Internal Revenue Service Regulation 1.125-2

Miscellaneous cafeteria plan questions and answers

§1.125-2 Miscellaneous cafeteria plan questions and answers, EE-130-86, 3/7/89 and REG-209461-79, 1/10/2001.

The following is a list of the questions addressed in this section.

Q-1: What are the effective dates of these cafeteria plan rules?

Q-2: What does section 125 of the Code provide?

Q-3: What is a cafeteria plan under section 125?

Q-4: What benefits constitute qualified benefits and what benefits constitute cash under a cafeteria plan?

Q-5: May a cafeteria plan include a benefit that defers the receipt of compensation?

Q-6: In what circumstances may participants revoke existing elections and make new elections under a cafeteria plan?

Q-7: How do the rules governing the tax-favored treatment of employer-provided benefits apply to plans that are flexible spending arrangements?

Q-1: What are the effective dates of these cafeteria plan rules?

A-1: Q&A-1 through Q&A-6 of this §1.125-2 apply to plan years of cafeteria plans as set forth in Q&A-10 of §1.89(a)-1 (regarding the effective date of section 89). Q&A-7 of this §1.125-2 (relating to flexible spending arrangements) applies to plan years beginning after December 31, 1989.

Q-2: What does section 125 of the Code provide?

A-2: In general, an employee who has an election among nontaxable benefits and taxable benefits (including cash) must include in gross income any taxable benefits that the employee could have actually received pursuant to the employee's election. The amount of these benefits is included in the employee's income in the year in which the employee would have actually received the taxable benefits if the employee had elected such benefits. This generally is the result even if the employee's election between the nontaxable benefits and taxable benefits is made prior to the year in which the employee would have actually received the taxable benefits. However, section 125 provides that cash (including certain taxable benefits) provided under a nondiscriminatory cafeteria plan will not be included in a participant's gross income merely because the participant has the opportunity, before the cash becomes currently available to the participant, to choose among cash and the nontaxable benefits under the cafeteria plan.

Q-3: What is a cafeteria plan under section 125?

A-3: A cafeteria plan is a plan maintained by an employer for the benefit of its employees that satisfies the requirements of section 89(k), under which all participants are employees, and under which each participant has the opportunity to choose among cash and qualified benefits. Additionally, a cafeteria plan satisfies the written plan document requirement of clause (v) of Q&A-3 of §1.125-1 only if the plan describes the maximum amount of elective contributions available to any employee under the plan either by stating the maximum dollar amount or maximum percentage of compensation that may be contributed as elective contributions under the plan by employees or by stating the method for determining the maximum amount or percentage of elective contributions that employees may make under the plan. The meaning of "elective contributions" under a cafeteria plan is the same as the meaning of "salary reduction contributions" under a cafeteria plan. See also paragraph (a)(2) of Q&A-8 of §1.89(a)-1.

Q-4: What benefits constitute qualified benefits and what benefits constitute cash under a cafeteria plan?

A-4: (a) *Qualified benefits*—(1) *In general.* A benefit is a qualified benefit under a cafeteria plan if the benefit does not defer the receipt of compensation and the benefit is not includible in an employee's gross income by reason of an express provision of Chapter 1 of the Code. In the case of insurance-type benefits, such as benefits provided under accident or health plans (sections 106 and 105) and group-term life insurance plans (section 79), the benefit is the coverage under the plan.

(2) *Items that constitute qualified benefits*—(i) *Accident or health plans.* Coverage under an accident or health plan is a qualified benefit to the extent that such coverage is excludable from income under section 106. Thus, for example, coverage under a long-term disability plan and coverage under an accidental death and dismemberment policy may be qualified benefits.

(ii) *Group-term life insurance.* Group-term life insurance coverage that is excludable from gross income under section 79 and group-term life insurance coverage that is includible in gross income solely because the death benefit payable thereunder is in excess of the dollar limit of section 79 are qualified benefits.

