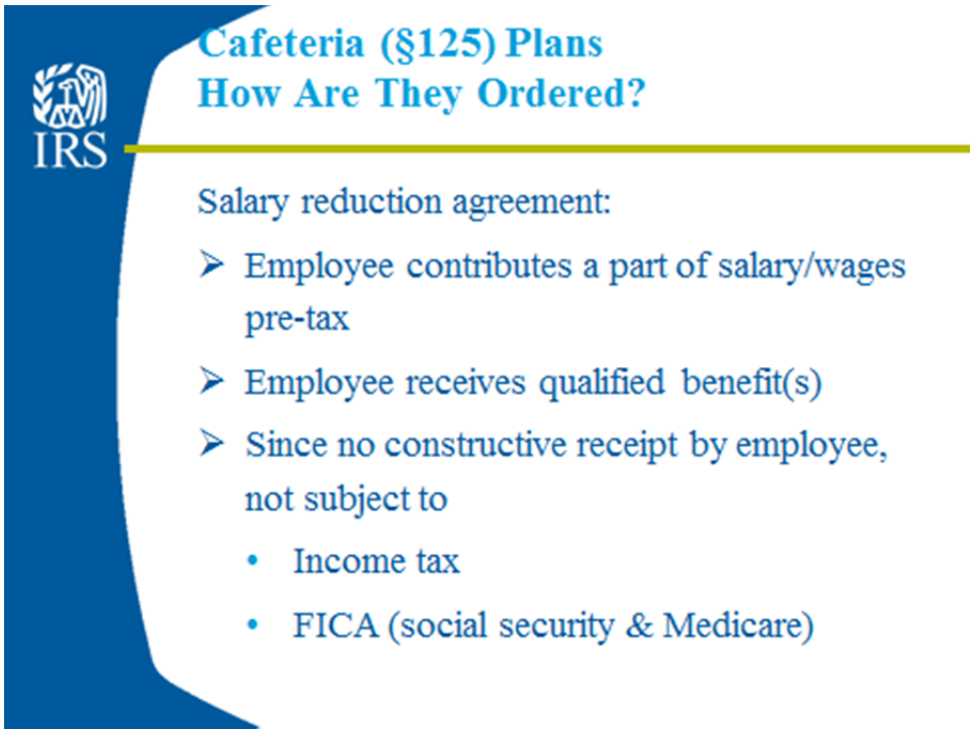
Welfare benefit plans are not section125 Plans. Such plans are beyond the scope of this presentation. If you have questions about them, please visit www.irs.gov and conduct a search on the term. You may also wish to refer to the instruction for Form 5500-SF.

SLIDE 14



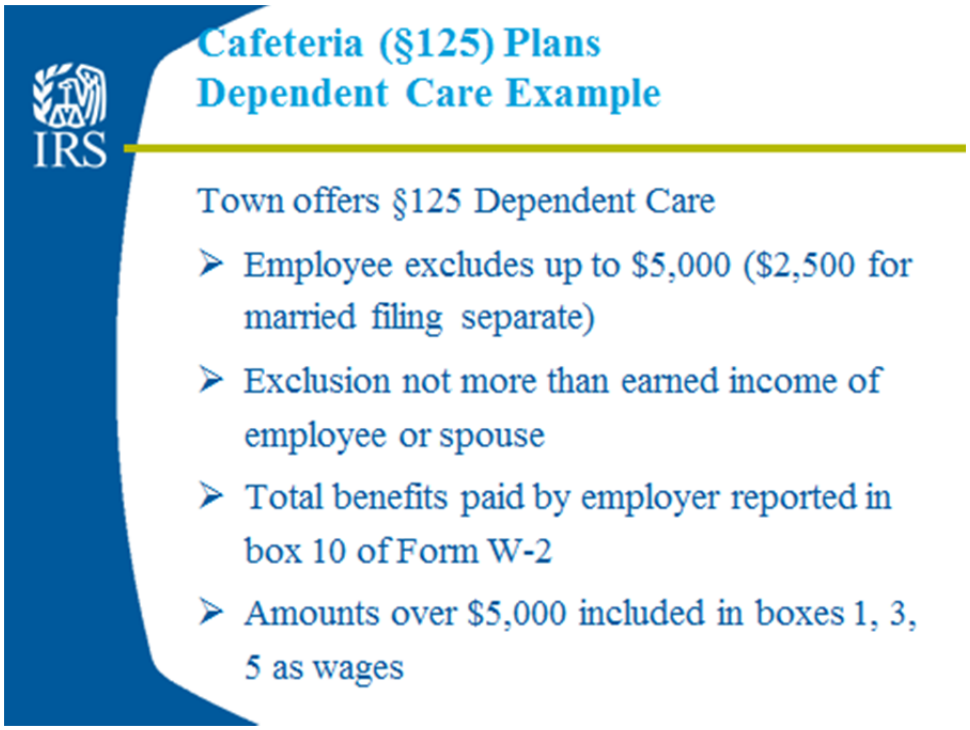
How do employees participate in an employer's Cafeteria Plan? They will generally fill out a form to inform the employer of the benefits they desire.

