# PART XII: EMPLOYEE FRINGE BENEFITS

## 8778. How are funds provided to employees through an educational assistance program taxed?

An employee may generally exclude from income amounts received pursuant to an employer-sponsored Educational Assistance Program (EAP) that was established in order to fund employee education-related expenses, subject to the maximum limitation discussed below.[1] This exclusion was made permanent by EGTRRA 2001 following a number of extensions in preceding years. Amounts received under an EAP may be excluded whether or not the educational expenses are job related.[2] An employee cannot exclude from income more than $5,250 in educational assistance benefits in any calendar year.[3]

## 8779. What requirements must an education assistance program (EAP) meet in order to receive tax-preferred treatment?

The following requirements must be met by an employer-sponsored educational assistance program (EAP) to receive tax-preferred treatment:

1. *Written plan*: the program must be a separate written plan of the employer providing educational assistance for the exclusive benefit of the company's employees.[4] A sole proprietor may treat himself as employer and employee and a partnership will be treated as the employer of all self-employed partners.[5]

2. *Nondiscrimination*: the program must benefit employees who qualify under a classification set up by the employer that does not discriminate in favor of highly compensated employees, as defined in Code section 414(q). Generally, highly compensated employees are 5 percent owners or members of the top-paid group of employees. Employees covered by a collective bargaining agreement may be excluded if educational assistance benefits were the subject of good faith bargaining.[6]

3. *More than 5 percent owners*: the class of shareholders and their spouses and dependents, each of whom owns more than five percent of the employer's stock, cannot receive more than 5 percent of the educational benefit amounts.[7]

4. *Employee choice*: a program cannot offer employees a choice between educational assistance and other benefits that are includable in income.[8]

1. IRC Sec. 127(a)(1).
2. Treas. Reg. §1.127-2(c)(4).
3. IRC Sec. 127(a)(2).
4. IRC Sec. 127(b)(1).
5. IRC Sec. 127(c)(3).
6. IRC Sec. 127(b)(2).
7. IRC Sec. 127(b)(3).
8. IRC Sec. 127(b)(4).

5. *Funding*: an educational assistance program may be funded or unfunded.[1]

6. *Notification*: eligible employees must receive reasonable notification of the program's availability and benefits.[2]

A plan will still be considered in compliance with these requirements even though different types of educational assistance are used more than others or because successful completion of the course or obtaining a certain grade is required or considered in the process of obtaining reimbursement under the plan.[3]

Further, a plan will continue to meet the requirements of Section 127(b) even if it provides benefits to former employees. Included in the category of former employees are retirees, persons who were unable to work due to disability, persons whose positions were terminated due to a corporate downsizing, persons who left the employer voluntarily and employees who were involuntarily terminated from their positions.[4]

## 8780. What types of "educational assistance" may be provided on a tax-preferred basis through an employer-provided educational assistance program?

"Educational assistance," for purposes of an employer-sponsored educational assistance program (EAP), is generally defined in IRC Section 127 as an employer's payment of expenses incurred by an employee for education. Expenses such as tuition, fees, books, supplies, equipment and employer-provided courses of instruction including books, supplies and equipment are all included within this definition.[5]

Educational assistance does not include payments for tools or supplies that the employee may keep after finishing the course of instruction, as well as meals, lodging and transportation. Payment for any course or education involving sports, games or hobbies is not considered to be "educational assistance."[6]

The IRS, in interpreting the IRC definition, has defined a graduate level course as "… any course taken by an employee who has a bachelor's degree or is receiving credit toward a more advanced degree, if the particular course can be taken for credit by any individual in a program leading to a law, business, medical, or other advanced academic or professional degree."[7]

According to IRS guidance, a course will be considered to begin on the first regular day of class for the courses offered during that term. The date upon which a student registers for a course has no effect on the date the course is considered to have started for purposes of the Section 127 exclusion.

1. IRC Sec. 127(b)(5).
2. IRC Sec. 127(b)(6).
3. IRC Sec. 127(c)(5).
4. Treas. Reg. §1.127-2(h)(1); Rev. Rul. 96-41, 1996-2 CB 8.
5. IRC Sec. 127(c)(1).
6. IRC Sec. 127(c)(1).
7. Notice 96-68, 1996-2 CB 236.

## 8781. What reporting requirements apply to employers who provide assistance to employees through an educational assistance program?

Until 2002, an employer who maintains an Educational Assistance Program under IRC Section 127 was required to file an information return (Schedule F to the Form 5500) for each year that the program is in effect. The information return had to include the number of employees currently working, the number of employees eligible to participate in the plan, the number of employees actually participating, the total plan cost, and the number of highly compensated employees. In addition, the employer must identify itself and state the type of business in which it is engaged.[1]

Notice 2002-24, however, suspended these reporting requirements with respect to EAPs and certain other employee fringe benefits. Employers are relieved of the obligation to file under Section 3039D until the IRS provides further notice.[2]

Notice 2002-24 superseded Notice 90-24, which exempted plans under Section 127 from furnishing the additional information concerning highly compensated employees that was required by the TRA '86 amendments to Section 6039D.

This reporting relief applies to any plan year that begins prior to the issuance of further guidance on this subject by the IRS.[3]

## 8782. What is a dependent care assistance program?

A dependent care assistance program is a separate written plan of an employer for the exclusive benefit of providing employees with payment for or the provision of services that, if paid for by the employee, would be considered employment-related expenses under IRC Section 21(b)(2).[4]

"Employment-related expenses" are amounts incurred to permit the taxpayer to be gainfully employed while he or she has one or more dependents under age thirteen (for whom he or she is entitled to a personal exemption deduction under IRC Section 151(c)) or a dependent or spouse who cannot care for themselves. The expenses may be for household services or for the care of the dependents.[5]

The plan is not required to be funded.[6] A dependent care program may also be provided through a cafeteria plan.[7] See Q 8783 for a discussion of the tax treatment of employer contributions to a dependent care assistance program. See Q 8785 on the limitations to the amounts that an employee may exclude from income.

1. IRC Sec. 6039D.
2. 2002-16 IRB 785.
3. Notice 90-24, 1990-1 CB 355.
4. IRC Secs. 129(d)(1), 129(e)(1).
5. IRC Sec. 21(b)(2).
6. IRC Sec. 129(d)(5).
7. See Notice 2005-42, 2005-23 IRB 1204.