(iii) *Certain discriminatory benefits.* Accident or health plan coverage, group-term life insurance coverage, and benefits under a dependent care assistance program do not fail to be qualified benefits under a cafeteria plan merely because they are includible in gross income solely because of section 89 or any other applicable nondiscrimination requirement (e.g., section 129(d)).

(iv) *Certain dependent care assistance benefits.* Benefits under a dependent care assistance program that would have been excludable from gross income under section 129 but for the elimination of overnight camp expenses from dependent care assistance under such section (effective January 1, 1988) or the reduction of the age limit on children qualifying as dependents under such section (effective January 1, 1989) do not fail to be qualified benefits merely because such changes in law cause such benefits to be taxable. However, the preceding sentence applies only if the benefits are provided under a program that otherwise qualifies as a dependent care assistance program under section 129, are taxable to the employee upon receipt, and are provided by the December 31 next following the effective date of the applicable change in law. After such date, such benefits will not constitute qualified benefits but may be treated as cash pursuant to paragraph (b) of this Q&A-4.

(b) *Currently taxable benefits treated as cash.* In general, a benefit is treated as cash if such benefit does not defer the receipt of compensation and an employee who receives such benefit purchases such benefit with after-tax employee contributions or is treated, for all purposes under the Code (including, for example, reporting and withholding purposes), as receiving, at the time that such benefit is received, cash compensation equal to the full value of such benefit at such time and then purchasing such benefit with after-tax employee contributions. Thus, for example, long-term disability coverage is treated as cash if the cafeteria plan provides that an employee may purchase the coverage under the plan with after-tax employee contributions, or provides that the employee receiving such coverage is treated as having received cash compensation equal to the value of the coverage and then as having purchased the coverage with after-tax employee contributions. Any taxable benefit that is not described in paragraph (a) of this Q&A-4 and is not treated as cash under this paragraph (b) may not be included in a cafeteria plan.

(c) *Qualified cash or deferred arrangements.* Elective contributions to a qualified cash or deferred arrangement (section 401(k)) are permitted under a cafeteria plan. In addition, after-tax employee contributions under a qualified plan subject to section 401(m) are permitted under a cafeteria plan. The right to make such contributions will not cause a plan to fail to be a cafeteria plan merely because, under the qualified plan, employer matching contributions are made with respect to elective or after-tax employee contributions.

(d) *Benefits that do not constitute qualified benefits or cash.* Benefits of the type described in section 117 or 132 do not constitute qualified benefits or cash and thus may not be included in a cafeteria plan regardless of whether any such benefit is purchased with after-tax employee contributions or on any other basis. Thus, for example, health diagnostic or examination plans are qualified benefits under a cafeteria plan because such plans

are accident or health plans that are eligible for the exclusion under section 106 and are not, in any case, eligible for the exclusion under section 132.

Q-5: May a cafeteria plan include a benefit that defers the receipt of compensation?

A-5: (a) *In general.* A cafeteria plan may not include any plan that offers a benefit that defers the receipt of compensation. In addition, a cafeteria plan may not operate in a manner that enables employees to defer compensation. For example, a plan that permits employees to carry over unused elective contributions or plan benefits (e.g., accident or health plan coverage) from one plan year to another operates to defer compensation. This is the case regardless of how the contributions or benefits are used by the employee in the subsequent plan year (e.g., whether they are automatically or electively converted into another taxable or nontaxable benefit in the subsequent plan year or used to provide additional benefits of the same type). Similarly, a cafeteria plan operates to permit the deferral of compensation if the plan permits participants to use contributions for one plan year to purchase a benefit that will be provided in a subsequent plan year (e.g., life, health, disability, or long-term care insurance coverage with a savings or investment feature, such as whole life insurance). For example, a cafeteria plan operates to permit the deferral of compensation if the cafeteria plan includes a health plan that is a flexible spending arrangement (as defined in Q&A-7 of this section) and such health plan may reimburse participants' premium payments for other accident or health coverage extending beyond the end of the plan year. See Q&A-7 of this section for the treatment of experience gains under a health plan that is a flexible spending arrangement.

