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Cash or Benefits — Take Your Choice — §125 Is Not The "Exclusive" Means for Avoiding Tax

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INTRODUCTION

The English language, despite all of its power and richness, is rarely written in a manner that conveys perfect clarity. For that reason, it comes as no surprise that legislative bodies, such as Congress, often fail in their attempt to draft legislation that means the same thing to everyone. Nevertheless, statutory mandates must be enforced, however ambiguous their strictures might be. To this end, the executive branch has rightly assumed the responsibility to "fill in the gaps." And, over the years, courts, with increasing frequency, have accepted the "gap filler" role played by the executive agencies and have generally deferred to their interpretations of legislative intent.

This article deals with a significant provision — known as the "exclusivity rule" — in Treasury's proposed 2007 cafeteria plan regulations and concludes that Treasury overstepped its "gap filler" role when it

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determined that individuals should bear an immediate tax when offered certain benefit choices.[1] Given that the exclusivity rule has been part of Treasury's proposed regulations on cafeteria plans for 30 years (the agency's initial proposal coming in 1984), it is highly likely that the rule will be part of the agency's soon-to-be-issued final regulations.[2] If this were to occur, the rule would pack a far greater wallop. Thus, there is a need for serious consideration of the rule now.

The ''exclusivity rule'' is found in Treasury's affirmative response to the following question: should providing an employee with a choice between a taxable and a nontaxable benefit outside the bounds of a cafeteria plan, in all cases, cause the employee who chooses the nontaxable benefit to recognize gross income in the amount of the taxable benefit? In simple terms, Treasury has proposed that if a taxable/nontaxable choice is offered to an employee, in any context whatsoever that is not a cafeteria plan, the choice creates an immediate taxable event for an employee choosing the nontaxable benefit. The proposed rule is absolute, admitting no exceptions or allowances for mitigating circumstances. Consequently, this all-encompassing rule could have applicability to taxable and nontaxable benefit choices that are offered to employees in a host of non-cafeteria plan situations, e.g., in the course of pre- and post-employment negotiations.

The authors believe the exclusivity rule to be in conflict with the wording of §125 and with Congress's clearly expressed intent, as recorded in the legislative history. Furthermore, although Treasury has indicated its belief that the exclusivity rule is consistent with long-standing constructive receipt principles, in fact, the opposite is true. The relevant constructive receipt rules, reflected in Treasury's own regulations and other guidance, contradict Treasury's position.[3] Consequently, the authors recommend that the exclusivity rule not be included in the final regulations and predict that if Treasury decides to include the rule, it will likely not survive judicial review.

THE EXCLUSIVITY RULE

Origins of the Rule

Prop. Reg. §1.125-1(b) provides that ''Section 125 is the *exclusive* means by which an employer can offer employees an election between taxable and nontaxable benefits without the election itself resulting in inclusion in gross income by the employees.''[4] This simple but exceedingly far-reaching statement means that any non-cafeteria plan choice made by an employee between a taxable and a nontaxable benefit results in the employee recognizing gross income upon choosing the nontaxable benefit.[5] As background, the preamble to the 2007 proposed regulations states that these ''new proposed regulations clarify and amplify the general rule in the prior proposed regulations that §125 is the exclusive means by which an employer can offer employees a choice between taxable and nontaxable benefits without the choice itself resulting in inclusion in gross income by the employees.'' The preamble does not provide Treasury's rationale for this rule. For that, one needs to review the prior proposed regulations.[6]

Treasury's first attempt at providing regulations under §125 came six years after the Revenue Act of 1978 added §125.[7] The 1984 proposed regulations — written in Q&A form — included the first version of the ''exclusivity rule.'' Q&A-9 states that ''Section 125 . . . provides an exception to the constructive receipt rules that apply with respect to employee elections among nontaxable and taxable benefits (including cash).'' This statement then provides Treasury's view of the relevant constructive receipt rules applicable to employee choices:

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[1] Although §125(l) authorizes Treasury to prescribe such regulations as may be necessary to carry out the provisions of the section, that authorization does not extend to writing a tax rule applicable to plans, programs and other arrangements offering benefit choices outside of the section. All section ''§'' references herein are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise stated.