SLIDE 15



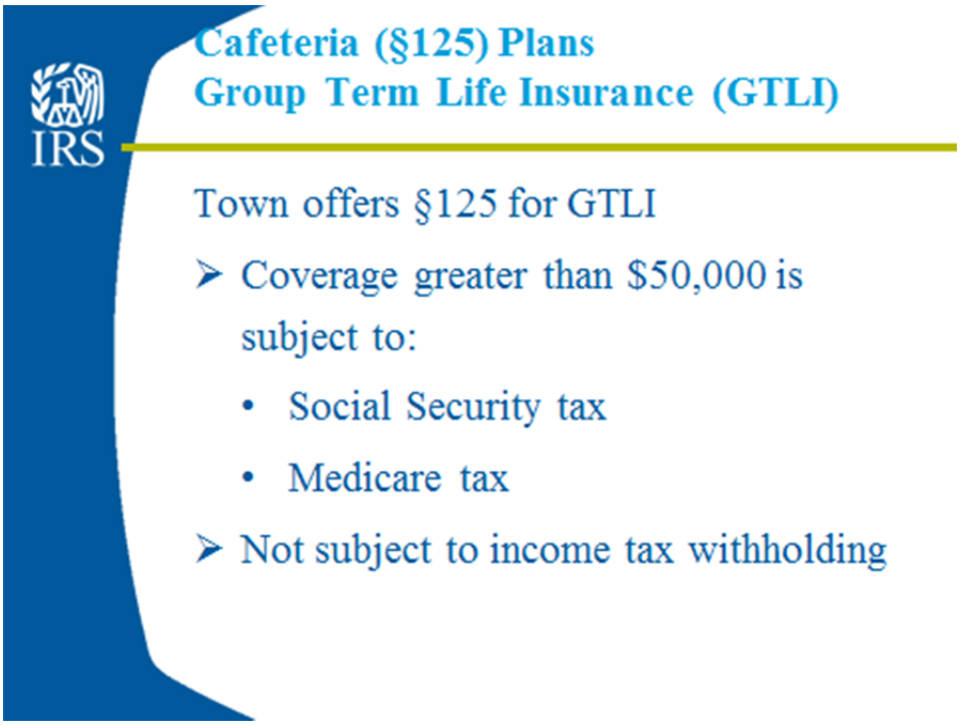
To pay for the benefit, employer contributions to Cafeteria Plans are usually made pursuant to salary reduction agreements between the employer and the employee. The employee agrees to contribute a portion of his or her salary on a pre-tax basis to pay for the qualified benefits. Salary reduction contributions are not actually or constructively received by the participant. For complete information on the rules, see the Proposed Regulations under IRC section 125. Benefits provided under Cafeteria Plans may automatically renew each year, so employees may not need to make a new election each year. However, if any employee wishes to change automatically renewing benefits, then a new submission should be made.