**8783. Is dependent care assistance provided by an employer as a fringe benefit taxable income to the employee? Do any nondiscrimination requirements apply in order for these benefits to be received tax-free?**

Non-highly compensated employees are permitted to exclude limited amounts (see Q 8785) received under an employer-sponsored dependent care assistance program for each tax year.[1] For highly compensated employees to enjoy the same income tax exclusion, the program must meet the following additional requirements:

(1) Plan contributions or benefits must not discriminate in favor of highly compensated employees as defined in IRC Section 414(q) or their dependents;

(2) The program must benefit employees in a classification that does not discriminate in favor of highly compensated employees or their dependents;

(3) No more than 25 percent of the amounts paid by the employer for dependent care assistance may be provided for the class of shareholders and owners, each of whom owns more than 5 percent of the stock or of the capital or profits interest in the employer (certain attribution rules under IRC Section 1563 apply);

(4) Reasonable notification of the availability and terms of the program must be provided to eligible employees;

(5) The plan must provide each employee, on or before January 31, with a written statement of the expenses or amounts paid by the employer in providing such employee with dependent care assistance during the previous calendar year; and

(6) The average benefits provided to non-highly compensated employees under all plans of the employer must equal at least 55 percent of the average benefits provided to the highly compensated employees under all plans of the employer.[2]

The dependent care assistance plan may disregard any employee with compensation less than $25,000 for purposes of the 55 percent test if benefits are provided through a salary reduction agreement.[3] For this purpose, compensation is defined in IRC Section 414(q)(4), but regulations may permit an employer to elect to determine compensation on any other nondiscriminatory basis.[4]

For purposes of the eligibility and benefits requirements (described in items (2) and (6) above), the employer may exclude the following employees from consideration:

(1) employees who have not attained age 21 and completed one year of service (provided all such employees are excluded), and

(2) employees covered by a collective bargaining agreement (provided there is evidence of good faith bargaining regarding dependent care assistance).[5]

1. IRC Sec. 129(d)(1).
2. IRC Sec. 129(d).
3. IRC Sec. 129(d)(8)(B).
4. IRC Sec. 129(d)(8)(B).
5. IRC Sec. 129(d)(9).

A program will not fail to meet the requirements above, other than the 25 percent test applicable to more than 5 percent shareholders, or the 55 percent test applicable to benefits, merely because of the utilization rates for different types of assistance available under the program. The 55 percent test may be applied on a separate line of business basis.[1]

## 8784. Is the employer entitled to a deduction for amounts paid to employees under a dependent care assistance program?

Yes. The employer's expenses incurred in providing benefits under a dependent care assistance program generally are deductible to the employer as ordinary and necessary business expenses under IRC Section 162.

## 8785. Is there a limit to the amount that an employee may exclude for payments paid by an employer under a dependent care assistance program?

An employee may exclude up to $5,000 paid by the employer for dependent care assistance provided during a tax year.[2] The excludable amount is reduced to $2,500 for a married individual filing separately. Additionally, the excludable amount cannot exceed the earned income of an unmarried employee or the lesser of the earned income of a married employee or the earned income of the employee's spouse.[3]

An employee cannot exclude from gross income any amount paid to an individual with respect to whom the employee or the employee's spouse is entitled to take a personal exemption deduction under IRC Section 151(c) or who is a child of the employee under nineteen years of age at the close of the taxable year, or the spouse.[4]

If the dependent care assistance is provided by way of on-site facilities (such as an on-site day care center), the amount of dependent care assistance excluded is based on a dependent's use of the facilities and the value of the services provided with respect to that dependent.[5]

The amount of employment-related expenses available in calculating the dependent care credit of IRC Section 21 is reduced by the amount excludable from gross income under IRC Section 129.[6]

## 8786. What reporting requirements apply in connection with amounts paid by an employer under a dependent care assistance program?

The employee must identify on the tax return all persons or organizations that provide care for the employee's dependent. This includes the name, address, and taxpayer identification number of the person (name and address in the case of a tax-exempt 501(c)(3) organization) providing the services. If the employee does not have the information, then the employee can use

1. See IRC Sec. 414(r).
2. IRC Sec. 129(a). See IRS Pub. 503.
3. IRC Sec. 129(b).
4. IRC Sec. 129(c).
5. IRC Sec. 129(e)(8).
6. IRC Sec. 21(c).

form W-10, Dependent Care Provider's Identification and Certification to request this information from the provider. The IRS may disallow a credit to an employee who fails to provide this information unless the taxpayer can show that he or she exercised due diligence in attempting to obtain the information. To show due diligence, the taxpayer should attach a statement explaining that the provider refused to complete the W-10.[1]

As is the case with employer-provided educational assistance programs, the IRS has suspended the reporting requirements that are otherwise applicable to dependent care programs until further notice.[2]

Prior to this suspension, IRC Section 6039D generally required an employer maintaining a dependent care assistance plan to file an information return with the IRS that provided the following information:

(1) its number of employees;

(2) the number of employees eligible to participate in the plan;

(3) the number of employees participating in the plan;

(4) the number of highly compensated employees ("HCEs") of the employer;

(5) the number of HCEs eligible to participate in the plan;

(6) the number of HCEs actually participating in the plan;

(7) the cost of the plan;

(8) the identity of the employer; and

(9) the type of business in which it is engaged.

## 8787. What is a cafeteria plan? What information must an employer provide in order to establish a cafeteria plan for its employees?

A cafeteria plan (or "flexible benefit plan") is a written plan that gives employees the option of choosing between cash and "qualified benefits." With certain limited exceptions, a cafeteria plan cannot provide for deferred compensation, which generally means that the taxpayer-employee must use all benefits within the tax year.[3]

Some cafeteria plans provide for salary reduction contributions by the employee and others provide benefits in addition to salary. In either case, the employee-participants are given the opportunity to purchase certain benefits with pre-tax dollars.

1. IRC Sec. 129(e)(9).
2. Notice 2002-24, 2002-16 IRB 785; Notice 90-24, 1990-1 CB 335.
3. IRC Sec. 125(d).

A plan may provide for automatic enrollment whereby an employee's salary is reduced to pay for "qualified benefits" unless the employee affirmatively elects cash.[1]

Under the 2007 proposed regulations (effective for plan years beginning on or after January 1, 2009), the written plan document must contain the following:

(1) a specific description of the benefits, including periods of coverage;

(2) the rules regarding eligibility for participation;

(3) the procedures governing elections;

(4) the manner in which employer contributions are to be made, such as by salary reduction or non-elective employer contributions;

(5) the plan year;

(6) the maximum amount of employer contributions available to any employee stated as (a) a maximum dollar amount or maximum percentage of compensation or (b) the method for determining the maximum amount or percentage;

(7) a description of whether the plan offers paid time off, and the required ordering rules for use of non-elective and elective paid time off;

(8) the plan's provisions related to any flexible spending arrangements (FSA) included in the plan;

(9) the plan's provisions related to any grace period offered under the plan; and

(10) the rules governing distributions from a health FSA to employee health savings accounts (HSAs), if the plan permits such distributions (see Q 8753).[2]