[2] The Priority Guidance Plan, periodically published by the Treasury Department to identify and prioritize issues that it plans to address, has included final regulations under §125 as a priority every year since the proposed regulations were issued, reflecting its intent to finalize these proposed regulations, which would likely include the exclusivity rule. *See, e.g.,* Dep't of the Treasury, *2014-2015 Priority Guidance Plan* (Aug. 26, 2014).

[3] These views are not novel. They were advanced forcefully by other critics in response to Treasury's first proposal of the exclusivity rule in 1984. *E.g.,* Rosina B. Barker & Kevin P. O'Brien, *Nontaxable Benefit Elections: Do They Trigger Taxable Income? More Confusion After Express Oil Change*, 12 Benefits L. J. 1 (1999); Leon E. Irish, *Cafeteria Plans in Transition*, William & Mary Annual Tax Conference 23 (1984); *see also* Charles K. Kerby III, *Employee Choice of Compensation and Benefits*, 10 Benefits L. J. 7, 17 (1997) (detailing opposition to the exclusivity rule).

[4] Prop. Reg. §1.125-1(b), 72 Fed. Reg. 43,938, 43,946 (Aug. 6, 2007) (emphasis added).

[5] Section 125 applies only to employees, rendering unclear the tax rules governing choices between taxable and nontaxable benefits offered outside of a cafeteria plan to non-employees, such as independent contractors. Presumably, agreements offering independent contractors a choice between a taxable and nontaxable benefit remain subject to common law notions of constructive receipt. Although taxation of choice offerings made to non-employees is beyond the scope of this article, the potential for disparate treatment of the same choice, when offered to employees and non-employees, caused by the exclusivity rule reveals an additional weakness within Treasury's position. Although Section 133 of the 1978 Revenue Act addressed deferred compensation paid to independent contractors, it merely clarified the timing of the employer's deduction. The tax treatment of deferred compensation at the independent contractor level is not addressed. Revenue Act of 1978, Pub. L. No. 95-600, §133, 92 Stat. 2763, 2783 (1978).

[6] Prop. Reg. §1.125-1, 49 Fed. Reg. 19,321 (May 7, 1984).

[7] Revenue Act of 1978, Pub. L. No. 95-600, §134, 92 Stat. 2763, 2783 (1978).

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> . . . These constructive receipt rules generally provide that an individual will be required to include in gross income the taxable benefits that he could have elected to receive if the individual had the opportunity to elect to receive or not receive the benefits event (sic) though both the opportunity to make this election occurs and the actual election is made before the benefits become currently available to the individual.

Constructive Receipt Doctrine

Treasury's description of the constructive receipt rules applicable to employee choices was at the time, and is currently, at odds with the state of the law.[8] Indeed, Treasury's view ignores the fundamental precepts of constructive receipt as laid down in its own regulations, issued many years before it proposed the exclusivity rule in 1984. Reg. §1.451-1 requires that a cash-basis taxpayer include compensation in gross income in the taxable year in which it is actually or constructively received. Reg. §1.451-2 provides that compensation is constructively received by a taxpayer in the taxable year in which it is ''credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.''[9]

If this were the extent of the constructive receipt rules, Treasury's position might be sound inasmuch as an employee's choice of a nontaxable benefit (e.g., medical coverage) over cash could be viewed as the employee's having turned his back on cash that was ''made available'' to him. But it is not, and never has been, axiomatic that an individual is in constructive receipt of income merely because of a taxable benefit (e.g., cash) being made available to him. And, moreover, at the time Treasury first proposed the exclusivity rule, it knew this to be true. Reg. §1.451-2 provided in 1984, and continues to provide today, that compensation ''is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.'' Consequently, where a choice offering requires an individual to forgo one benefit as a result of choosing another benefit, that offering is inherently fraught with ''limitations or restrictions.''[10]