(b) *Exceptions.* A plan does not fail to be a cafeteria plan merely because the plan permits participants to make elective contributions under a qualified cash or deferred arrangement under section 401(k) or permits participants employed by certain educational institutions to purchase retiree group-term life insurance. Similarly, a cafeteria plan does not include a benefit that defers the receipt of compensation merely because the cafeteria plan provides the opportunity to make after-tax employee contributions subject to section 401(m) under a qualified plan. In addition, a cafeteria plan will not be treated as including a benefit that defers the receipt of compensation merely because, under the qualified plan, employer matching contributions (as defined in section 401(m)(4)(A)) are made with respect to such elective contributions or after-tax employee contributions. Finally, reasonable premium rebates or policy dividends paid with respect to benefits provided under a cafeteria plan do not constitute impermissible deferred compensation if such rebates or dividends are paid before the close of the 12-month period immediately following the plan year to which such rebates and dividends relate.

(c) *Treatment of paid vacation days under a cafeteria plan*—(1) *In general.* A cafeteria plan may include elective, paid vacation days by permitting participants to receive either additional or fewer paid vacation days than the employer otherwise provides to the employees on a nonelective basis, if the inclusion of elective vacation days under the plan does not operate to permit the deferral of compensation.

(2) *Ordering of elective and nonelective vacation days.* In determining whether a plan that provides for paid vacation days operates to permit the deferral of compensation, and thus fails to be a cafeteria plan, a participant is deemed to use nonelective vacation days (i.e., the vacation days with respect to which the employee had no election) before elective vacation days.

(3) *Cashing out unused elective vacation days.* A plan does not operate to permit the deferral of compensation merely because the plan permits a participant who has not used all elective, paid vacation days for a plan year to receive in cash the value of such unused days in exchange for such days if the participant receives the cash on or before the earlier of the last day of the plan year of the cafeteria plan or the last day of the employee's taxable year to which the elective contributions used to purchase the unused days relate.

(4) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1. Assume that an employer provides an employee with 2 weeks of paid vacation for each calendar year and maintains a calendar year cafeteria plan that permits the employee to "purchase," with elective contributions, an additional week of paid vacation. Assume further that Employee A, with a calendar tax year, purchases 1 additional week of vacation. If Employee A uses only 2 weeks of vacation during the year, the

employee is treated as having used the 2 nonelective weeks and as having retained the 1 elective week. If the 1 remaining week (i.e., the elective week) may be carried over to the next year (or the value thereof used for any other purpose in the next year), the plan operates to permit the deferral of compensation and thus is not a cafeteria plan. However, the cafeteria plan may permit the employee to receive the value of the unused elective vacation week in cash before the end of the applicable calendar year.

Example 2. The facts are the same as set forth in Example 1, except that Employee A uses only 1 week of vacation during the year. Thus, Employee A is treated as having used 1 nonelective week and as having retained 1 nonelective week as well as 1 elective week of vacation. Because the nonelective vacation days are not part of the cafeteria plan (i.e., the employer or plan does not permit participants to exchange regular vacation days for other benefits), Employee A may be permitted to carry over the 1 nonelective week of vacation to the next year. In addition, under the terms of the cafeteria plan, Employee A must either forfeit the remaining elective vacation week or receive in cash the value of such unused days before the end of the applicable calendar year.

Q-6: In what circumstances may participants revoke existing elections and make new elections under a cafeteria plan?

A-6: (a) *In general.* A plan is not a cafeteria plan unless the plan requires that participants make elections among the benefits offered under the plan. In general, an election will not be deemed to have been made if, after a participant has elected and begun to receive a benefit under the plan, the participant is permitted to revoke the election during the period of coverage under the plan, even if the revocation relates only to the remaining portion of the coverage period with respect to the benefit and even if the revocation is in response to a change in the tax treatment of such benefit. However, to the extent permitted under §1.125-4, the terms of a cafeteria plan may permit a participant to revoke an existing election and to make a new election with respect to the remaining portion of the period of coverage.