The plan document need not be self-contained, but may incorporate by reference separate written plans.[3]

Participants should note that, under the Patient Protection and Affordable Care Act, for purchases made in 2011 and thereafter, the cost of an over-the-counter medicine or drug cannot be reimbursed from FSAs (Q 8792), HRAs (Q 8743) or HSAs (Q 8744) unless a prescription is obtained.[4] These new rules do not affect insulin, even if purchased without a prescription, or other health care expenses such as medical devices, eye glasses, contact lenses, co-pays and deductibles. FSA and HRA participants may continue using debit cards to buy prescribed over-the-counter medicines, if certain requirements are met (see Q 8743).[5] In addition, starting in 2013, there are new rules about the $2,500 limit on the amount that can be contributed to an

1. Rev. Rul. 2002-27, 2002-1 CB 925.
2. Prop. Treas. Reg. §1.125-1(c), 72 F.R. 43938 (Aug. 6, 2007).
3. Prop. Treas. Reg. §1.125-1(c)(4).
4. P.L. 111-148.
5. IRS News Release IR-2010-128 (Dec. 23, 2010).

FSA (see Q 8792) and, beginning in 2014, the new optional $500 carryover provision that can be incorporated into a health FSA.[1]

Former employees may participate in an employer's cafeteria plan (although the plan may not be established predominantly for their benefit), but self-employed individuals may not.[2] A full-time life insurance salesperson who is treated as an employee for Social Security purposes will also be considered an employee for cafeteria plan purposes (see Q 8671).[3]

See Q 8788 for an explanation of benefits that may be offered through cafeteria plans. See Q 8789 for a discussion of the nondiscrimination requirements that apply to cafeteria plans. See Q 8790 for a discussion of "simple" cafeteria plans.

## 8788. How can a cafeteria plan be used by employers to offer employee benefits?

An employer may offer employees who are participants in a cafeteria plan a choice among two or more benefits consisting of cash and qualified benefits.[4] A cash benefit is not strictly limited to cash, but includes a benefit that may be purchased with after-tax dollars or the value of which is generally treated as taxable compensation to the employee (provided the benefit does not constitute deferred compensation).[5]

A qualified benefit is a benefit that is not includable in the gross income of the employee because of an express statutory exclusion and because the benefit constitutes deferred compensation. Contributions to Archer Medical Savings Accounts, qualified scholarships, educational assistance programs, or excludable fringe benefits are not qualified benefits. Products that are advertised, marketed, or offered as long-term care insurance similarly do not qualify as qualified benefits.[6]

When insurance benefits, such as those provided under accident and health plans and group term life insurance plans, are provided through a cafeteria plan, the benefit is the coverage under the plan. Accident and health benefits are qualified benefits to the extent that coverage is excludable under IRC Section 106.[7] Accidental death coverage offered in a cafeteria plan under an individual accident insurance policy is excludable from the employee's income under IRC Section 106.[8]

Group term life insurance coverage on employee-participants can be offered through a cafeteria plan. Coverage may be offered through the plan even if it exceeds the $50,000 excludable limit under IRC Section 79.[9] The application of IRC Section 79 to group term life insurance and IRC Section 106 to accident or health benefits is explained in Q 8727 to Q 8730.

1. Notice 2012-40, 2012-26 IRB 1046.
2. Prop. Treas. Reg. §1.125-1(g)(2).
3. IRC Sec. 7701(a)(20); Prop. Treas. Reg. §1.125-1(g)(1)(iii).
4. IRC Sec. 125(d)(1)(B).
5. Prop. Treas. Reg. §1.125-1(a)(2).
6. IRC Sec. 125(f); Prop. Treas. Reg. §1.125-1(q).
7. Prop. Treas. Reg. §1.125-1(h)(2).
8. Let. Ruls. 8801015, 8922048.
9. Prop. Treas. Reg. §1.125-1(k).

Accident and health coverage, group term life insurance coverage, and benefits under a dependent care assistance program are still counted as "qualified" benefits even if they must be included in income because a nondiscrimination requirement has been violated.[1]

For tax years beginning after 2012, a health flexible spending arrangement (FSA) offered under a cafeteria plan is not a qualified benefit unless the plan limits employees to no more than $2,500 in salary reduction contributions for each tax year.[2] Beginning in 2014, up to $500 of the balance of a health FSA may be carried forward to the subsequent tax year if the FSA incorporates a provision that permits such a carryover.

A cafeteria plan generally cannot provide for deferred compensation, permit participants to carry over unused benefits or contributions from one plan year to another, or permit participants to purchase a benefit that will be provided in a subsequent plan year. A cafeteria plan, however, may permit a participant in a profit sharing, stock bonus, or rural cooperative plan that has a qualified cash or deferred arrangement to elect to have the employer contribute on the employee's behalf to the plan.[3] After-tax employee contributions to an IRC Section 401(m) qualified plan are permissible benefits under a cafeteria plan, even if the employer makes matching contributions.[4]

A cafeteria plan may permit a participant to elect to have the employer contribute to a health savings account (HSA) on the participant's behalf (see Q 8744 to Q 8756).[5] Unlike other benefits, HSA balances may be carried over from one year to another even if they are funded through a cafeteria plan.

Generally, life, health, disability, or long-term care insurance with an investment feature, such as whole life insurance, or an arrangement that reimburses premium payments for other accident or health coverage extending beyond the end of the plan year cannot be provided under a cafeteria plan.[6] Supplemental health insurance policies that provide coverage for cancer and other specific diseases are not treated as providing deferral of compensation and are properly considered accident and health benefits under IRC Section 106.[7]

Participants in a cafeteria plan maintained by an educational organization described in IRC Section 170(b)(1)(A)(ii) (i.e., one with a regular curriculum and an on-site faculty and student body) can be permitted to elect postretirement term life insurance coverage. The postretirement life insurance coverage must be fully paid up on retirement and must not have a cash surrender value at any time. Postretirement life insurance coverage meeting these conditions will be treated as group term life insurance under IRC Section 79 (see Q 8621 to Q 8624).[8]

1. IRC Sec. 129(d); Prop. Treas. Reg. §1.125-1(b)(2).
2. IRC Sec. 125(i).
3. IRC Sec. 125(d)(2).
4. Prop. Treas. Reg. §1.125-1(o)(3)(ii).
5. IRC Sec. 125(d)(2)(D).
6. Prop. Treas. Reg. §1.125-1(p)(1)(ii).
7. TAM 199936046.
8. IRC Sec. 125(d)(2)(C).

Under the Affordable Care Act, plans and issuers that offer dependent coverage must make this coverage available until a child reaches the age of 26.[1] Even if a cafeteria plan has not yet been amended to provide coverage for children under age 27, the ACA allows employers with cafeteria plans to permit employees to immediately make pre-tax salary reduction contributions to provide coverage for these children in order to assist with implementation of the expanded coverage requirements.