For example, where an employee is offered the choice between cash and medical coverage, the choice poses the dilemma of having to elect between two fundamentally different benefits, each offering uncertain levels of potential value to the employee depending on the employee's particular circumstances. An employee with a healthy family may elect medical coverage even though he may have a dire and immediate need for the cash. Where the choice of one benefit automatically precludes the opportunity to take the other, it is clear that the availability of either benefit is subject to a restriction or limitation. The §1.451-2 regulations state that if the taxpayer can demonstrate that the restriction or limitation burdening the choice is ''substantial,'' the doctrine of constructive receipt does not apply.

Section 125 as a Safe Harbor

Treasury's exclusivity rule gives no credence to the constructive receipt principles set forth in its own regulations. Furthermore, as stated above, the authors believe that the exclusivity rule is in conflict with the clear wording of the statute and congressional intent. These factors, when considered in the context of the historical events that led to the passage of §125, point more logically to the conclusion that §125 provides nothing more than a safe harbor: choices may be offered under a compliant, nondiscriminatory cafeteria plan with no fear of tax challenge, whereas the taxation of choices made outside of the safe harbor remain dependent upon how their particular facts and circumstances align with the well-established rules of constructive receipt.

Congress's safe harbor intent is readily gleaned from the words of the statute. Section 125(a) provides that ''no amount shall be included in the gross income of a participant in a cafeteria plan *solely because . . . the participant may choose among the benefits of the plan*.''[11] This provision may not reasonably be read as stating or implying that a similar choice made outside of a cafeteria plan is, in all cases, taxable, irrespective of the different benefit choices involved, the timing of the taxpayer's election to accept one of the choices and other facts and circumstances traditionally relevant to a constructive receipt analysis. The only circumstance in which the explicit wording of §125 mandates an addition to an employee's gross income is where a cafeteria plan either discriminates in favor of highly compensated employees or provides exces-

[8] Courts generally view the constructive receipt doctrine as an artificial concept at odds with the cash receipts and disbursements method of accounting. Accordingly, courts have cautioned that the constructive receipt doctrine should be applied sparingly. *See, e.g., Gullett v. Commissioner*, 31 B.T.A. 1067, 1069 (1935). Consequently, the IRS has had a poor record of success when asserting a constructive receipt position against a taxpayer in the courts. *See, e.g., Childs v. Commissioner*, 103 T.C. 36 (1994); *Martin v. Commissioner*, 96 T.C. 814 (1991). *But see Sainte Claire Corp. v. Commissioner*, T.C. Memo 1997-171.

[9] Reg. §1.451-2(a).

[10] The IRS has recognized that the existence of a substantial limitation or restriction is controlled by the facts and circumstances of each case. GCM 36456 (Oct. 8, 1995). Moreover, it has acknowledged the idea that surrendering one right in order to select another constitutes a substantial limitation or restriction. *See* Rev. Rul. 80-300, 1982-2 C.B. 165 (citing *Estate of Hales v. Commissioner*, 40 B.T.A. 1245 (1939)); Rev. Rul. 58-230, 1958-1 C.B. 204; *see also Cohen v. Commissioner*, 39 T.C. 1055 (1963).

[11] §125(a) (emphasis added).

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sive non-taxable benefits to key employees.[12] Section 125 is silent as to the tax consequences of offering employees a choice between taxable and nontaxable benefits outside of its stated requirements, and, as noted above, Treasury's authority under §125(l) to write regulations as may be necessary to carry out the provisions of the section does not extend to choice offerings made outside of those provisions.[13]

Based on the discussion below, we believe that Congress intended that the ''solely because'' language be read as a safe harbor and that the legislative history of the provision fully supports this view.

