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CC:TEGE:EOEG:ET2:EEwards
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MEMORANDUM FOR ROBERT WESTHOVEN

FROM: Jerry Holmes
TEGE:EOEG:ET2

SUBJECT: Additional Questions: State and Local Governments

This is in partial response to your document transmitting 65 questions dealing with employment tax issues of state and local governments. These responses were prepared by other branches in TEGE.

Question #8: A municipality has a group-term life insurance plan. The employer pays for the cost of insurance coverage under \$50,000. The employee may purchase additional insurance which may exceed \$50,000. Is any part of the premium taxable?

Answer: An employer can provide up to \$50,000 of group-term life insurance coverage tax-free. The employee is taxed on the cost of coverage in excess of \$50,000 (reduced by any amounts paid by the employee toward the cost of the coverage), but only if the insurance is "provided under a policy carried directly or indirectly by the employer." The cost of the insurance must be computed using the premiums prescribed in Table I of the Internal Revenue Code (Code) section 79 regulations. To determine the amount to be included in an employee's income, total the coverage provided under all policies "carried directly or indirectly by the employer" and reduce that coverage by \$50,000. Next, go to Table I to determine the cost of the insurance and then reduce that cost by any premium amounts paid by the employee.

A policy is carried directly or indirectly by the employer under two circumstances: (1) if the employer pays any cost of the life insurance; or (2) if the employer arranges for the premium payments and the premiums paid by at least one employee subsidize those paid by at least one other employee. The test for determining whether some employees are subsidizing other employees is found in section 1.79-0 of the regulations. Under that test, there is employee subsidization if at least one employee is charged less than the cost of his or her insurance (as determined under Table I) and at least one other employee is charged more than the cost of his or her insurance (as determined under Table I). This is sometimes referred to as the straddle rule. That is,

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if the premiums charged the employees “straddle” the Table I premium rates, the insurance is “carried directly or indirectly by the employer.” Each policy must be tested separately to determine if it is carried directly or indirectly by the employer. As a general rule, all insurance coverage provided by the same insurance company (or any of its subsidiaries) is considered one policy.

Thus, the question cannot be answered without knowing whether the employer-paid coverage and the employee-paid coverage are purchased from the same or different insurance companies. If the insurance is purchased from different insurers, the employer-paid coverage is “carried directly or indirectly by the employer” because it is financed by you. The optional insurance, even though it is paid for entirely by employee after-tax dollars, must also be included in the calculations for group-term insurance if the premiums charged to the employees “straddle” the Table I rates. If the premiums charged to employees for the optional insurance do not “straddle” the Table I rates, only the cost of the employer-paid coverage is subject to inclusion in income—and because you do not pay for more than \$50,000 of coverage, no amounts would be taxable.

If you use the same insurer (or a subsidiary) to purchase both the employer-paid coverage and the optional coverage paid by the employees, as a general rule you must test both types of coverage as one policy. Because insurance provided under that policy is partially financed by the employer, it is “carried directly or indirectly by the employer,” and the two coverages must be combined to determine the amount, if any, to be included in an employee’s income. Note, however, that the regulations provide an exception to the rule that all coverage from the same insurer must be tested as one policy. For most group-term insurance, the exception is met only if the premiums are properly allocated among the coverages and the employer elects to treat the coverages as separate policies. To determine if premiums are properly allocated, the IRS often looks at whether the premiums are developed using separate mortality or claims experience, and whether credits and dividends are properly allocated between the coverages. If you meet the exception, you can test the employer-paid coverages separately, as if they were purchased from different insurance companies.

Question #15: Are the employer and employee contributions to a section 457 plan taxable for social security and Medicare?

Answer: Section 3121(v)(2)(A) of the Code provides that any amount deferred under a nonqualified deferred compensation plan shall be taken into account for purposes of social security and Medicare as of the later of (i) when the services are performed, or (ii) when there is no substantial risk of forfeiture of the rights to the amount.

Section 3121(a)(5)(E) of the Code provides that wages do not include any payment made to, or on behalf of, an employee or his beneficiary under, or to, an exempt governmental deferred compensation plan (as defined in section 3121(v)(3)).

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However, section 3121(v)(3) of the Code provides that the term “exempt governmental deferred compensation plan” does not include any plan to which section 457(a) or section 457(e)(1) applies. Thus, contributions to an eligible state deferred compensation plan are not excludable from the definition of the term “wages” for purposes of the FICA taxes.

Both the employer and employee contributions to a 457 plan are taxable for social security and Medicare.

Question #27: A State Retirement Plan pays for life insurance for the employee’s spouse and children in the amount of \$5,000. Is this coverage taxable as income to the employee?

Answer: The cost of employer-provided group-term life insurance on the life of an employee’s spouse or dependent is not taxable to the employee if the face amount of the coverage does not exceed \$2,000. This coverage is deemed to be a de minimis fringe benefit. Amounts with a higher face amount may also be a de minimis fringe benefit. IRS Notice 98-110 requires that in determining whether coverage higher than \$2,000 is a de minimis fringe benefit, only the excess (if any) of the cost of such insurance over the amount paid for the insurance by the employee on an after-tax basis shall be taken into account.