Both married and unmarried children qualify for this coverage. This rule applies to all plans in the individual market and to new employer plans, as well as to existing employer plans unless the adult child has another offer of employer-based coverage. Beginning in 2014, children up to age 26 can stay on their parent's employer plan even if they have another offer of coverage through an employer.

Employees are eligible for the new tax benefit beginning March 30, 2010 and thereafter if the children are already covered under the employer's plan or are added to the employer's plan at any time. For this purpose, a child includes a son, daughter, stepchild, adopted child, or eligible foster child. This "up to age 26" standard replaces the lower age limits that applied under prior tax law, as well as the requirement that a child generally qualify as a dependent for tax purposes.

## 8789. What nondiscrimination requirements apply to cafeteria plans that provide benefits to highly compensated or key employees?

If a cafeteria plan discriminates in favor of highly compensated individuals as to eligibility to participate or as to contributions or benefits, highly compensated participants will be considered in constructive receipt of the available cash benefit, which will prevent these employees from excluding the amounts from income.[2]

"Highly compensated" individuals are officers, shareholders owning more than 5 percent of the voting power or value of all classes of stock, those who are "highly compensated," and any of their spouses or dependents. For this purpose, "highly compensated" means (1) any individual or participant who, for the preceding plan year (or the current plan year in the case of the first year of employment), had compensation from the employer in excess of the compensation amount specified in IRC Section 414(q)(1)(B) ($115,000 for 2012-2014), and, (2) if elected by the employer, also was in the top-paid group of employees (determined by reference to Section 414(q)(3)) for such preceding plan year (or for the current plan year in the case of the first year of employment).[3]

Participation will be nondiscriminatory if the following requirements are satisfied:

(1) the plan benefits a classification of employees found by the Secretary of Treasury not to discriminate in favor of employees who are officers, shareholders, or highly compensated;

1. See IRC Sec. 105(b); Notice 2010-38, 2010-1 CB 682.
2. IRC Sec. 125(b)(1); Prop. Treas. Reg. §1.125-7(m)(2).
3. IRC Sec. 125(e); Prop. Treas. Reg. §1.125-7(a)(3); IRS News Release IR-2011-103 (Oct. 20, 2011), IR-2012-77 (Oct. 18, 2012); IR-2013-86 (Oct. 31, 2013).

(2) no more than three years of employment are required for participation and the employment requirement for each employee is the same; and

(3) eligible employees begin participation by the first day of the first plan year after the employment requirement is satisfied.[1]

Under the proposed regulations, a cafeteria plan does not discriminate in favor of highly compensated individuals if the plan benefits a group of employees who qualify under a reasonable classification established by the employer and the group of employees included in the classification satisfies the safe harbor percentage test or the unsafe harbor percentage test.[2]

If a cafeteria plan offers health benefits, the plan is not discriminatory as to contributions and benefits if:

(1) contributions for each participant include an amount that either:

(x) equals 100 percent of the cost of the health benefit coverage under the plan of the majority of the highly compensated participants who are similarly situated (e.g., same family size); or

(y) equals or exceeds 75 percent of the cost of the most expensive health benefit coverage elected by any similarly-situated participant; and

(2) contributions or benefits in excess of (1) above bear a uniform relationship to compensation.[3]

A plan is considered to satisfy all discrimination tests if it is maintained under a collective bargaining agreement between employee representatives and one or more employers.[4]

Further, a "key employee," as defined for purposes of the top-heavy rules, is treated as though he or she is in constructive receipt of the available cash benefit option in any plan year in which nontaxable benefits provided under the plan to key employees exceed 25 percent of the aggregate of such benefits provided to all employees under the plan. In making this calculation, excess group term life insurance coverage that is includable in income (see Q 8721 and Q 8722) is not considered a nontaxable benefit.[5]

Employees of a controlled group of corporations, employers under common control, or members of an "affiliated service group" are treated as employed by a single employer.[6]

Employer contributions include amounts that the employer contributes to a cafeteria plan pursuant to a salary reduction agreement to the extent that the agreement relates to compensation that has not been actually or constructively received by the employee as of the date of

1. IRC Sec. 125(g)(3); Prop. Treas. Reg. §1.125-7(b).
2. Prop. Treas. Reg. §1.125-7(b)(1).
3. IRC Sec. 125(g)(2); Prop. Treas. Reg. §1.125-7(e).
4. IRC Sec. 125(g)(1).
5. IRC Sec. 125(b)(2).
6. IRC Sec. 125(g)(4).

the agreement if such compensation does not subsequently become currently available to the employee.[1]

See Q 8790 for the application of the nondiscrimination requirements to simple cafeteria plans.

## 8790. What is a simple cafeteria plan for small businesses?

A "simple cafeteria plan" is a cafeteria plan that is established and maintained by an eligible employer and with respect to which contribution, eligibility, and participation requirements are met.[2]

For years beginning in 2011 and thereafter, the Patient Protection and Affordable Care Act (ACA) creates a safe harbor "simple cafeteria plan" under which an "eligible employer" (generally an employer with fewer than 100 employees) is treated as meeting any applicable nondiscrimination requirements (Q 8789) for the year.[3]

The employer is required to make contributions on behalf of each "qualified employee" in an amount equal to the following:

(1) a uniform percentage (not less than 2 percent) of the employee's compensation; or

(2) an amount not less than the lesser of (x) 6 percent of the employee's compensation for the plan year, or (y) twice the amount of salary deduction contributions of each qualified employee.[4]

Contribution requirement option (2) is not met if the rate of contributions with respect to the salary contributions of any highly compensated or key employee at any rate of contribution is greater than that with respect to an employee who is not a highly compensated or key employee.[5]

All employees with at least 1,000 hours of service during the preceding plan year must be eligible to participate. Further, each employee who is eligible to participate must be able to select any benefit available under the plan.[6] An employee can be excluded if the employee:

(1) is under age twenty-one;

(2) has less than one year of service;

(3) is covered by a collective bargaining agreement and the benefits of the cafeteria plan were the subject of good faith bargaining; or

(4) the employee is a nonresident alien working outside of the United States.[7]

1. Prop. Treas. Reg. §1.125-1(r).
2. IRC Sec. 125(j)(2), as added by PPACA 2010; IRS Publication 15-B.
3. IRC Sec. 125(j)(1), as added by PPACA 2010.
4. IRC Sec. 125(j)(3)(A), as added by PPACA 2010.
5. IRC Sec. 125(j)(3)(B), as added by PPACA 2010.
6. IRC Sec. 125(j)(4)(A), as added by PPACA 2010.
7. IRC Sec. 125(j)(4)(B), as added by PPACA 2010.

