Agenda Item
IV.

Executive Director's Report

H. Board Education

TREATING SALARY DEFERRALS UNDER A CAFETERIA PLAN AS COMPENSATION

Board Trustee Dianna Porter requested education regarding MPERA's treatment of certain salary deferrals under a 125 Cafeteria Plan as compensation for retirement purposes. A copy of the Board's policy on this issue is attached. The following is a brief summary of the requirements set out in the policy.

I. Montana statutes defining compensation for retirement purposes include pretax deductions allowed by state and federal law.

II. Pretax deductions may include elective contributions to Internal Revenue Code (IRC) Section 125 cafeteria plans.

III. Federal law allows elective contributions to IRC 125 cafeteria plans to be considered compensation if the contributions would be considered gross income but for the fact they were made under a bona fide IRC 125 cafeteria plan.

A. A bona fide IRC cafeteria plan must have a written plan document that incorporates all 125 plan operating rules.

B. Reference Policy at III. Procedures C.4.B. for a list of the necessary operating rules.

IV. The elective contributions [health insurance premiums] can be considered compensation only if the participant has the option of choosing either a qualified benefit [insurance coverage] or cash. Therefore, one of the following two options must exist:

A. The cafeteria plan allows participants to choose among 2 or more benefits consisting of cash and qualified benefits [insurance coverage]; or

B. If insurance coverage is required, the participants must be able to choose whether to pay the premiums with pre-taxed [qualified benefit] or taxed money [cash equivalent].

V. The cafeteria plan must allow for annual irrevocable elections to participate in the insurance plan, or if participation is required, to pay for the premiums with either pre- or post-tax money.

V. The elective contributions [health insurance premiums] can be considered compensation for retirement purposes ONLY if they are considered compensation for all other required purposes.

A. Required purposes include:

1. Federal and state income taxes
2. FICA
3. Unemployment insurance
4. Shift differentials
5. Workers' Compensation
6. Benefits based on compensation – i.e. disability benefits
7. Minimum benefit adjustments for non-GABA retirees

B. Required purposes do not include:

1. FLSA overtime
2. Montana's Wage Protection Act

MONTANA PUBLIC EMPLOYEES' RETIREMENT BOARD

TITLE: Treating Salary Deferrals Under a Cafeteria Plan as Compensation

POLICY NO: BOARD Admin 05 EFFECTIVE DATE: 12/09/05

I. POLICY AND OBJECTIVES

The Public Employees' Retirement Board (Board) must administer the retirement systems under its purview "in a manner required to satisfy the applicable qualification requirements for a qualified governmental plan, as provided in the Internal Revenue Code." Section 19-2-1010(1), MCA. The Board has received favorable determination letters from the Internal Revenue Service (IRS) indicating that the retirement systems it administers have met this requirement and are qualified governmental plans under IRS Code sections 401(a) and 414(d).

The Board's primary objective is to maintain the qualified status of the retirement systems it administers. In order to meet this objective, the Board must comply with the IRS Code when determining what constitutes "compensation".

II. APPLICABILITY

A. This policy applies when considering whether a salary deferral permitted under an employer's cafeteria plan should be considered "compensation" for any of the Board-administered retirement systems.

B. Background

1. The definitions of compensation under Section 19-3-108, MCA for purposes of the Public Employees' Retirement System (PERS), Section 19-5-101, MCA for purposes of the Judges' Retirement System (JRS), Section 19-6-101, MCA for purposes of the Highway Patrol Officers' Retirement System (HPORS), Section 19-7-101, MCA for purposes of the Sheriffs' Retirement System (SRS), Section 19-8-101, MCA for purposes of the Game Wardens' and Peace Officers' Retirement System (GWPORS), Section 19-9-104, MCA for purposes of the Municipal Police Officers' Retirement System (MPORS), and Section 19-13-104(2), MCA for purposes

of the Firefighters' Unified Retirement System (FURS) all include pretax deductions allowed by state and federal law.

2. Under federal law, pretax deductions that may be included in the definition of compensation include elective contributions under an Internal Revenue Code (Code) section 125 cafeteria plan, but only to the extent the amounts would be includible in gross income but for Code section 125(a). Code section 415(c)(3)(D).