(b) *Cessation of required contributions.* A cafeteria plan may provide that a benefit will cease to be provided to an employee if the employee fails to make the required premium payments with respect to the benefit (e.g., employee ceases to make premium payments for health plan coverage after a separation from service). However, in such case, the plan must prohibit the employee from making a new benefit election for the remaining portion of the period of coverage.

Q-7: How do the rules governing the tax-favored treatment of employer-provided benefits apply to plans that are flexible spending arrangements?

A-7: (a) *In general.* Health plans that are flexible spending arrangements as defined in paragraph (c) of this Q&A-7 (health FSAs) must conform to the generally applicable rules under sections 105 and 106 in order for the coverage and reimbursements under such plans to qualify for tax-favored treatment under such sections. Thus, health FSAs must qualify as accident or health plans. This means that, in general, while the health coverage under the FSA need not be provided through a commercial insurance contract, health FSAs must exhibit the risk-shifting and risk-distribution characteristics of insurance. Similarly, reimbursements under health FSAs must be paid specifically to reimburse the participant for medical expenses incurred previously during the period of coverage. Furthermore, a health FSA cannot operate under a cafeteria plan in a manner that enables participants to receive coverage only for periods for which the participants expect to incur medical expenses if such periods constitute less than a plan year. A reimbursement is not paid specifically to reimburse the participant for medical expenses if the participant is entitled to these amounts, in the form of cash or any other taxable or nontaxable benefit (including health coverage for an additional period), without regard to whether or not the employee incurs medical expenses during the period of coverage. A health FSA will not qualify for tax-favored treatment under sections 105 and 106 of the Code if the effect of the reimbursement arrangement eliminates all, or substantially all, risk of loss to the employer maintaining the plan or other insurer. These rules apply with respect to a health plan without regard to whether the plan is provided through a cafeteria plan. See Q&A-17 of §1.125-1.

(b) *Special requirements*—(1) *In general.* A health FSA must satisfy the requirements set forth in this paragraph (b) in order for the employer-provided health coverage provided through the health FSA to qualify for

the exclusion from income under section 106 and for the reimbursements and other benefits pursuant to the health FSA coverage to qualify for the exclusion from income under section 105.

(2) *Uniform coverage throughout coverage period.* The maximum amount of reimbursement under a health FSA must be available at all times during the period of coverage (properly reduced as of any particular time for prior reimbursements for the same period of coverage). Thus, the maximum amount of reimbursement at any particular time during the period of coverage cannot relate to the extent to which the participant has paid the required premiums for coverage under the health FSA for the coverage period. Similarly, the payment schedule for the required premiums for coverage under a health FSA may not be based on the rate or amount of covered claims incurred during the coverage period. Reimbursement will be deemed to be available at all times if it is paid at least monthly or when the total amount of the claims to be submitted is at least a specified, reasonable minimum amount (e.g., $50). If the employee revokes existing elections, the employer must reimburse the employee for any amount previously paid for coverage or benefits relating to the period after the date of the employee's separation from service regardless of the employee's claims or reimbursements as of such date. The following examples illustrate the rules of this paragraph (b)(2):

Example 1. Assume that an employee elects coverage under a health FSA providing coverage of up to $300 in medical expenses and the annual premium for a calendar year of coverage is $300. Assume also that the employee is permitted to pay the $300 premium through salary reduction of $25 per month throughout the coverage period. The employee must be eligible to receive the maximum amount of reimbursement of $300 at all times throughout the coverage period (reduced by prior reimbursements). Thus, if the employee incurs $250 of medical expenses in January, the full $250 must be available for reimbursement even though the employee has made only one premium payment. If the employee incurs another $50 in health expenses in February, the remaining $50 of the $300 maximum must be available for reimbursement. The employer or plan may not provide for an acceleration of the required premium payments based on the employee's incurred claims and reimbursements.