LEGISLATIVE HISTORY

Section 125 was added to the I.R.C. by the Revenue Act of 1978 (1978 Act),[14] which also added §401(k) and §457. All of these provisions deal with the taxation of salary reduction choices made by employees with respect to employer-provided compensation and benefits. It is no coincidence that these employee choice-oriented provisions found their way into the I.R.C. at the same time. These provisions were, in fact, Congress's direct response to Treasury's earlier attempts to alter the well-established tax-timing rules established in case law and revenue rulings.[15]

Section 125 — Reasons for Enactment

In order to better understand what §125 was intended to do, it is necessary to consider the motivating forces that led to its enactment. Prior to 1972, there was established guidance permitting employees to choose between receiving compensation currently and deferring it into a tax-qualified benefit plan. This guidance declared that, in appropriate circumstances, such salary reduction arrangements did not result in an employee's being currently taxable on the compensation he elected to defer. Rather, the employee would be taxable only when the compensation was paid or made available to him under the plan.[16]

In 1972, Treasury signaled its intention to break with the established guidance when it issued Prop. Reg. §1.402(a)-1(a). Under that provision —

> [a]n amount contributed to an exempt trust will . . . be considered to be contributed by an employee if at his individual option such amount was so contributed in return for a reduction in his basic regular compensation or in lieu of an increase in such compensation.[17]

This proposed regulation drew heavy criticism from practitioners, so much so that Congress, two years later in ERISA, addressed Treasury's effort to change the pre-existing tax treatment of salary reduction arrangements.

In ERISA §2006, Congress imposed a temporary moratorium on the tax rules relating to salary reduction pension and welfare benefit arrangements in existence on June 27, 1974. These ''grandfathered'' arrangements were to remain protected for a limited period to allow time for Congress to determine the proper tax treatment.[18] New arrangements, however, were to be subject to the proposed Treasury regulations until such time as Congress reached a decision as to their proper treatment. Congress's expressed rationale for subjecting new arrangements to Treasury's proposed regulations was that it did not want to encourage more employers to develop new arrangements in reliance on pre-1972 law until it had completed its study of the matter.[19]

Following ERISA, Treasury withdrew the controversial proposed §402(a) regulations, but did not back away from its desire to subject employee salary reduction choices to early taxation, in spite of prior case law and guidance. In February 1978, Treasury issued proposed regulations that purported to tax compensa-

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[12] Although the provision addressing key employees, §125(b)(2), was added several years after Congress first passed §125, it was included for the same underlying reason as the provision addressing highly compensated employees: an employer may not take advantage of the cafeteria plan safe harbor unless the cafeteria plan is nondiscriminatory. *See* Tax Reform Act of 1984, Pub. L. No. 98-369, §531(b)(3), 98 Stat. 881, 882 (1984) (adding §125(b)(2)).

[13] The types of arrangements that exist beyond the bounds of §125 include any that do not involve a formal written document that offers employees an explicit choice between a taxable and nontaxable benefit. These could include written plans that, in combination, provide employees a choice between a taxable and a nontaxable benefit by discretion and not design, e.g., where terminating employees become potentially eligible for benefits under two different plans and the employer, wishing to avoid a doubling-up of benefits, offers them a choice of one or the other. Other arrangements include choices offered in the course of negotiating an employee's benefits package, wherein the employee is offered, either orally or in a written term sheet, a choice between certain taxable and nontaxable benefits.

[14] Revenue Act of 1978, Pub. L. No. 95-600, §134, 92 Stat. 2763, 2783 (1978).

[15] *See* Leon E. Irish, *Cafeteria Plans in Transition*, William & Mary Annual Tax Conference 23, at 36 (1984).

[16] *See* Rev. Rul. 56-497, 1956-2 C.B. 284. One case decided before 1972, *Hicks v. United States*, required an employee to include in gross income amounts deferred under a profit-sharing plan, even if the employee elected to have the employer place the amount in a trust before the amounts became payable. 314 F.2d 180 (4th Cir. 1963). However, the IRS distinguished *Hicks* on the grounds that the plan document specifically deemed the deferral contributions made the by employee to be employee contributions. Rev. Rul. 63-180, 1963-2 C.B. 189. The IRS reaffirmed this ruling several years later. Rev Rul. 68-69, 168-1 C.B. 402.