3. The Board is required to administer PERS, JRS, HPORS, SRS, GWPORS, MPORS, and FURS in a manner required to satisfy the applicable qualification requirements for a qualified governmental plan, as provided in the Code. MCA 19-2-1010(1). Therefore, the Board adopts the following rule to ensure that only elective contributions that would be includible in gross income but for the fact they were made under a bona fide cafeteria plan under Code section 125 will be included as compensation for purposes of PERS, JRS, HPORS, SRS, GWPORS, MPORS, and FURS.

III. PROCEDURES

A. Compensation must be Treated Consistently.

1. If an employer increases a member's compensation to account for health, dental, vision, life or disability costs, the amount of the increase can be included in compensation for retirement system purposes only if the employer includes that amount, to the extent required by applicable federal and state law, in its calculation of the member's compensation for all purposes, including, but not limited to:

   a. federal income taxes;

   b. state income taxes;

   c. Federal Insurance Contribution Act (FICA);

   d. state unemployment insurance;

   e. overtime under the Fair Labor Standards Act (FLSA);

   f. overtime under Montana's Wage Protection Act;

   g. shift differentials;

   h. workers' compensation; and

i. benefits based on compensation, such as life or disability benefits based on a multiple or percentage of annual pay.

2. If the employer does not comply with paragraph 1 above, the Board will not consider the amount as an elective contribution under a cafeteria plan that would be includable in gross income but for Code section 125(a), and will not include the increase as compensation for purposes of PERS, JRS, HPORS, SRS, GWPORS, MPORS, and FURS.

3. If the Board has any reason to doubt that the employer is complying with paragraph 1 above, the Board has the right to obtain documentation up to and including an audit of any participating employer to ensure compliance with Section A above. If compliance with Section A cannot be verified by the Board, the participating employer's 125 Plan contribution will not be considered compensation for retirement system purposes.

B. Plans that Offer a Choice among Nontaxable Benefits Only.

1. If an employer has a plan or program under which it contributes on behalf of its employees a certain dollar amount, which can be used by the employee to purchase optional nontaxable benefits, but there is no ability for the employee to receive the employer contribution in cash or other taxable benefit, the Board will not consider the employer contribution an elective contribution under a cafeteria plan that would be includible in gross income but for Code section 125(a), and will not include the employer contribution as compensation for purposes of PERS, JRS, HPORS, SRS, GWPORS, MPORS, and FURS.

2. **Example of Nontaxable Benefit Only Plan**: Employer A agrees to make a $6,000 per year contribution to an optional benefit program. Under the program, the employee may elect to use all of any portion of the $6,000 to purchase one or more of the following benefits: (1) health plan coverage; (2) dental plan coverage or (3) a contribution to a 403(b) tax sheltered annuity plan. Options (1) and (2) are part of a 125 cafeteria plan. Option (3) is not. All options are alternatives to a cash payment. The employee has no ability to receive the $6,000 in cash. This program is not a cafeteria plan because it provides the employee a choice among only nontaxable benefits (see section C.6. below). Thus, there is no elective contribution under a cafeteria plan to be included as compensation for purposes of PERS, JRS, HPORS, SRS, GWPORS, MPORS, and FURS.

C. Bona Fide Cafeteria Plans

1. Elective employee contributions must be made to a bona fide cafeteria plan for that contribution to be eligible for treatment as compensation for purposes of PERS, JRS, HPORS, SRS, GWPORS, MPORS, and FURS.

2. To be a bona fide cafeteria plan, the employer must establish and sponsor a written plan that includes the requirements of Code section 125 outlined in 3. through 12. below. The cafeteria plan must also be operated in compliance with the requirements of Code section 125 outlined in 3. through 12. below. The Board may, from time to time, review an employer's cafeteria plan documentation and require that an employer certify or provide evidence to the Board that its cafeteria plan has been operating in compliance with Code section 125.

3. The written plan document must incorporate all of the operating rules prescribed in Code section 125 and its regulations and must be formally adopted by the employer before the first day of the first plan year of the cafeteria plan.