Example 2. Assume that an employee elects coverage under a health FSA with a maximum reimbursement limit of $500 for a calendar year of coverage and is required to pay the $450 premium for such coverage in two equal $225 installments, one at the beginning of the period of coverage and the second installment by the beginning of the sixth month of coverage. Assume further that the employee incurs a $400 medical expense in February and the FSA makes a $400 reimbursement to the employee in March. The employee does not incur any additional medical expenses before the end of June, at which time the employee separates from service. If the employee fails to make the second premium installment, the employee's coverage under the FSA may be terminated as of the end of June so that medical expenses incurred after June are not covered. If the employee pays the second premium installment, the employee's coverage under the FSA must continue, so that additional medical expenses (up to the remaining $100) incurred before the end of December are covered.

(3) *Twelve-month period of coverage.* The period of coverage under a health FSA must be 12 months or, in the case of a short first plan year or a short plan year of a cafeteria plan where the plan year is being changed, the entire short plan year. Election changes to increase or decrease the level of coverage under a health FSA during the 12-month period of coverage are not permitted with respect to health FSAs. However, a cafeteria plan may permit participants to make health FSA election changes for the remaining portion of the 12-month period of coverage on account of and consistent with certain family status changes. See Q&A-6 of this section. In addition, a cafeteria plan may provide that the period of coverage under a health FSA terminates if the employee ceases to make required premium payments; however, such employee may not be permitted to make a new health FSA benefit election for the remaining portion of the original coverage period. Also, a cafeteria plan may permit an employee who separates from the service of the employer during a period of coverage to revoke existing benefit elections and terminate receipt of benefits, including coverage under the health FSA. For the application of the health care continuation rules of section 4980B of the Code to health FSAs, see the regulations under section 4980B or its predecessor section 162(k) of the Code. The requirements of this paragraph (b)(3) are illustrated by the following example:

Example. Assume that an employee has elected a $300 calendar year health FSA, with monthly premium payments of $25 during the 12-month period of coverage. Such employee separates from service for the employer at the end of June and ceases to make additional premium payments. The cafeteria plan may provide that the FSA's period of coverage does not extend beyond June if the employee does not continue to make the required premium payments. However, if the employee makes the total premium payment for the 12-month period of coverage, the cafeteria plan may not terminate the FSA's period of coverage merely because the employee separated from service before the end of the coverage period.

(4) *Prohibited reimbursement.* A health FSA can only reimburse medical expenses as defined in section 213. Thus, for example, a health FSA cannot reimburse dependent care expenses. In addition, a health FSA may not treat participants' premium payments for other health coverage as reimbursable expenses. Thus, for example, a health FSA may not reimburse participants for premiums paid for other health plan coverage, including premiums paid for health coverage under a plan maintained by the employer of the employee's spouse or dependent. (See also Q&A-5 of this section with respect to whether the reimbursement of other premiums constitutes impermissible deferred compensation.) This paragraph (b)(4) does not prevent premiums for current health plan coverage (including coverage under a health FSA) from being paid on a salary reduction basis through the ordinary operation of the cafeteria plan.

(5) *Claims substantiation.* A health FSA may reimburse a medical expense only if the participant provides a written statement from an independent third party stating that the medical expense has been incurred and the amount of such expense and the participant provides a written statement that the medical expense has not been reimbursed or is not reimbursable under, any other health plan coverage. Thus, for example, as with any other flexible spending arrangement, a health FSA cannot make advance reimbursements of future or projected expenses. In determining whether, under all the facts and circumstances, employees are being reimbursed for inadequately substantiated claims, special scrutiny will be given to other arrangements such as employer-to-employee loans that are related to the employee premium payments or actual or projected employee claims.