[17] Prop. Reg. §1.402(a)-1(a), 37 Fed. Reg. 25,938 (Dec. 6, 1972).

[18] H.R. Rep. No. 93-1280, at 355 (1974) (Conf. Rep.). The moratorium was initially scheduled to last until December 31, 1976. This ''temporary freeze of the status quo'' was extended in later amendments to January 1, 1980. Pub. L. No. 95-615, §5, 92 Stat. 3097, 3097 (1978); Pub. L. No. 94-455, §1506, 90 Stat. 1520, 1739 (1976).

[19] H.R. Rep. No. 93-1280, at 355 (1974) (Conf. Rep.).

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tion in the year in which it could have been readily received by an employee, but for the employee's "option" to defer its receipt until a later year. These proposed regulations — referred to in practitioner circles as the infamous §1.61-16 regulations — provoked more howls of protest than the earlier-issued §402(a) regulations. This is because the §1.61-16 regulations, if finalized, would have taken away the principal tax advantage underling virtually all forms of salary reduction arrangements, thereby eliminating such techniques as viable tax planning strategies.

Revenue Act of 1978

Some months later, Congress responded to Treasury's efforts to change the existing constructive receipt law by adding the "deferred compensation provisions" to the 1978 Act.[20] In addition to adding §125, §401(k) and §457 to the I.R.C., the 1978 Act included a provision aimed directly at halting further efforts by the Treasury to change the tax-timing rules for deferred compensation arrangements. Section 132 of the 1978 Act (which was not made part of the I.R.C.) provided that amounts deferred under "private" deferred compensation plans were to be included in gross income in accordance with principles established in regulations, rulings, and judicial decisions that were in effect on February 1, 1978. The purpose of this provision was to place private deferred compensation plans completely outside the ambit of Treasury's Prop. Reg. §1.61-16, issued February 3, 1978. Important for these purposes is the fact that the moratorium imposed by Section 132 of the 1978 Act applies to virtually any type of salary reduction arrangement sponsored by a private employer that defers the receipt of compensation, including a cafeteria plan. The statute explicitly defines a "private employer deferred compensation plan" as any "plan, agreement, or arrangement [sponsored by a taxable employer] under which the payment or other way of making compensation available, is deferred."[21]

It is against this background that §125 (and §401(k), for that matter) must be considered.[22] Section 132 of the 1978 Act was Congress's way of stat-

[20] The Act's table of contents refers to Sections 131-135 as the "deferred compensation provisions." Section 131 added §457 to deal with deferred compensation plans sponsored by state and local governments. Section 132 imposed a permanent moratorium on Treasury's tinkering with the taxation of "private" deferred compensation plans. Section 133 dealt with the taxation of deferred compensation of independent contractors. Section 134 added §125 dealing with cafeteria plans. And, finally, Section 135 added §401(k), which dealt with cash or deferred arrangements.

[21] One could argue that Section 132 of the 1978 Act does not apply to a choice between a taxable and a nontaxable benefit because in choosing the nontaxable benefit there is no deferral of taxable compensation. Instead, where an individual opts for the nontaxable benefit, he permanently avoids (rather than postpones) paying tax on the compensation he could have received. But this is a narrow and, in the authors' opinion, unreasonable interpretation of the provision. Section 132 was intended to bar Treasury from modifying the constructive receipt rules established in regulations, rulings and case law in effect on February 1, 1978. Since it is clear that Treasury's exclusivity rule is based on a version of the constructive receipt principles that is in conflict with the preexisting guidance, it follows that Treasury's rule is barred by the Section 132 moratorium, which has never been repealed.