4. The written cafeteria plan document must contain operating rules covering each of the following topics:

   a. a description of benefits available under the plan;

   b. eligibility rules;

   c. how the plan is funded and the maximum amount of employer and employee contributions;

   d. the plan year;

   e. timing of participant elections and how elections are made; and

   f. irrevocability of participant elections.

5. All participants in the cafeteria plan must be employees.

   a. Self-employed individuals cannot participate in the cafeteria plan.

b. Independent contractors cannot participate in the cafeteria plan.

6. The cafeteria plan must allow participants to choose among 2 or more benefits consisting of cash and qualified benefits.

   a. **Example of No Cafeteria Plan:** Employer A agrees to make a $6,000 per year contribution to a cafeteria plan to account for health plan costs. If an employee elects health coverage, he will receive the full contribution to pay for his health coverage on a pretax basis. If an employee does not elect health coverage, he receives nothing. This $6,000 contribution is not considered compensation for retirement purposes because the employee does not have a choice to receive cash instead of the qualified benefit (pretax payment of the health coverage).

   b. **Example of Bona Fide Cafeteria Plan:** The same facts as in the above Example, except that if an employee does not elect health coverage, he receives the $6,000 in cash. Assuming the cafeteria plan meets all other requirements under Code section 125, this $6,000 contribution is considered compensation for retirement purposes because the employee does have a choice to receive cash instead of a qualified benefit. This choice among benefits may be provided through an affirmative election, a mandatory election, or a waiver of participation.

7. Under an affirmative election, the employee must be permitted to elect, on an annual basis, whether to purchase qualified benefits under the cafeteria plan.

   a. **Example of Invalid Affirmative Election:** Under an employer's cafeteria plan, a new hire is permitted to elect to purchase health insurance benefits and pay for them on a pretax basis. That election, however, is irrevocable for the remainder of the employee's employment. This is not a bona fide cafeteria plan because the employee is not allowed to choose on an annual basis between the qualified benefit (pretax payment of the health insurance premium) and cash.

   b. **Example of Valid Affirmative Election:** Under an employer's cafeteria plan, a new hire is permitted to elect to purchase health insurance benefits and pay for them on a pretax basis or elect to receive all his compensation as

taxable cash. In addition, employees are permitted to change their election each year during the cafeteria plan's open enrollment period. Assuming the cafeteria plan meets all other requirements under Code section 125, this plan provides for valid affirmative elections and provides a choice between a qualified benefit and cash.

8. Under a mandatory election, the cafeteria plan can mandate that, if an employee chooses a certain benefit, he must pay for it on a pretax basis; however, the employer cannot mandate **both** that the employee choose the benefit **and** that he pay for it on a pretax basis under the cafeteria plan.

   a. **Example of Invalid Mandatory Election:** Employer A increases its employees' compensation by $6,000 per year to account for health plan costs. Employer A's collective bargaining agreement with its employees mandates that employees be covered under the employer's health plan. The employee-only annual premium is $6,000. Because health coverage is mandatory, Employer A cannot also mandate that employees pay for this coverage on a pretax basis under a cafeteria plan. If it does so, there is no bona fide cafeteria plan because there is no choice between a qualified benefit (pretax payment of health benefits) and cash ($6,000 increase in taxable compensation).

   b. **Example of Valid Mandatory Election of Pretax Payment:** The same facts as in the above Example, except that the collective bargaining agreement does not mandate that employees be covered under the employer's health plan. In this case, Employer A can mandate that, to elect health coverage, the employee must elect to pay for that coverage on a pretax basis under the cafeteria plan, otherwise the $6,000 would simply be taxable income to the employee.

   c. **Example of Valid Mandatory Election of Health Coverage:** The same facts as in the first Example above, except that employees have a choice of paying the $6,000 annual premium for the mandatory health coverage on a pretax or an after tax basis. Assuming the cafeteria plan meets all other requirements under Code section 125, this plan provides for valid mandatory elections and provides a choice between a qualified benefit (pretax payment for mandatory health coverage) and cash (after tax payment for mandatory health coverage).