To implement a simple cafeteria plan, an employer must be an "eligible employer," which is, with respect to any year, any employer that employed an average of 100 or fewer employees on business days during either of the two preceding years.[1] An employer that initially qualifies for a simple cafeteria plan ceases to qualify in the year after the number of employees reaches 200.[2]

A qualified employee is any employee who is eligible to participate in the cafeteria plan and who is not a highly compensated or key employee.[3]

## 8791. What are the tax benefits that can be realized by providing employee benefits through a cafeteria plan?

As a general rule, a participant in a cafeteria plan is not treated as being in constructive receipt of taxable income solely because he has the opportunity – before a cash benefit becomes available – to elect among cash and "qualified" benefits (generally, nontaxable benefits).[4]

A participant must elect the qualified benefits before the cash benefit becomes currently available in order to avoid taxation. That is, the election must be made before the specified period for which the benefit will be provided begins—generally, the plan year.[5]

A cafeteria plan may, but is not required to, provide default elections for one or more qualified benefits for new employees or for current employees who fail to timely elect between permitted taxable and qualified benefits.[6]

Benefits provided under a cafeteria plan through employer contributions to a health flexible spending arrangement (FSA) are not treated as qualified unless the plan provides that an employee may not elect to have salary reduction contributions in excess of $2,500 made to the FSA for any tax year.[7] Under IRS Notice 2012-40:

(1) the $2,500 limit does not apply for plan years that begin before 2013;

(2) the term "taxable year" in IRC Section 125(i) refers to the plan year of the cafeteria plan, as this is the period for which salary reduction elections are made;

(3) plans may adopt the required amendments to reflect the $2,500 limit at any time through the end of calendar year 2014;

(4) in the case of a plan providing a grace period (which may be up to two months and fifteen days), unused salary reduction contributions to the health FSA for plan years beginning in 2012 or later that are carried over into the grace period for that plan year will not count against the $2,500 limit for the subsequent plan year; and

1. IRC Sec. 125(j)(5)(A), as added by PPACA 2010.
2. IRC Sec. 125(j)(5)(C), as added by PPACA 2010.
3. IRC Sec. 125(j)(3)(D), as added by PPACA 2010.
4. IRC Sec. 125; Prop. Treas. Reg. §1.125-1.
5. Prop. Treas. Reg. §1.125-2.
6. Prop. Treas. Reg. §1.125-2(b).
7. IRC Sec. 125(i).

(5) unless a plan's benefits are under examination by the IRS, relief is provided for certain salary reduction contributions exceeding the $2,500 limit that are due to a reasonable mistake and not willful neglect, and that are corrected by the employer.

Under IRS Notice 2013-71, heath FSAs may now be amended so that $500 of unused amounts remaining at the end of the plan year may be carried forward to the next plan year. However, plans that incorporate the carry forward provision may not also offer the grace period that would otherwise allow FSA participants an additional period after the end of the plan year to exhaust account funds.[1]

## 8792. What is a health flexible spending arrangement (FSA)?

*Editor's Note*: *The Affordable* ("ACA") imposes a new annual limitation on contributions to a health FSA. For taxable years beginning after 2012, FSA contributions will not be treated as a qualified benefit unless the cafeteria plan provides that an employee may not elect for any taxable year to have salary reduction contributions in excess of $2,500 made to the arrangement. The limit will be indexed for inflation.[2]

A health flexible spending arrangement (FSA) is a program that is established under IRC Section 125 to provide for the reimbursement of certain expenses that have already been incurred. This benefit may be provided as a stand-alone plan or as part of a traditional cafeteria plan.

Health coverage under an FSA is not required to be provided under commercial insurance plans, but the coverage that is provided must demonstrate the risk shifting and risk distribution characteristics of insurance. Reimbursements under a health FSA must be paid specifically to reimburse medical expenses that have been incurred previously.

A health FSA cannot provide coverage only for periods during which the participants expect to incur medical expenses if the period is shorter than a plan year. Further, the maximum reimbursement amount must be available at all times throughout the period of coverage (properly reduced for prior reimbursements for the same period of coverage).

This must be true without regard to the extent to which the participant has paid the required premiums for the coverage period, and without a premium payment schedule based on the rate or amount of covered claims incurred in the coverage period.[3] Though there was no statutory limit on contributions to a health FSA prior to 2013, most employers imposed a limit to protect themselves against large claims that had not yet been funded by salary reductions.

The period of coverage must be 12 months, or in the case of a short first plan year, the entire first year (or the short plan year where the plan year is changed). Elections to increase or decrease coverage may not be made during a coverage year, but prospective changes may be allowed consistent with certain changes in family status.

1. Notice 2013-71, 2013-47 IRB 532.
2. IRC Sec. 125(i), as added by PPACA 2010; Notice 2012-40, 2012-1 CB 1046.
3. Prop. Treas. Reg. §1.125-5(d).

The plan may permit the period of coverage to be terminated if the employee fails to pay premiums, provided that the terms of the plan prohibit the employee from making a new election during the remaining period of coverage. The plan may permit revocation of existing elections by an employee who terminated service.[1]

As is the case with a cafeteria plan, a health FSA may provide a grace period of no more than 2½ months following the end of the plan year for participants to incur and submit expenses for reimbursement. The grace period must apply to all participants in the plan. Plans may adopt a grace period for the current plan year by amending the plan document before the end of the current plan year.[2]

For tax years beginning in 2014 and beyond, a health FSA may be amended so that $500 of unused amounts remaining at the end of the plan year may be carried forward to the next plan year. However, plans that incorporate the carry forward provision may not also offer the grace period.[3]

The plan may not reimburse premiums paid for other health plan coverage, but it may reimburse medical expenses of the kind described under IRC Section 213(d).[4] Beginning in 2011, reimbursements for medicine are limited to doctor-prescribed drugs and insulin. Over-the counter medicines are no longer qualified expenses unless the participant obtains a doctor's prescription.[5]

The reimbursed medical expenses must be expenses incurred to obtain medical care during the period of coverage. The employee must provide substantiation that the expense claimed has been incurred and is not reimbursable under other health coverage.[6] The IRS has approved the use of employer-issued debit and credit cards to pay for medical expenses as incurred, provided that the employer requires subsequent substantiation of the expenses or has in place sufficient procedures to substantiate the payments at the time of purchase.[7] On a one-time basis, a plan may allow a qualified HSA distribution (see Q 8753).

An employee must include the value of employer-provided coverage for qualified long-term care services provided through an FSA in gross income.[8]

## 8793. What is a dependent care flexible spending arrangement (FSA)?

A dependent care flexible spending arrangement (FSA) is a program that is established under IRC Section 125 to provide for the reimbursement of certain expenses related to dependent care that have already been incurred. This benefit may be provided as a stand-alone plan or as part of a traditional cafeteria plan.