[22] The §401(k) regulations issued in 1988 include their own version of the exclusivity rule, which, while similarly questionable, is not within the scope of this article. However, it is worthwhile to point out the following: in response to commentators who suggested that §401(k) should not be considered the exclusive means for electively deferring compensation under qualified plans on a pre-tax basis, Treasury, in the preamble to the final §401(k) regulations, stated in conclusory fashion that its position was supported by the Revenue Act of 1978, its legislative history and subsequent legislation. It went on to say that, but for specific provisions in the Revenue Act of 1978, elective deferrals to qualified plans, cafeteria plans and other arrangements "are includible in the employee's gross income for the taxable year in which such amounts would have been received by the employee (but for the employee's election)." Treasury's response concludes with a rather illusory statement to the effect that the exclusion from gross income afforded by §402(a)(8) (now §402(e)(3)) "applies with respect to compensation that has not yet become currently available [and that the] 'currently available' concept is not related to the question of whether amounts are treated as having been made available under section 451." In the authors' view, this statement represents an ill-disguised and failed effort by Treasury to explain why the exclusivity rules for cafeteria and §401(k) plans were not attempts to circumvent the moratorium on imposing new constructive receipt rules imposed by Section 132 of the Revenue Act of 1978.

In marked contrast to §125 and §401(k), which are silent as to the taxation of benefit choices made outside the confines of those Sections, Congress, in adding §457 to the I.R.C., provided explicit tax timing rules for two types of government-sponsored deferred compensation plans: eligible and ineligible. In general, deferrals under eligible plans would be taxable when paid. However, deferrals under ineligible plans would be taxable upon the lapse of a substantial risk of forfeiture, i.e., when vested. This was a clear departure from the traditional rule which would have taxed such deferrals when paid or made available. In the governmental plan area (and later the tax-exempt organization plan area), Congress saw the need for a stricter tax timing rule because of the lack of "tax tension," i.e., such employers were indifferent to the tax trade-offs confronted by employers in the private sector. Indeed, governmental and tax exempt employers were perhaps more inclined to accept deferral elections from their employees because the result was that they did not have to pay the compensation currently and, unlike private employers, did not give up a tax benefit, i.e., a current deduction, to enjoy the benefits of the use of the money during the deferral period. For purposes of this article, however, the real importance of §457 is that Congress knew how to write explicit tax-timing rules for compliant and noncompliant governmental deferred compensation plans. That Congress did not, in the same revenue act, provide similar rules for plans and arrangements operating outside of §125 and §401(k) must be viewed as intentional. The most plausible explanation for this omission is that Congress intended that the taxation of benefit choices made under these plans and arrangements be determined under existing law. And to secure this result, Congress, in enacting Section 132 of the 1978 Act, expressly barred Treasury from making up its own rules with respect to such plans and arrangements.

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ing its affirmance of the established order created by the pre-existing regulations, rulings and case law that governed the tax recognition of employee choices relating to compensation and benefits. In Section 132 of the 1978 Act, Congress was declaring that the pre-existing rules underlying the constructive receipt doctrine were not to be overturned by executive fiat.

Legislative History Supports Safe Harbor Interpretation

The following section explains Congress's use of the ''solely because'' language in writing the cafeteria plan requirements of §125.[23] The doctrine of constructive receipt has always required the application of a subjective and fact-based analysis that has never been easy for taxpayers to apply with confidence or for the IRS to enforce with success. The ''solely because'' language was intended by Congress to provide a ''safe harbor'' for employers seeking to offer their employees a choice between a taxable benefit and a nontaxable benefit. The words ''solely because'' told employers that if they established a nondiscriminatory written plan and followed the other requirements of §125, their employees would not recognize gross income by opting for a nontaxable benefit instead of a taxable benefit. And, more importantly, those words meant that this result was obtainable by employers without the need to validate the tax consequences of their choice offering by relying on a fact-based position that could be challenged by the IRS.