9. Under a waiver, an employee will be deemed to have elected qualified benefits under the cafeteria plan unless the employee signs a waiver, on an annual basis, of those benefits under the cafeteria plan.

   a. **Example of Invalid Waiver:** Employer A makes a $6,000 annual contribution to a cafeteria plan for each employee to account for health plan costs. Under the cafeteria plan, employees are deemed to have elected to use that $6,000 contribution to pay for their health coverage on a pretax basis unless they waive health coverage. If the employee waives health coverage, however, the employee receives nothing under the cafeteria plan. This is not a bona fide cafeteria plan, as the employee does not have a choice between a qualified benefit (the pretax payment for health coverage) and cash.

   b. **Example of Valid Waiver:** Employer A makes a $6,000 annual contribution to a cafeteria plan for each employee to account for health plan costs. Under the cafeteria plan, employees are deemed to have elected to use that $6,000 contribution to pay for their health coverage on a pretax basis unless they waive health coverage (or, alternatively, waive pretax payment for their health coverage and elect to pay for it on an after tax basis). If the employee waives coverage (or the pretax payment of coverage) the employee receives $6,000 in taxable compensation. There is an annual waiver available during the cafeteria plan's open enrollment period. Assuming the cafeteria plan meets all other requirements under Code section 125, this plan provides for valid waivers and provides a choice between a qualified benefit and cash.

10. The cafeteria plan may offer only qualified benefits as defined under Code section 125(f).

    a. Qualified benefits include:

       i. benefits that do not defer the receipt of compensation and are not included in gross income by reason of an express provision in Chapter I of the Code, including:

          (A) coverage under an accident or health plan to the extent the coverage is excludable from income under Code section 106 (including medical expense reimbursement accounts);

(B) group term life insurance excluded under Code section 79; and

(C) benefits under a dependent care assistance program excluded under Code section 129.

ii. vacation days;

iii. contributions to a 401(k) plan; and

iv. adoption assistance excluded under Code section 137.

b. Qualified benefits do not include:

i. fringe benefits governed by Code section 132 (such as pretax parking and qualified employee discounts);

ii. scholarships under Code section 117;

iii. educational assistance programs under Code section 127; and

iv. long-term care insurance.

11. Elections made under the cafeteria plan must be irrevocable for an entire plan year, except to the extent mid-year election changes are permitted under Code section 125 and its regulations.

12. The cafeteria plan must satisfy the nondiscrimination requirements of Code section 125.

IV. IMPLEMENTATION AND COMPLIANCE

A. A participating employer must demonstrate compliance with this policy effective with the next 125 plan year that follows August 25, 2005.

1. The employer must submit to the Board a copy of the employer's 125 plan document and the salary reduction or election form that must be completed by the employees wishing to participate.

2. The salary reduction or election form must be the document that will be used for the enrollment period that precedes the next 125 plan year.

3. Once compliance has been demonstrated, the employer must verify on an annual basis that its IRC section 125 plan document and election form have not changed. If either document does change, the new document or election form must be submitted to the Board.

B. If an employer fails to provide the 125 plan document, the salary reduction or election form in a format that complies with this policy, or fails to use the salary reduction or election form during the enrollment period, compensation for that employer shall not include the 125 plan's salary reduction amount.

C. **Example of a Demonstration of Compliance when the 125 Plan Year is Calendar Year 2006:** The plan year for an employer's 125 plan starts on January 1. The open enrollment period for that plan year is the month of October. An employer who wishes to include the 125 salary reduction in the definition of compensation must submit to the Board a copy of the employer's 125 plan document and the salary reduction or election form prior to the commencement of the plan year, January 1, 2006. The employer must use the salary reduction form in the October 2005 enrollment period. The 125 plan and the salary reduction form must meet the criteria in the policy.

V. CROSS-REFERENCES

The following laws, rules or policies may contain provisions that might modify a decision relating to refunds of contributions for terminated members. The list should not be considered exhaustive - other policies may apply.

Internal Revenue Code Section 125
Internal Revenue Code Section 401
Internal Revenue Code Section 414
Section 19-2-1010, MCA
Section 19-3-108, MCA
Section 19-5-101, MCA
Section 19-6-101, MCA
Section 19-7-101, MCA
Section 19-8-101, MCA
Section 19-9-104, MCA
Section 19-13-104, MCA

VI. HISTORY

Originally approved August 2005
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