1. Prop. Treas. Reg. §1.125-5(e).
2. Prop. Treas. Reg. §1.125-1(e); Notice 2005-42, 2005-1 CB 1204; Notice 2012-40, 2012-1 CB 1046.
3. Notice 2013-71, 2013-47 IRB 532.
4. Prop. Treas. Reg. §1.125-5(k).
5. IRC Sec. 106(f), as added by PPACA 2010.
6. Prop. Treas. Reg. §1.125-6(b); Rev. Proc. 2003-43, 2003-1 CB 935; superseded and modified by Notice 2013-30, 2013 IRB LEXIS 418. See *Grande v. Allison Engine Co.*, 2000 U.S Dist. LEXIS 12220 (S.D. Ind. 2000).
7. Notice 2006-69, 2006-2 CB 107. See also Notice 2007-2, 2007-1 CB 254.
8. IRC Sec. 106(c)(1).

Substantially, the same rules apply to dependent care FSAs as health FSAs (see Q 8792), except that the maximum amount of reimbursement need not be available throughout the entire period of coverage. A plan may limit a participant's reimbursement to amounts that were actually contributed to the plan and that are still available in the participant's account.[1] Contributions to a dependent care FSA may not exceed $5,000 (or $2,500 for a married individual filing a separate return) during a taxable year.[2]

Like a health FSA, a dependent care FSA may permit a grace period of no more than 2½ months following the end of the plan year for participants to incur and submit expenses for reimbursement.[3] A dependent care FSA may not, however, permit the same $500 carryfoward option that is now permitted in the context of health FSAs.

The IRS has also approved the use of employer-issued debit and credit cards to reimburse for recurring dependent care expenses. Because expenses may not be reimbursed until the dependent care services are provided, reimbursements through debit cards must flow in arrears of expenses incurred.[4]

## 8794. Is a surviving spouse of an employee taxed on the value of death benefits paid under a plan of the employer?

A surviving spouse, who receives death benefits payable under a contract, or pursuant to an established plan of the employer, must include such amounts in income.[5] However, if the employee death benefits are payable because of the death of certain terrorist attack victims or astronauts, they may be excluded from gross income.[6]

Frequently, death benefits are funded by insurance on the life of the employee, with the insurance owned by and payable to the employer. These death benefits do not become tax-exempt to the employee's surviving spouse simply because the proceeds of the insurance policy are received tax-free by the employer. While the employer receives the proceeds as life insurance proceeds, the surviving spouse receives them as compensation payments from the employer.[7] As a result, employee death benefits rarely qualify as life insurance benefits wholly excludable under IRC Section 101(a).[8] Death benefits payable to an employee's surviving spouse under a split-dollar arrangement, however, may be received free of income tax obligations.

Contractual death benefits are treated as "income in respect of a decedent."[9] As a result, where an estate tax has been paid, the recipient of the death payments is entitled to an income tax deduction for that portion of the estate tax attributable to the value of the payments.

1. Prop. Treas. Reg. §1.125-5.
2. IRC Sec. 129(a)(2)(A); Notice 2012-40, 2012-1 CB 1046.
3. Notice 2005-42, 2005-1 CB 1204; Notice 2012-40, 2012-1 CB 1046.
4. Notice 2006-69, 2006-2 CB 107.
5. *Simpson v. U.S.*, 261 F.2d 497 (7th Cir. 1958); *Robinson v. Comm.*, 42 TC 403 (1964).
6. IRC Sec. 101(i).
7. *Essenfeld v. Comm.*, 311 F.2d 208 (2d Cir. 1962).
8. See *Edgar v. Comm.*, TC Memo 1979-524.
9. *Est. of Wright v. Comm.*, 336 F.2d 121 (2d Cir. 1964).

## 8795. What types of benefits can an employer provide in the form of services that do not require an employee to include the value of the benefit in income?

Generally, fringe benefits not expressly excluded from income by the Code must be included in gross income for income tax purposes and in wages for purposes of FICA and FUTA.[1] IRC Section 132 provides that certain fringe benefits that are classified as "no-additional-cost-service" may be excluded from income.[2]

As the name suggests, a "no-additional-cost-service" is one offered by the employer at no substantial additional cost (including foregone revenue) to the employer for providing such service to the employee and such service is offered to customers in the ordinary course of the line of business of the employer in which the employee is working.

For example, the cost of a flight provided to an airline employee traveling on a space-available basis is an excess capacity service and is eligible for treatment as a no-additional-cost-service. In addition, the services of a flight attendant and the cost of in-flight meals given to the airline employee traveling on a space-available basis are merely incidental to the services being provided (i.e. the flight) and, thus, the employee does not have to include them in income.[3] Reciprocity is allowed between unrelated employers if certain conditions are met.[4]

The no-additional-cost services exclusion applies to services provided to retired and disabled employees, spouses and dependent children, as well as to current employees. Widowers and widows of employees who died while employed also qualify for the exclusion.[5] A partner who performs services for a partnership will be considered employed by the partnership.[6]

The no-additional-cost services exclusion is not available to highly compensated employees unless the service is provided on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of highly compensated employees.[7] For this purpose, "highly compensated employee" has the same meaning as provided in Code section 414(q) for qualified plans.[8] Generally, a highly compensated employee is any employee:

(1) who was a five percent owner at any time during the year or the preceding year; or

(2) for the preceding year had compensation in excess of $80,000 (as indexed, $115,000 in 2014) and was in the top-paid group of employees for the preceding year.

1. IRC Sec. 61(a)(1).
2. IRC Sec. 132.
3. Treas. Reg. §1.132-2(a)(5).
4. See Treas. Reg. §1.132-2(b).
5. IRC Sec. 132(h).
6. Treas. Reg. §1.132-1(b).
7. IRC Sec. 132(j)(1).
8. IRC Sec. 132(j)(6).

## 8796. What types of tax-preferred transportation-related fringe benefits can an employer provide to its employees?

A "qualified transportation fringe" is a benefit provided by an employer to employees, and includes the following:

(1) transportation in a commuter highway vehicle that is used in connection with travel between an employee's home and place of work;

(2) any transit pass; or

(3) qualified parking.[1]

A cash reimbursement from an employer to an employee for one of these items also falls within the qualified transportation fringe definition.[2] Self-employed individuals and owner-employees are not considered employees for purposes of qualified transportation fringes.[3]

Code section 132 places a limit on the amount that may be excluded from income for a qualified transportation fringe. These limitation amounts are adjusted for inflation.[4]

For 2014, an employee can exclude up to $130 per month in (combined) employer-provided transportation in a commuter vehicle or for transit passes. An employee may exclude $250 per month for qualified parking expenses.[5] The limits are indexed for inflation annually.

