INTERNAL REVENUE SERVICE

Number: **200015021**
Release Date: 4/14/2000
TL-N-7055-99
Index No. 125.00-00

January 7, 2000

District Counsel,
Attention:

Chief, Branch 6 CC:EBEO:6

At our request, you forwarded the captioned case to this office by memorandum dated December 7, 1999. The Fed/State Coordinator had previously requested assistance from your office, on behalf of the Attorney General's office, as to whether an arrangement established by qualifies as a cafeteria plan under section 125 of the Internal Revenue Code. Coincidentally, by letter dated November 16, 1999, Senator requested assistance from the National Director for Legislative Affairs on the same issue.

We responded to Senator letter on December 22, 1999 (copy enclosed). Our response to Senator states that we do not rule on the issue of whether a plan satisfies the requirements of section 125. However, as a general rule, plans that provide for deferred compensation, and do not comply with the "use it or lose it" rule, like , do not qualify as cafeteria plans. In addition, we suggested alternative approaches on how a plan could be structured to accomplish the purpose of House Bill 2397.

Please feel free to use our letter to Senator as the response to the Fed/State Coordinator's request for assistance.

If you have any questions, please contact Felix Zech at (202) 622-6080.

Harry Beker

Enclosure.

December 22, 1999

The Honorable
United States Senator

Dear Senator :

This letter is in reply to your inquiry of November 16, 1999, enclosing a copy of a memo from Delegate and a letter from , Assistant Attorney General, . Those documents concern and seek a favorable ruling from the Internal Revenue Service (IRS) that the arrangement established by that statute qualifies under section 125 of the Internal Revenue Code (the Code).

, which was approved during the 1999 General Assembly and signed by the Governor on March 24, 1999, allows retiring State employees to irrevocably elect to have the amount of their accrued annual leave, sick leave, and unpaid wages credited to a supplemental health insurance account. Money in the account will be withdrawn to supplement the existing health insurance credit for retirees. If the retiree dies before the account is exhausted, the balance will be paid to his or her survivors. However, specifically provides it will only become effective on the first day of the third month following a ruling from the IRS that the plan "shall be treated as a qualified plan for Federal income tax purposes" (i.e., qualify as a cafeteria plan).

We regret that we did not have enough information when you first inquired about a ruling on to know that you were asking about a cafeteria plan, rather than some other type of health plan arrangement. Unfortunately, the IRS does not provide rulings on cafeteria plans. Section 8.07 of Rev. Proc. 99-4, 1999-1 IRB 115, (copy enclosed) states, "The Service does not issue letter rulings or determination letters on whether a plan satisfies the requirements of section 125." However, we can provide the following general information which discusses the law and offers alternative approaches to accomplishing the purpose of .

Section 125(d)(1) of the Code states that a cafeteria plan is a written plan under which all participants are employees and the participants may choose among two or more benefits consisting of cash and qualified benefits. A "qualified benefit" means any benefit, such as health insurance, that is excluded from the gross income of an employee if provided by his or her employer. A cafeteria plan permits an employee to

purchased qualified benefits with pre-tax dollars by entering into a salary reduction agreement with the employer.

However, under section 125(d)(2), a cafeteria plan may not provide for deferred compensation. The term "deferred compensation" is discussed in Q&A-5 of section 1.125-2 of the Proposed Income Tax Regulations, which states that a cafeteria plan permits the deferral of compensation if participants can use contributions for one plan year to purchase a benefit that will be provided in a subsequent plan year.
, which allows amounts to be carried from one year to the next to purchase supplemental health insurance, permits the deferral of compensation and therefore would not qualify as a cafeteria plan.

contains one additional problem under section 125. The provision which permits any unused amounts in the account to be paid to a retiree's beneficiaries is inconsistent with the "use it or lose it" rule that applies to all qualified benefits in a cafeteria plan. To satisfy section 125, would have to provide that any amount not used to provide accident and health insurance premiums within the taxable year remains with the State.

To have a cafeteria plan that meets the requirements of a section 125, retirees would have to use accumulated annual leave, sick leave and other unpaid wages to purchase retiree health insurance on a pre-tax basis but only for the remainder of the year in which the employee retires. Any accumulated annual leave, sick leave and unpaid wages not elected to be used to pay the cost of the retiree health insurance, would be paid to the retiree and includible in gross income. There would be no deferral of compensation under this arrangement.

As an alternative, an employer could use accumulated annual leave, sick leave and unpaid wages to fund health insurance for retirees without recourse to section 125 by following the approach outlined in Rev. Rul. 75-539, 1975-2 CB 45 (copy enclosed).

Revenue Ruling 75-539 considers two situations in which accumulated unused sick leave is used to purchase retiree health insurance. In the first situation, the retired employee has the option of receiving cash or applying the amount toward continued participation in the employer's medical insurance until the funds are exhausted. The IRS concludes that if participation is optional, then the value of the unused sick leave is included in the retiree's gross income regardless of whether it is paid in cash or used to pay health care premiums. In the second situation, the plan requires the mandatory payment of a portion of the accumulated unused sick leave for accident and health coverage. Under no circumstances can the retired employee, spouse, or dependents receive any of the amounts in cash. In this situation, where participation is mandatory, the value of the unused sick leave is excluded from the retiree's gross income. Since the plans described in Rev. Rul. 75-539 are not cafeteria plans, the amounts are not limited to the year of retirement but may be used year-to-year until exhausted.

I appreciate interest in fostering health insurance coverage for retired employees and regret that I could not provide a more positive response to his request. However, I hope the information provided will be helpful. If you have any questions please contact me at (202) 622-6010 or Mr. Felix Zech of my staff at (202) 622-6080.

Sincerely,
Mary Oppenheimer
Assistant Chief Counsel
Office of the Associate Chief Counsel
(Employee Benefits and Exempt Organizations)

Enclosures (2)