Section 125.— Cafeteria Plans

(Also § 106, § 415.)

Cafeteria plans. Cafeteria plans may use an automatic enrollment process whereby the employee's salary is reduced each year to pay for a portion of the group health coverage under the plan unless the employee affirmatively elects cash. In addition, employers may treat all participants as being in the cafeteria plan for section 415 purposes even though the plan mandates salary reduction and coverage for uninsured participants.

Rev. Rul. 2002–27

ISSUES

(1) Whether employer contributions used to purchase group health coverage under § 125 of the Internal Revenue Code are included in the gross income of the employee solely because the plan uses an automatic enrollment process whereby

the employee's salary is reduced each year to pay for a portion of the coverage unless the employee affirmatively elects to receive the amount in cash.

(2) Whether an employer can treat contributions used to purchase group health coverage as compensation for purposes of § 415(c)(3) when the employee does not have the opportunity to elect cash in lieu of such contributions under a § 125 arrangement because the employee is not able to certify that he or she has other health coverage.

FACTS

Situation (1). Employer M maintains a calendar year cafeteria plan ("Plan"). The Plan offers group health insurance indemnity coverage with the option for employee-only or family coverage. The Plan is in writing and is available to all employees immediately upon hire.

The Plan provides for an automatic enrollment process. Under this Plan feature, each new employee (and each current employee for the first plan year the automatic enrollment process is effective) is automatically enrolled in employee-only indemnity coverage, with the employee's salary reduced pre-tax to pay for a portion of the cost of the coverage, unless the employee affirmatively elects cash. Alternatively, if the employee has a spouse or child, he or she can elect family coverage.

At the time an employee is hired, the employee receives a notice explaining the automatic enrollment process and the employee's right to decline coverage and have no salary reduction. The notice includes the salary reduction amounts for employee-only coverage and family coverage, procedures for exercising the right to decline coverage, information on the time by which an election must be made, and the period for which an election will be effective. The notice is also given to each current employee before the beginning of each subsequent plan year, except that the notice for a current employee includes a description of the employee's existing coverage, if any.

For a new hire, an election to receive cash or to have family coverage rather than employee-only coverage is effective if made when the employee is hired or within a reasonable period ending before the compensation for the first pay period is currently available. For a current employee, an election is effective if made prior to the start of each calendar year or under any other circumstances permitted under § 1.125–4 of the Income Tax Regulations. An election made for any prior year carries over to the next succeeding plan year unless changed.

Situation (2). Employer N also maintains a plan ("Plan") that offers group health insurance indemnity coverage which includes employee-only and family coverage options and has an automatic enrollment process. The automatic enrollment process is the same as that described in Situation (1), except that, under N's automatic enrollment process a new employee (and each current employee for the first calendar plan year the automatic enrollment process is effective) can affirmatively elect to receive cash, either at hire or during the annual election period under the Plan, only if the employee certifies that he or she has other health coverage. Employer N does not otherwise request or collect from employees information regarding other health coverage as part of the enrollment process. The Plan procedures relating to notice to employees and elections under this Plan are otherwise the same as those under the Plan sponsored by Employer M.

LAW AND ANALYSIS

Sections 106 and 125

In general, § 106(a) provides that gross income of an employee does not include employer-provided coverage under an accident or health plan.

Section 125(a) states that no amount will 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. Section 125(d) defines a cafeteria plan as 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.

Section 125(f) defines qualified benefits as any benefit not includible in the gross income of the employee by reason of an express provision of Chapter 1 of the Code other than certain specified benefits that are not qualified benefits. Qualified benefits include employer-provided accident or health coverage under § 106(a).

Section 125 applies if the employee can choose between cash and qualified benefits. However, § 125 permits an employee's choice to be either in the form of an affirmative election to receive qualified benefits in lieu of cash or an affirmative election to receive cash in lieu of qualified benefits. Under Employer M's automatic enrollment process as described in Situation (1), an employee's salary is reduced pursuant to a procedure under which the employee receives a notice explaining his or her right to have group health coverage through salary reduction or to decline such coverage and receive the cash instead. After receiving the notice, the employee has an opportunity to choose between cash and a qualified benefit. Therefore, the Plan's automatic enrollment process is subject to the requirements of § 125.

The same conclusions apply to Situation (2) to the extent that an employee can elect cash. However, under Employer N's automatic enrollment process as described in Situation (2), an employee who does not have other health coverage is not given a choice between cash and a qualified benefit with respect to the employee-only option under the indemnity coverage. Rather, if the employee cannot certify that he or she has other health coverage, the pre-tax salary reduction is mandatory and the employee is automatically enrolled in the employee-only indemnity coverage. With respect to these employees, because there is no ability to elect cash instead of employee-only coverage, § 125 is not applicable to the employee-only coverage. (§ 125 is applicable, however, to these employees' elections to take family coverage instead of employee-only coverage).