For purposes of Section 132, a "commuter highway vehicle" is defined as any highway vehicle that seats at least six persons and which is used at least 80 percent of the time for transporting employees between their homes and places of work.[6]

A "transit pass" is any pass, token, fare card, voucher or similar item which entitles an individual to transportation on mass transit facilities or in commuter highway vehicles.[7]

"Qualified parking" is defined as parking provided to an employee on or near the employer's business location or near a location from which an employee commutes to work by mass transit, commuter highway vehicle, or carpool. It does not include any parking near the employer's place of business that the employee uses for residential parking.[8]

## 8797. Can an employee exclude from income the value of employee discounts offered by the employer?

The "qualified employee discount" exclusion applies to employee discounts provided by the employer on any property (other than real property or personal property of a kind held for investment) or services which are offered for sale to customers in the ordinary course of the

1. IRC Sec. 132(f)(1).
2. IRC Sec. 132(f)(3).
3. IRC Sec. 132(f)(5)(E).
4. IRC Sec. 132(f)(6).
5. IRC Sec. 132(f)(2), IRS Publication 15-B.
6. IRC Sec. 132(f)(5)(B).
7. IRC Sec. 132(f)(5)(A).
8. IRC Sec. 132(f)(5)(C).

line of business of the employer for which the employee works. For the benefit to be excludable from income, the discount may not exceed:

(1) the gross profit percentage of the price at which the property is being offered by the employer to customers in the case of property; or

(2) 20 percent of the price at which services are offered by the employer to customers, in the case of services.[1]

For purposes of this provision, an insurance policy or a commission or similar fee charged by a brokerage house or an underwriter on sales of securities is considered a service.[2] The qualified employee discount will generally be available for employees of leased sections of department stores.[3] The same nondiscrimination rules apply to qualified employee discounts as apply to no-additional-cost services (see Q 8795).[4]

## 8798. What is a "working condition" fringe benefit?

A "working condition fringe" benefit is defined as property or services provided by the employer to the extent that, if the employee paid for such property or services, he would be able to deduct the expenses as a business expense.[5]

For example, qualified automobile demonstration is considered to be a working condition fringe benefit and is defined as the use of an auto by a full-time auto salesman in the area where the dealer's sales office is located provided that the auto is used to aid the salesman in his job and personal use is substantially restricted.[6]

This exclusion is generally available to any current employee, any partner who performs services for the partnership, any director of the employer, and any independent contractor who performs services for the employer.[7] There is no nondiscrimination requirement.

## 8799. What is a "de minimis" fringe benefit?

The "de minimis fringe" exception allows an employee to exclude from income any property or services provided by the employer, if the value of such property or services is so small as to make accounting for it unreasonable or administratively impractical.[8]

For example, an employer-operated eating facility is considered a de minimis fringe if it is located on or near the business premises and the revenue from the facility equals or exceeds its operating costs. These rules are applicable to highly-compensated employees only if access to the facility is available on substantially the same terms to each member of a group of employees

1. IRC Sec. 132(c).
2. Treas. Reg. §1.132-2(a)(2).
3. IRC Sec. 132(j)(2).
4. IRC Sec. 132(j)(1).
5. IRC Sec. 132(d).
6. IRC Sec. 132(j)(3).
7. Treas. Reg. §1.132-1(b)(2).
8. IRC Sec. 132(e)(1).

which is defined under a reasonable classification set up by the employer which does not discriminate in favor of highly compensated employees (see Q 8795).[1]

The frequency with which the employer provides the benefit at issue must be taken into account in determining whether the value is de minimis. The benefits provided must be calculated on a per-employee basis. For example, if an employer provides one meal to only one employee on a daily, the value of the free daily meal would not be de minimis to that individual employee, even though the provision of one daily meal to one employee would be de minimis with respect to the employer's entire workforce.[2]

If, however, it would be administratively difficult to determine the frequency with which the employer provides the fringe benefit to an individual employee, the employer may measure frequency based on the frequency for the provision of the fringe benefit to all employees. The regulations use the example of an employer who uses reasonable means to restrict use of employer-provided copy machines to business-related use and is successful in ensuring that 85 percent of the copying is for business use. Any personal use of the copy machine by a particular employee will be considered a de minimis fringe because it would be administratively difficult for the employer to measure usage on a per-employee basis.[3]

An employer may provide meals, money for meals or local transportation fare as de minimis benefits if the following conditions are satisfied:

(1) The benefit is provided on an occasional basis, determined by examining the availability of the benefit and the regularity with which the benefit is provided to the employee. If an employer provides one of these benefits, or a combination of the three benefits, on a regular or routine basis, they are not provided on an occasional basis;

(2) The benefit is provided because of overtime work that requires an extension of the employee's work schedule, even if the conditions giving rise to the need for overtime are reasonably foreseeable;

(3) In the case of a meal or meal money, the benefit is provided to enable the employee to work overtime hours.

Meal money and local transportation fare will not qualify as de minimis benefits if the amounts provided are calculated based on the number of hours that the employee works.[4]

## 8800. How is the value of a fringe benefit that is not excludable under IRC Section 132 determined for purposes of determining the amount that must be included in the employee's income?

A fringe benefit not excludable under the rules discussed in Q 8795 to Q 8799 (no-additional-cost, transportation, employee discount and de minimis fringe benefits) is included in the gross income of the employee to the extent that the fair market value of the benefit exceeds

1. IRC Sec. 132(e)(2).
2. Treas. Reg. §1.132-6(b)(1).
3. Treas. Reg. §1.132-6(b)(2).
4. Treas. Reg. §1.132-6(d)(2).

the sum of (a) the amount, if any, paid by the employee for the benefit and (b) the amount, if any, specifically excluded by some other section of the IRC.[1]

Therefore, if the employee pays fair market value for the benefit, no amount must be included in gross income.[2]

The fair market value of a fringe benefit is determined on the basis of objective facts and circumstances. The amount that an individual would have to pay for the fringe benefit in an arm's length transaction is considered in determining the fair market value.[3] The regulations specifically provide that in calculating fair market value, any special relationship that exists between the employer and employee must be disregarded.[4]

Special optional rules are available for determining the fair market value of employer-provided automobiles. Specifically, the fair market value is based on the amount that the employee would be required to pay in order to lease the same or comparable vehicle, under comparable conditions (for example, taking use restrictions into consideration) in an arm's length transaction in the same geographic area.[5]

## 8801. Can an employer provide employee fringe benefits through a stock bonus plan?

Yes, an employer can provide employees with benefits through a stock bonus plan. Generally, a stock bonus plan is a profit sharing plan that holds employer securities and generally distributes those securities to participants when benefits are paid.[6]

Stock bonus plans can be funded through an employer's contribution of employer securities, cash, or both. Traditionally, the IRS has taken the position that the distribution must be in the form of employer stock (except for the value of a fractional share).[7] The Tax Court has agreed with the IRS position.[8] A stock bonus plan may provide for payment of benefits in cash if certain conditions are met (see Q 8802). For the purpose of allocating contributions and distributing benefits, the plan is subject to the same requirements as a profit sharing plan.