SLIDE 16



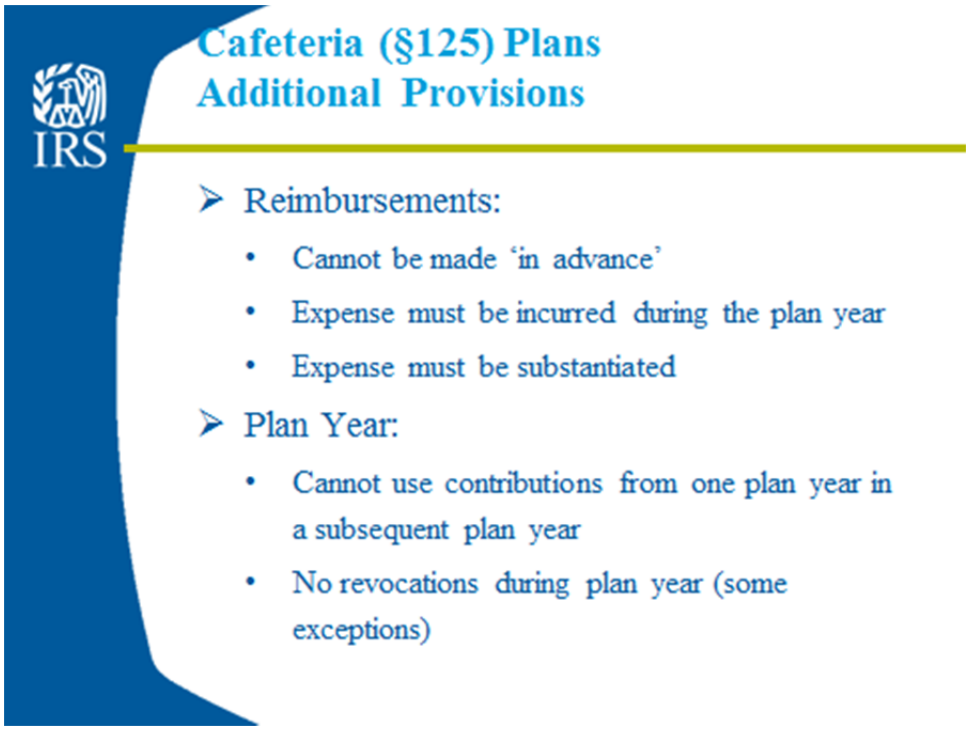
Example – dependent care expenses: An employee can generally exclude from gross income up to $5,000 of benefits received under a dependent care assistance program each year. The limit is reduced to $2,500 for married employees filing separate returns. The exclusion cannot be more than the earned income of either the employee or the employee's spouse. The total dependent care benefits the employer paid to the employee or incurred on the employee's behalf (including amounts from a section 125 plan) should be reported in Box 10 of Form W-2. Any amount over $5,000 should be included in boxes 1, 3 and 5, as "wages," "social security wages" and "Medicare wages." See Publications 535 and 15-A for additional information.

SLIDE 17



Example – group term life insurance: An employee is 53 years old on the last day of the plan year and received $100,000 worth of group-term life insurance during the year. The cost of the first $50,000 of value is not includable in the employee's income, however, the cost of the second $50,000 is includable as wages in boxes 1, 3 and 5 of Form W-2 and is shown in box 12 of Form W-2 with code 'C.' It is subject to applicable social security and Medicare taxes, but not to income tax withholding. Looking at Table 2.2 in Publication 15-B, we see that the cost per additional $1,000 per month is $0.23, resulting in additional wages of $11.50 (50 increments of $1,000 times $0.23) per month, or $138.00 for the year.