Section 415

Section 415 imposes limitations on contributions and benefits under qualified retirement plans. Some of the limitations under § 415 that may apply to contributions or benefits provided on behalf of a participant are based on the participant's compensation, within the meaning of § 415(c)(3). The definition of compensation under § 415(c)(3) is also used for

purposes of a number of other plan qualification requirements (*see* § 414(s)(1)). Section 415(c)(3)(D)(ii) provides that an employee's compensation under § 415(c)(3) includes any amount that is contributed by the employer at the election of the employee and that is not includible in the gross income of the employee by reason of § 125. Section 415(c)(3)(D) is effective for years beginning after December 31, 1997.

Section 1.415–2(d) provides rules regarding acceptable definitions of compensation under § 415(c)(3). Under § 1.415–2(d)(3)(iv), amounts that receive special tax benefits, such as premiums for group-term life insurance (to the extent the premiums are not includible in gross income of the employee) are not included in compensation for purposes of § 415(c)(3). Thus, pursuant to § 1.415–2(d)(3)(iv), premiums for group health coverage are not treated as compensation for purposes of § 415(c)(3), except for amounts that are contributed by the employer at the election of the employee and that are not includible in the gross income of the employee by reason of § 125.

Section 415(j) directs the Secretary to prescribe such regulations as may be necessary to carry out the purposes of § 415. Section 1.415–2(d)(13) provides that the Commissioner may, in revenue rulings, notices, and other guidance of general applicability, provide additional definitions of compensation that are treated as satisfying § 415(c)(3).

Pursuant to § 1.415–2(d)(13), this revenue ruling provides that a definition of compensation does not fail to satisfy the requirements of § 415(c)(3) and § 1.415–2(d) merely because the definition provides that amounts that are not available to an employee in cash in lieu of group health coverage because the employee is not able to certify that he or she has other health coverage are treated as subject to § 125. Under this definition, amounts are permitted to be treated as subject to § 125 only if the employer does not otherwise request or collect information regarding the employee's other health coverage as part of the enrollment process for the health plan.

An employer may apply this rule for any plan year or limitation year beginning after December 31, 1997.

Section 401(b) and the regulations thereunder provide a remedial amendment period during which an amendment to a disqualifying provision may be made retroactively effective, under certain circumstances, to comply with the requirements of § 401(a). Section 1.401(b)–1(b) provides that a disqualifying provision includes an amendment to an existing plan that causes the plan to fail to satisfy the requirements of § 401(a). Notice 2001–42 (2001–30 I.R.B. 70) provides a remedial amendment period under Code § 401(b) ending not prior to the last day of the first plan year beginning on or after January 1, 2005, in which any needed retroactive amendment with regard to the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107–16, (EGTRRA), may be adopted. The availability of this remedial amendment period is conditioned on the adoption of a good faith EGTRRA plan amendment no later than the later of: (i) the end of the plan year in which the EGTRRA change in the qualification requirement is required to be, or is optionally, put into effect under the plan; or (ii) the end of the GUST[1] remedial amendment period for the plan.

HOLDINGS

(1) Under Situation (1), contributions used to purchase group health coverage under § 125 are not included in the gross income of the employee solely because the plan uses an automatic enrollment process whereby the employee's salary is reduced each year to pay for a portion of the group health coverage under the plan unless the employee affirmatively elects cash.

Under Situation (2), contributions used to purchase group health coverage under § 125 are not included in the gross income of the employee to the extent that an employee can elect cash. Section 125 does not apply to the employee-only coverage of an employee in Situation (2) who cannot certify that he or she has other health coverage and, therefore, does not have the ability to elect cash in lieu of health coverage. The lack of a choice between cash and a qualified benefit for these employees has no effect on whether the Plan satisfies the requirements for the exclusion from gross income of accident or health coverage under § 106(a).

(2) In determining compensation of employees for purposes of § 415(c)(3) under Holding (1), Situation (2) above, the employer can choose to treat "deemed § 125 compensation" as subject to § 125. For this purpose, "deemed § 125 compensation" is an excludable amount that is not available to an employee in cash in lieu of group health coverage under a § 125 arrangement because that employee is not able to certify that he or she has other health coverage. Under this definition, an amount is permitted to be treated as "deemed § 125 compensation" only if the employer does not otherwise request or collect information regarding the employee's other health coverage as part of the enrollment process for the health plan.