## 8802. What special requirements apply to a stock bonus plan offered by an employer?

In addition to meeting all of the requirements of IRC Section 401(a) and the requirements outlined below, employee stock bonus plans must meet certain distribution (Q 8803) and voting (Q 8804) requirements as to employer stock that is held by the plan.[9]

1. Treas. Reg. §1.61-21(b)(1).
2. Treas. Reg. §1.61-21(b)(1).
3. Treas. Reg. §1.61-21(b)(2).
4. Treas. Reg. §1.61-21(b)(2).
5. Treas. Reg. §1.61-21(b)(4).
6. Treas. Reg. §1.401-1(a)(2)(iii).
7. Rev. Rul. 71-256, 1971-1 CB 118.
8. *Miller v. Comm.*, 76 TC 433 (1981).
9. IRC Secs. 401(a)(23), 4975(e)(7).

If the employer securities held within the plan are not readily traded on a public market, any transactions involving stock require an independent valuation of the stock for that transaction. A stock bonus plan generally is required to give participants the right to demand benefits in the form of employer securities. If employer securities are not readily tradable on an established market, the participant must be given the right to require the employer (not the plan) to repurchase employer securities under a fair valuation formula (a "put option").[1]

The requirement that participants have the right to demand benefits in the form of employer securities does not apply in situations where the charter or bylaws of the employer restrict the ownership of substantially all outstanding employer securities to employees, to a qualified plan trust, or to an S corporation.[2]

The employer must make this put option available for at least sixty days following distribution of the stock and, if it is not exercised within that time, it must be made available for another sixty day period (at a minimum) in the following year.[3]

The plan may repurchase the stock instead of the employer, but the plan cannot be required to do so. Certain banks that are prohibited by law from redeeming or purchasing their own shares are not subject to the requirement that they give participants a put option.[4]

If, pursuant to a put option, an employer is required to repurchase securities distributed to an employee as part of a "total distribution," the amount paid for the securities must be paid in substantially equal periodic payments (at least annually), over a period beginning within thirty days after the exercise of the put option, and not exceeding five years. The employer must provide adequate security and reasonable interest must be paid on any unpaid amounts. A total distribution is a distribution to the recipient within one taxable year of the balance to the credit in his or her account.[5] If an employer is required to repurchase securities distributed to an employee as part of an "installment distribution," the amount paid for the securities must be paid within thirty days after the put option is exercised.[6]

## 8803. What rules govern distributions from an employer-sponsored stock bonus plan?

Distributions from a stock bonus plan are subject to mandatory 20 percent withholding, unless the employee elects a direct rollover.[7] The mandatory withholding requirement does not apply to any distribution that consists only of securities of the employer corporation and cash of up to $200 that is received in lieu of stock. The maximum amount to be withheld under the mandatory withholding rules may not exceed the sum of the amount of money received and the fair market value of property other than securities of the employer corporation received in the distribution.[8]

1. IRC Sec. 409(h).
2. IRC Sec. 409(h)(2)(B).
3. IRC Sec. 409(h)(4).
4. IRC Sec. 409(h)(3).
5. IRC Sec. 409(h)(5).
6. IRC Sec. 409(h)(6).
7. IRC Sec. 3405(c).
8. IRC Sec. 3405(e)(8).

The plan must provide that if a participant, with the consent of his or her spouse, so elects, the distribution of the account balance will begin within one year after the plan year:

(1) in which the participant separates from service by reason of attainment of the normal retirement age under the plan, disability, or death; or

(2) which is the fifth plan year following the plan year in which the participant otherwise separated from service.

Distribution under (2) will not be required if the participant is re-employed by the employer before distributions actually begin under (2).[1]

The plan also must provide that, unless the participant elects otherwise, distribution of the participant's account balance will be made in substantially equal periodic payments (at least annually) over a period not longer than the greater of (1) five years, or (2) in the case of a participant with an account balance in excess of $1,050,000 as indexed in 2014 (up from $1,035,000 in 2013), five years plus one additional year (not to exceed five additional years) for each $210,000 in 2014 (up from $205,000 in 2013), or fraction thereof, by which the employee's account balance exceeds $1,050,000.[2]

**Planning Point:** An employer whose stock is not publicly traded, and therefore is subject to the employer's potential obligation to repurchase its stock from terminating plan participants, should be concerned about the impact that obligation could have on its cash flow. The employer should consider writing its plan to take the maximum time allowed, generally five years, to begin the process of distributing stock from the plan and then repurchasing that stock from former employees. *Martin Silfen, J.D., Brown Brothers Harriman Trust Co., LLC.*

Notwithstanding these requirements, if the general rules for commencement of distributions from qualified plans require distributions to begin at an earlier date, those general rules control.[3]

## 8804. Does participation in an employer's stock bonus plan entitle the employee-participant to voting privileges?

A stock bonus plan is required to pass through certain voting rights to participants or beneficiaries. If an employer's securities are "registration-type," each participant or beneficiary generally must be entitled to direct the plan as to how securities allocated to him are to be voted.[4] "Registration-type" securities are securities that must be registered under Section 12 of the Securities and Exchange Act of 1934 or that would be required to be registered except for an exemption in that law.[5]

If securities are not "registration-type" and more than 10 percent of a plan's assets are invested in securities of the employer, each participant (or beneficiary) must be permitted to direct voting rights under securities allocated to his or her account with respect to approval of

1. IRC Sec. 409(o)(1)(A).
2. IRC Sec. 409(o)(1)(C); IR-2012-77 (Oct. 18, 2012); IR-2013-86 (Oct. 31, 2013).
3. See General Explanation of TRA '86, p. 840.
4. IRC Secs. 401(a)(28), 4975(e)(7), 409(e)(2).
5. Sec. 12(g)(2)(H).

corporate mergers, consolidations, recapitalizations, reclassifications, liquidations, dissolutions, sales of substantially all of the business's assets, and similar transactions as provided in future regulations.[1]

If the plan contains non-registration-type securities, the plan satisfies this requirement if each participant is given one vote with respect to an issue and the trustee votes the shares held by the plan in a proportion that takes this vote into account.[2]

1. IRC Sec. 409(e)(3).
2. IRC Secs. 401(a)(22), 409(e)(3), 409(e)(5).