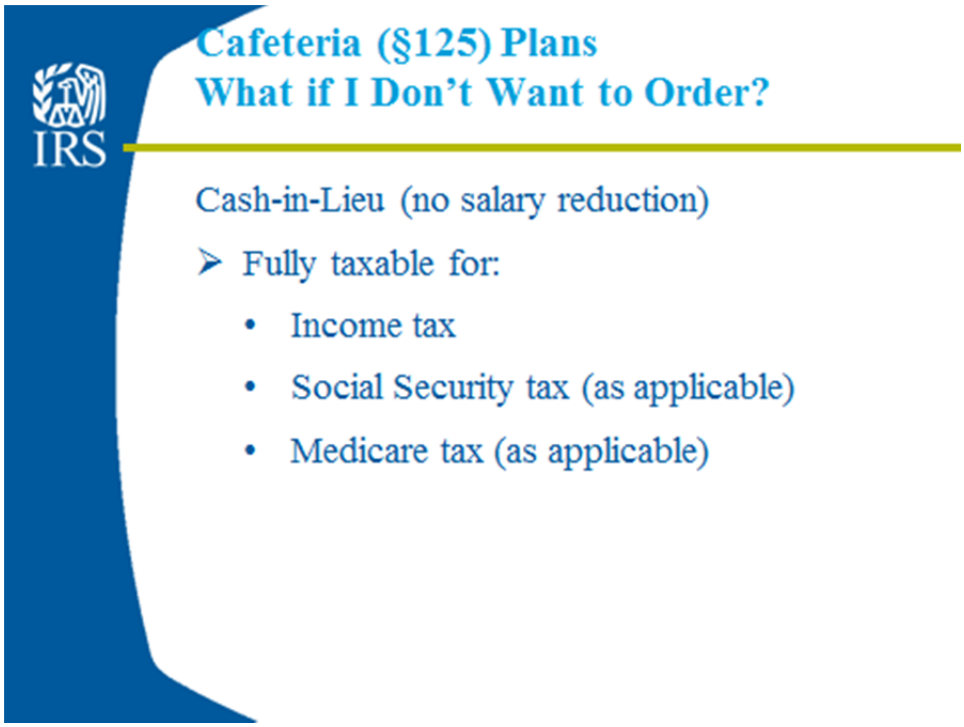
SLIDE 18



Each plan year stands on its own. Advance reimbursements are not permissible. Expenses must be incurred during the plan year and to receive reimbursements without them being considered taxable compensation, must be substantiated.

Contributions to a plan cannot be carried over to a subsequent plan year, and revocations during a year, with certain exceptions, are not permissible.

SLIDE 19



If an employee elects to receive cash instead of any qualified benefit, it is treated as wages subject to all applicable employment taxes. For more information, see Publication 535, Chapter 5 or Publication 15-A. And now, let's have another polling question before moving on.