If the face amount exceeds \$2,000 (or is not otherwise a de minimis fringe benefit described in Notice 89-110), the entire cost of the insurance, including the cost of the first \$2,000, is included in the employee’s income. The cost of the insurance must be computed using the premiums prescribed in the Uniform Premium Table (Table I) found in the Code section 79 regulations. Any premium amounts paid by the employee on an after-tax basis reduce the amount included in the employee’s income.

Question #59: The employees of a town are covered by the State Retirement life insurance. This insurance coverage, combined with the town’s other life insurance, is in an amount greater than \$50,000 for each employee. Are these policies combined to figure the taxable income over \$50,000?

Answer: The statute excluding from income the cost of up to \$50,000 of group-term life insurance coverage on the life of an employee does not apply to insurance provided under a life insurance contract purchased as part of a qualified retirement plan. Different rules of taxation apply to such insurance. Whether the life insurance is provided under the retirement plan depends on the provisions of the plan.

Assuming that the life insurance provided through the state is not purchased as part of the provisions of a retirement plan, the insurance provided through the city and that provided through the state are generally combined to determine the amount to be included in an employee’s income. But refer to the discussion in Question #8

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(concerning whether a policy is carried directly or indirectly by the employer) if one or both of the insurance coverages are paid for entirely by the employees.

Question #16: Please explain a SEP-IRA. Can a town offer its employees a SEP-IRA?

Answer: Yes, a town can offer its employees a SEP-IRA (simplified employee pension). Under a SEP, you make the contributions to an individual retirement arrangement established by or for each eligible employee. SEP-IRAs are owned and controlled by the employees, and you make contributions to a financial institution where the SEP-IRAs are maintained. A SEP-IRA is set up for, at a minimum, each eligible employee.

An eligible employee is an individual who has: 1) reached age 21; 2) worked for you in at least 3 of the last 5 years; and 3) received at least \$450 in compensation from you during the calendar year 2000.

Note: you can establish less restrictive participation requirements than those listed but not more restrictive ones.

There are three basic steps in setting up a SEP:

- 1) You must execute a formal written agreement to provide benefits to all employees who are eligible.
- 2) You must give each eligible employee certain information about the SEP, and
- 3) An IRA account must be established by or for each eligible employee.

The SEP rules permit you to contribute a limited amount of money each year to each employee's SEP-IRA. You do not have to make contributions every year. But if you make contributions, they must be based on a written allocation formula and must not discriminate in favor of highly compensated employees. When you contribute, you must contribute to the SEP-IRAs of all participants who actually performed personal services during the year for which the contributions are made, even employees who died or terminated employment before the contributions were made.

Contributions cannot be more than the smaller of 15% of the employee's compensation or \$30,000. Do not include SEP contributions as wages on an employee's Form W-2. Your contributions to a SEP, to any other qualified defined contribution plan, and benefits under any other qualified defined benefit plan cannot exceed certain limits set forth in Code section 415.

Publication 560 discusses Simplified Employee Pension plans in detail.

This publication discusses what type of plan to set up, as well as how to set up a plan. It also tells how much you can contribute to a plan, how to treat distributions, and how to report information about the plan to the Internal Revenue Service and your employees.

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You can also call the Employee Plans Taxpayer Assistance telephone service between the hours of 1:30 PM and 3:30 PM, Eastern Time, Monday through Thursday at (202) 622-6074/6075. (These are not toll-free numbers.)

Question #50: A municipality offers employees not participating in the state retirement system the option of a matching IRA up to \$1,000. Employees must show proof of contribution through bank documentation. The municipality then sends a check directly to the bank for contribution to the employee's IRA. Is this contribution taxable?

Answer: Yes. This arrangement is an IRA described in Code section 408(c). Employer contributions to IRAs are treated as payment of compensation to the employee. They are includible in the employee's gross income in the taxable year for which the amount was contributed. Section 219(f)(5). The total amount of the employee's contribution and the employer's contribution cannot exceed \$2,000, or the amount of compensation includible in the employee's gross income for the taxable year if the employee's compensation is less than \$2,000.

Question #35: Is there a filing requirement for a town that maintains a cafeteria plan?

Answer: Yes, state and governmental agencies are required to file Form 5500, Annual Return/Report of Employee Benefit Plan, for Internal Revenue Code section 125 cafeteria plans. This is true even though state agencies are exempt under the Employee Retirement Income Security Act of 1974 (ERISA) from filing Form 5500 for pension benefit and welfare benefit plans such as 401(k) plans and health insurance plans.

Question #44: A town has a cafeteria plan (section 125 plan), which offers dependent care assistance. The benefits received by an employee exceed \$5,000. How is this benefit reported on Form W-2?

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

Question #45: What remuneration under a cafeteria plan is not subject to FICA, FUTA, Medicare tax or income tax withholding?