(6) *Claims incurred.* Medical expenses reimbursed under a health FSA must be incurred during the participant's period of coverage under the FSA. Expenses are treated as having been incurred when the participant is provided with the medical care that gives rise to the medical expenses, and not when the participant is formally billed or charged for, or pays for the medical care. Also, expenses are not treated as incurred during a period of FSA coverage if such expenses are incurred before the later of the date the health FSA is first in existence or the participant first becomes enrolled under the health FSA.

(7) *FSA experience gains.* If a health FSA has an experience gain with respect to a year of coverage, the excess of the premiums paid (e.g., employer contributions, including salary reduction contributions and after-tax employee contributions) and income (if any) of the FSA over the FSA's total claims reimbursements and reasonable administrative costs for the year may be used to reduce required premiums for the following year or may be returned to the premium payers (the participants for premiums paid by salary reduction or employee contributions) as dividends or premium refunds. Such experience gains must be allocated among premium payers on a reasonable and uniform basis. It is permissible to allocate such amounts based on the different coverage levels under the FSA received by the premium payers. However, in no case may the experience gains be allocated among premium payers based (directly or indirectly) on their individual claims experience. The requirements of this paragraph (b)(7) are illustrated in the following example:

Example. Assume that an employer maintains a cafeteria plan under which its 1,200 employees may elect one of several different annual coverage levels under a health FSA in $100 increments from $500 to $2,000. For a plan year, 1,000 employees elect levels of coverage under the health FSA. For such year, the FSA has an experience gain of $5,000 (i.e., premium payments for the year exceed reimbursed claims plus administrative costs by $5,000). The $5,000 may be allocated to all premium payers for the year, as a premium refund, on a per capita basis weighted to reflect the participants' elected levels of coverage. Alternatively, the $5,000 may be used to reduce the required premiums under the health FSA for all eligible employees for the next plan year (e.g., a $500 health FSA for the next year might be priced at $480) or to reimburse claims incurred above the elective limit in such year as long as such reimbursements are made in a nondiscriminatory manner.

(8) *Dependent care assistance.* Analogous rules to this paragraph (b), with the exception of paragraph (b)(2) relating to uniform coverage throughout the coverage period, are applicable to dependent care assistance provided under section 129. See Q&A-18 of §1.125-1.

(c) *Definition of flexible spending arrangement.* A flexible spending arrangement (FSA) generally is a benefit program that provides employees with coverage under which specified, incurred expenses may be reimbursed (subject to reimbursement maximums and any other reasonable conditions) and under which the maximum amount of reimbursement that is reasonably available to a participant for a period of coverage is not substantially in excess of the total premium (including both employee-paid and employer-paid portions of the premium) for such participant's coverage. A maximum amount of reimbursement is not substantially in excess of the total premium if such maximum amount is less than 500 percent of the premium. A single FSA may provide participants with different levels of coverage and maximum amounts of reimbursement. However, for purposes of section 89, each different level of coverage under a FSA is a separate plan.

(d) *Effective date.* This Q&A-7 is effective for plan years beginning after December 31, 1989.

(e) *Authority to issue additional requirements.* The Commissioner, in revenue rulings, notices and other publications of general applicability, may make any modification to, or issue such additional requirements for the application of, the rules contained in this Q&A-7 as may be necessary to insure proper compliance with the intent of such rules.

(f) *Example.* The provisions of paragraph (c) of this Q&A-7 are illustrated by the following example:

Example 1. Assume that an employer with 1,000 employees maintains a cafeteria plan under which the employees may elect among several benefit options, including insured health plans and HMOs. The plan provides that the required premiums or contributions for the benefits are to be made by salary reduction. Even though the plan may characterize employees' premium payments and other contributions as flexible spending contributions or credits, the operation of a cafeteria plan to permit employees' contributions to be made on a salary reduction basis does not, standing alone, cause the plan (or any benefit thereunder) to be treated as a flexible spending arrangement.