Pursuant to § 1.415–2(d)(13), a definition of compensation that otherwise satisfies § 415(c)(3) will not fail to satisfy § 415(c)(3) merely because it is amended to incorporate deemed § 125 compensation, as provided in this revenue ruling. A definition of compensation under § 415(c)(3) as amended to incorporate deemed § 125 compensation may also be used for purposes of other plan qualifica-

[1]The term "GUST" refers to the following:

- The Uruguay Round Agreements Act, Pub. L. 103–465;
- The Uniformed Services Employment and Reemployment Rights Act of 1994, Pub. L. 103–353;
- The Small Business Job Protection Act of 1996, Pub. L. 104–188;
- The Taxpayer Relief Act of 1997, Pub. L. 105–34;
- The Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105–206; and
- The Community Renewal Tax Relief Act of 2000, Pub. L. 106–554.

Unless § 19 of Rev. Proc. 2002–20, 2000–6 I.R.B. 553, as modified by Notice 2001–42 and Rev. Proc. 2001–55, 2001–55 I.R.B. 552, applies, the GUST remedial amendment period generally ended on February 28, 2002.

tion requirements (*e.g.*, § 414(s)). To the extent that a definition of compensation incorporates deemed § 125 compensation, it must apply uniformly to all employees with respect to whom amounts subject to § 125 are included in compensation.

This additional definition of compensation under § 415(c)(3) may be used in any plan year or limitation year beginning after December 31, 1997.

Retroactive Application—Pursuant to § 7805(b), for plan years beginning after December 31, 1997, and prior to January 1, 2002, the Service will not treat a qualified plan as having failed to satisfy the requirements of § 401(a) merely because the plan treated "deemed § 125 compensation" as compensation for purposes of § 415(c)(3), provided the plan is amended to provide the definition of "deemed § 125 compensation" on or before the end of the 2002 plan year and the amendment is effective for all years the plan operated in accordance with this definition.

Prospective Application. A plan that has not in operation been including "deemed §125 compensation" for purposes of § 415(c)(3) for plan or limitation years beginning before January 1, 2002, may not be amended retroactively, but must be amended for years beginning on or after January 1, 2002, in order for such amounts to be treated as § 415(c)(3) compensation in such years. Such amendment must be adopted no later than the end of the plan year in which it is effective.

Any plan amendment adopted in a timely manner pursuant to this revenue ruling will, if it results in a disqualifying provision, have the same remedial amendment period as the EGTRRA remedial amendment period. *See* Notice 2001–42. The Appendix provides a model plan amendment that a plan sponsor, or a sponsor of a pre-approved plan, may adopt to use the alternative definition of compensation. Adoption of the model amendment will not result in a disqualifying provision.

EFFECT ON OTHER REVENUE RULINGS

None

DRAFTING INFORMATION

The principal authors of this Revenue Ruling are Felix Zech of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and Andrew Zuckerman of Employee Plans (Tax Exempt and Government Entities Division). For further information regarding this Revenue Ruling, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Zech may be reached at 1–202–622–6080 and Mr. Zuckerman may be reached at 1–202–283–9655 (not toll-free numbers).

APPENDIX — MODEL AMENDMENT

The following is a model amendment that a sponsor of a qualified plan may choose to adopt if the sponsor maintains a health program in conjunction with a § 125 arrangement but permits an employee to elect cash in lieu of group health coverage only if the employee is able to certify that he or she has other health coverage. The use of this amendment will generally also apply to the definition of compensation for purposes of Code § 414(s) unless the plan otherwise specifically excludes all amounts described in § 414(s)(2).

A pre-approved plan (that is, a master or prototype or volume submitter plan) may be amended by the document's sponsor to use the alternative definition of compensation to the extent authorized. Alternatively, adopting employers may adopt a plan amendment as an addendum to the plan or adoption agreement. The inclusion of the model plan amendment below in an addendum to a plan adopted to comply with EGTRRA will not cause a pre-approved plan to be treated as an individually designed plan. A plan sponsor that adopts the model amendment verbatim (or with only minor changes) will have reliance that the form of its plan satisfies the requirements of this revenue ruling, and the adoption of such an amendment will not adversely affect the plan sponsor's or the adopting employer's reliance on a favorable determination, opinion or advisory letter.

1. Effective date. This section _____ shall apply to plan years and limitation years beginning on and after [insert the later of January 1, 1998, or the first day of the first plan year the plan was operated in accordance with the definition in this section.]

2. For purposes of the definition of compensation under section(s) _____, amounts under § 125 include any amounts not available to a participant in cash in lieu of group health coverage because the participant is unable to certify that he or she has other health coverage. An amount will be treated as an amount under § 125 only if the Employer does not request or collect information regarding the participant's other health coverage as part of the enrollment process for the health plan. [Insert in the blank section references for the plan's provisions that refer to amounts under § 125.]