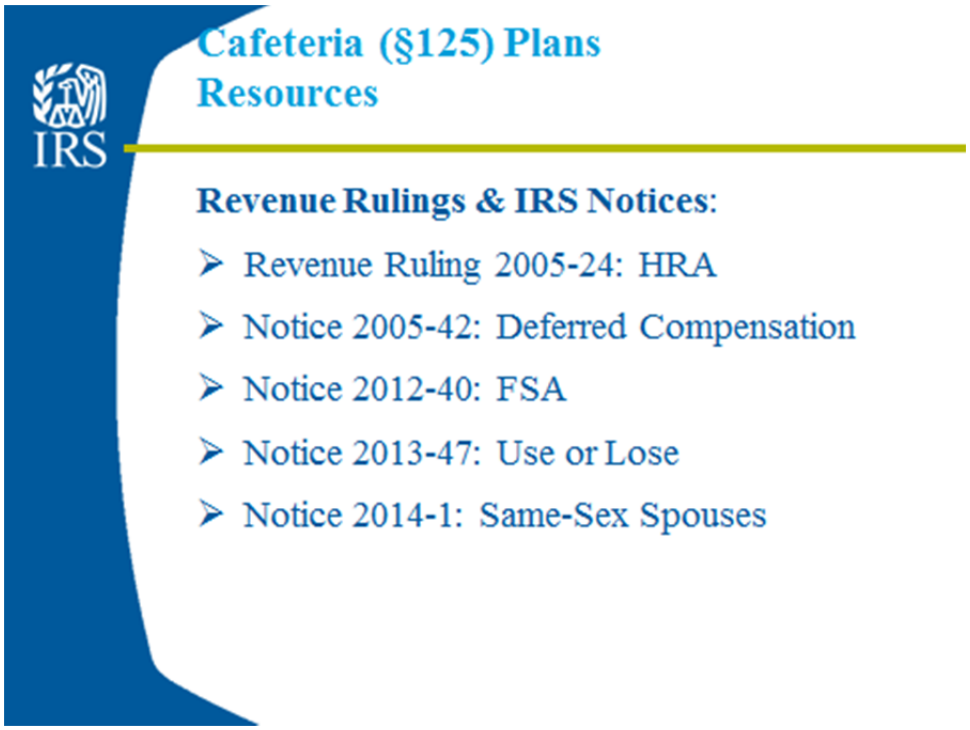
SLIDE 20

Review: To summarize Cafeteria Plans, remember the keys: the plan, in writing, provided by the employer for its employees, offering employees an option to select between at least one taxable benefit (for example, cash) and one qualified benefit, and know what, if any, taxes are applicable to the benefit(s) selected.

SLIDE 21

Much of the information regarding Cafeteria plans will be found in the Proposed Treasury Regulations under section 1.125-1; 2; 5; 6 and 7.

SLIDE 22



For additional information on:

- Health Reimbursement Arrangements, or HRAs, see Revenue Ruling 2005-24.
- Deferred compensation relative to Cafeteria Plans, see Notice 2005-42
- Flexible Spending Arrangements for Cafeteria Plans, see Notice 2012-40
- Use or Lose provisions of Cafeteria Plans, see Notice 2013-47, and
- For the new provisions for same-sex spouses, see Notice 2014-1

SLIDE 23

Cafeteria (§125) Plans Resources

Publications:

- Publication 15-B
- Publication 535
- Publication 969 (begin page 13)

SLIDE 24 – FSLG Pacific Area Group

Name	Email	Location Telephone Number	Coverage Area
Kathleen Rodegeb Group Manager	Kathleen.Rodegeb@irs.gov	Walnut Creek, CA (925) 974-3827	Pacific Area
Alice Huang FSLG Specialist	Alice.Huang2@irs.gov	El Monte, CA (626) 927-1238	California
A. "Jay" Gonzales FSLG Specialist	Amelito.Gonzales@irs.gov	San Diego, CA (619) 744-7160	California
Clark Fletcher FSLG Specialist	Clark.M.Fletcher@irs.gov	Bellevue, WA (425) 489-4042	Hawaii Oregon Washington
Nimfa Destreza FSLG Specialist	Nimfa.G.Destreza@irs.gov	San Carlos, CA (760) 736-7347	California
Ronald Coleman FSLG Specialist	Ronald.Coleman@irs.gov	San Diego, CA (619) 744-7169	California Nevada
Thomas Mansell FSLG Specialist	Thomas.Mansell@irs.gov	Santa Rosa, CA (707) 535-3830	Alaska California

The Pacific Area group of FSLG covers the states of Alaska, Hawaii, Washington, Oregon, California and Nevada. This slide contains a list of the Pacific Area group members, including their telephone numbers, email addresses and areas of coverage. Please feel free to contact us with your questions and requests for assistance.

Questions and Answers from the presentation:

Q1. Is cash in lieu of benefits taxable?

A1. Yes. Remember, Cafeteria Plans must be written and must offer at least one permitted taxable benefit and at least one qualified benefit.

Q2. We have retiree's that receive reimbursement and cash for not taking retirement benefits. Is this taxable income?

A2. Yes, it is taxable and is required to be reported on Form W-2, subject to all applicable payroll taxes and withholding.

Q3. For group term life insurance of retired employees, is coverage over 50,000 taxable?

A3. Yes, the value of group term life insurance in excess of $50,000 for retirees is taxable.

Q4. Is group term life insurance over $50,000 subject only to Social Security and Medicare? Is it subject to State and Federal taxes?

A4. The cost of group term life insurance is not subject to federal income tax withholding. We cannot answer questions regarding the taxability of benefits at the state level.