Answer: Generally, qualified benefits under a cafeteria plan are not subject to FICA, FUTA, Medicare tax, or income tax withholding. However, group-term life insurance

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that exceeds \$50,000 of coverage is subject to social security and Medicare taxes, but not FUTA tax or income tax withholding, even when provided as a qualified benefit in a cafeteria plan. Adoption assistance benefits provided in a cafeteria plan are subject to social security, Medicare, and FUTA taxes, but not income tax withholding. If an employee elects to receive cash instead of any qualified benefit, it is treated as wages subject to all employment taxes. For more information, see Chapter 5 in Pub. 535 or Pub. 15-A.

Question #46: Please explain how the cafeteria plan works.

Answer: Code section 125 makes it possible for employers to offer their employees a choice between cash salary and a variety of nontaxable benefits (qualified benefits).

A qualified benefit is a benefit that does not defer compensation and which is excludable from an employee's gross income under a specific provision of the Code, without being subject to the principles of constructive receipt. Qualified benefits include health care, vision and dental care, group-term life insurance, disability, adoption assistance and certain other benefits. See Sections 125(a), 125(f), 79, 105, 106, 129 and 137 of the Code.

Employers may also offer flexible spending accounts to employees under a cafeteria plan that provides coverage under which specified, incurred expenses may be reimbursed. These include health flexible spending accounts for expenses not reimbursed under any other health plan and dependent care assistance programs.

Employer contributions to the cafeteria plan are usually made pursuant to salary reduction agreements between the employer and the employee in which the employee agrees to contribute a portion of his or her salary on a pre-tax basis to pay for the qualified benefits. Salary reduction contributions are not actually or constructively received by the participant. Therefore, those contributions are not considered wages for federal income tax purposes. In addition, those sums generally are not subject to FICA and FUTA. See Sections 3121(a)(5)(G) and 3306(b)(5)(G) of the Code.

The above discussion provides only the most basic rules governing a cafeteria plan. For a complete understanding of the rules, see the proposed and final regulations under Code section 125.

Question #65: A town has a cafeteria plan which offers health care benefits to domestic partners. Does a domestic partner and his or her child qualify to be covered under the health plan?

Answer: Cafeteria plans can offer health insurance to employees, their spouses and their dependants. The domestic partner and dependants in this case may not be participants in a cafeteria plan because they are not employees, but the plan may provide benefits to them. For example, a domestic partner may not be given the

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opportunity to select or purchase benefits offered by the plan, but the domestic partner may benefit from the employee's selection of family medical insurance coverage or of coverage under a dependent care assistance program.

If the domestic partner and his or her child do not qualify as the employee's dependents, those individuals may receive coverage under the cafeteria plan on a taxable basis. This means that the fair market value of the coverage for the domestic partner and his or her child must be included in the employee's wages for purposes of income tax withholding, FICA and FUTA taxes.

Question #66: What if the employer does not have a section 125 plan, but offers health insurance coverage to a domestic partner and his or her child? Is this a taxable fringe benefit to the employee?

Answer: Employer-provided coverage under an accident or health plan for individuals other than the employee, the employee's spouse or dependents is included in the employee's gross income. Code section 106. The term "dependent" is defined in section 152(a) of the Code.

Question #49: Employee X has 34 years of service with school districts. X is a participant in the State Retirement System and contributes 7.65% of his gross salary to the plan. For the past 4 years, X has been employed as superintendent of schools of the ABC school district in the State.

1. What is the maximum amount of elective deferrals X can contribute in 2000 to a 403(b) contract purchased for X by ABC School District based on his salary of \$50,000+?

Answer: A plan that provides for salary reduction contributions must not exceed the maximum deferral limitations under section 401(a)(30) of the Code. For the 2000 year, the maximum 403(b) elective deferral limit is \$10,500 plus increases permitted for 15-year employees. See Publication 571, page 4, "Increase for 15-year employees," for an explanation of how to figure the amount of the yearly increase. Also see the discussion in Answer 4 below.

2. Do either employer or employee contributions to the State Retirement System, or both, have to be included when figuring the limit on elective deferrals under the 403(b) contract?

Answer: We have not been told the plan type of the State Retirement System, i.e., the Code section which applies to it. If the retirement plan is any of the plans described below, the annual limit on Employee X's deferrals under a 403(b) contract would have to be reduced by the total of all elective deferrals contributed for the year on behalf of X (even if by different employers) to:

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- 401(k) plans to the extent excluded from X's income,
- Section 501(c)(18) plans to the extent excluded from X's income,
- SIMPLE plans, and
- 403(b) plans.

See section 401(a)(30) and page 4 of Publication 571.

If the State Retirement System is a section 457 plan, the school district should adjust the limitations accordingly.

3. When figuring the amount previously excludable what exactly do you include in this figure?

Answer: To figure Employee X's exclusion allowance, you must know the amounts previously excludable from X's income. Page 8 of Publication 571 explains how to figure this.

4. In figuring the increase in the dollar limit of elective deferrals, can Employee X use the years in other school districts to qualify for the increase in the dollar limit for a 15-year employee?

Answer: No. Tacking of years of service for purposes of section 402(g)(8) is not permitted in other than a 414(e) church environment.