Example 2. Assume that an employer with 1,000 employees maintains a cafeteria plan under which the employees may elect, among other benefits, a level of coverage under an arrangement that will reimburse medical expenses incurred during a year up to the specified amount elected by the employee. The maximum amount of reimbursement that can be deducted for a year is $5,000. Each employee's premium for such coverage is equal to the maximum reimbursement amount selected by the employee. Such an arrangement is a health FSA. [Reg. §1.125-2 .]

TEMP-REG, 2002FED ¶7323, §1.125-2T, **Question and answer relating to the benefits that may be offered under a cafeteria plan (Temporary).**

§1.125-2T Question and answer relating to the benefits that may be offered under a cafeteria plan (Temporary).

Q-1: What benefits may be offered to participants under a cafeteria plan?

A-1: (a) Generally, for cafeteria plan years beginning on or after January 1, 1985, a cafeteria plan is a written plan under which participants may choose among two or more benefits consisting of cash and certain other permissible benefits. In general, benefits that are excludable from the gross income of an employee under a specific section of the Internal Revenue Code may be offered under a cafeteria plan. However, scholarships and fellowships under section 117, vanpooling under section 124, educational assistance under section 127 and certain fringe benefits under section 132 may not be offered under a cafeteria plan. In addition, meals and lodging under section 119, because they are furnished for the convenience of the employer and thus are not elective in lieu

of other benefits or compensation provided by the employer, may not be offered under a cafeteria plan. Thus, a cafeteria plan may offer coverage under a group-term life insurance plan of up to $50,000 (section 79), coverage under an accident or health plan (sections 105 and 106), coverage under a qualified group legal services plan (section 120), coverage under a dependent care assistance program (section 129), and participation in a qualified cash or deferred arrangement that is part of a profit-sharing or stock bonus plan (section 401(k)). In addition, a cafeteria plan may offer group-term life insurance coverage which is includible in gross income only because it is in excess of $50,000 or is on the lives of the participant's spouse and/or children. In addition, a cafeteria plan may offer participants the opportunity to purchase, with after-tax employee contributions, coverage under a group-term life insurance plan (section 79), coverage under an accident or health plan (section 105(e)), coverage under a qualified group legal services plan (section 120), or coverage under a dependent care assistance program (section 129). Finally, a cafeteria plan may offer paid vacation days if the plan precludes any participant from using, or receiving cash for, in a subsequent plan year, any of such paid vacation days remaining unused as of the end of the plan year. For purposes of the preceding sentence, elective vacation days provided under a cafeteria plan are not considered to be used until all nonelective paid vacation days have been used.

(b) Note that benefits that may be offered under a cafeteria plan may or may not be taxable depending upon whether such benefits qualify for an exclusion from gross income. However, a cafeteria plan may not offer a benefit that is taxable because such benefit fails to satisfy any applicable eligibility, coverage, or nondiscrimination requirement. Similarly, a plan may not offer a benefit for purchase with after-tax employee contributions if such benefit would fail to satisfy any eligibility, coverage, or nondiscrimination requirement that would apply if such benefit were designed to be provided on a nontaxable basis with employer contributions. Also, note that section 125(d)(2) provides that a cafeteria plan may not offer a benefit that defers the receipt of compensation (other than the opportunity to make elective contributions under a qualified cash or deferred arrangement) and may not operate in a manner that enables participants to defer the receipt of compensation. [Temporary Reg. §1.125-2T .]

.10 Historical Comment: Adopted 1/29/86 by T.D. 8073 . [Reg. §1.125-2T does not reflect P.L. 99-514 (1986), P.L. 100-647 (1988), P.L. 101-508 (1990) or P.L. 104-191 (1996). See ¶7320.0129 et seq., ¶7324.01 and ¶7324.021 .]

FINAL-REG, 2002FED ¶7323B, §1.125-3, **Effect of the Family and Medical Leave Act (FMLA) on the operation of cafeteria plans.—**