Treasury's proposed ''exclusivity rule'' either ignores the ''solely because'' language or, worse yet, distorts its meaning. In the preamble to the 2007 proposed regulations, the most recent iteration of the exclusivity rule, Treasury asserts that the rule is supported by the legislative history. However, Treasury's summary of the history provides little if any support to its conclusion.[24] The best argument that one can make from this summary is that ERISA §2006 recognized two groups of cafeteria plans arrangements: one group existing before June 27, 1974 and the other established after that date. Since participants making choices in plans covered in the latter group were subject to an immediate tax regardless of which choice they made — taxable benefit or nontaxable benefit — Treasury seems to infer that when Congress incorporated §125 into the I.R.C., it was *allowing* this latter group of plans to offer choices without the immediate tax impact that would have applied under the proposed regulations. Based on this inference, Treasury posits the notion that §125 provides the exclusive means of offering taxable and nontaxable choices to employees without the choice itself resulting in an immediate tax. This conclusion seems to rest on the assumption that, but for the passage of §125, this group of cafeteria plan arrangements would have remained subject to the negative tax treatment implied by Prop. Reg. §1.402(a)-1(a), relating to salary reduction deferrals made to tax-qualified plans.

We believe that this is not what Congress intended. The better reading of the legislative history, in our view, is that Congress intended to create a safe harbor for both groups of cafeteria plan arrangements, namely, the pre-ERISA group that was exempt from the negative tax treatment of the proposed regulations and the post-ERISA group that was subject to that treatment. The legislative history surrounding the 1978 Act's passage of §125 indicates clearly that §125 was intended to apply only to benefit choices explicitly offered to employees under formal written plans and that the tax consequences of all other plans and arrangements were to continue to be determined under existing law.

The Conference Report noted that the Senate bill was the same as the House bill except for the Senate amendment that added certain clarifying language and ''[made] it clear that a plan must be in writing to be subject to the cafeteria plan rules.'' More importantly for these purposes, the conferees added the following statement to their report: ''Thus, this provision will apply only when there is a written plan which provides employees a choice between taxable and nontaxable benefits. The taxation of benefits provided under other types of arrangements will be determined under existing law.''[25]

In its General Explanation of the Revenue Act of 1978, the Joint Committee on Taxation put a finer point on the ambit of §125 when it included the following example of the Section's limited reach: ''While it could be argued that a shareholder who controls a corporation always has the right to elect either taxable or nontaxable fringe benefits for himself by reason of controlling the corporation, it is not intended that the cafeteria plan rules apply in such a situation unless the election between taxable and nontaxable benefits is provided under the terms of a written arrangement.''[26]

These statements clearly support the position that plans and arrangements operating outside the bounds

[23] It also explains the ''merely because'' language used by Congress in §402(a)(8) (now §402(e)(3)).

[24] The preamble starts by quoting the Senate Report, which first explains that the choice itself between a taxable and nontaxable benefit triggers includible income for cafeteria plans not in existence in 1974, but that the new rule does not apply to plans that predated 1974. S. Rep. No. 95-1263, at 74 (1978). The preamble then references the Senate Report again for the assertion that a choice offered pursuant to a *written* cafeteria plan does not automatically result in inclusion of the taxable benefit. S. Rep. No. 95-1263, at 75. Finally, it excerpts from the legislative history of the 1984 amendments to §125, stating that a participant in a nondiscriminatory cafeteria plan will not automatically be treated as receiving a taxable benefit under the plan ''solely because'' the participant, before the benefit becomes available, has the opportunity to choose between taxable and nontaxable benefits. H.R. Rep. No. 98-861, at 1173 (1984) (Conf. Rep.). Treasury's summary of the legislative history excerpts portions that merely explain the operation of §125 and provides no specific evidence to support its views. Additionally, Treasury selectively quotes the legislative history, omitting sources that do *not* support its views, namely the Conference Report and the Blue Book.

[25] H.R. Rep. No. 95-1800, at 206 (1978) (Conf. Rep.).

[26] Joint Comm. on Tax'n, General Explanation of the Revenue

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of §125 were to be governed by existing law and that the taxation of choices offered under those plans and arrangements was to be determined on the basis of their particular facts and circumstances. Oddly, Treasury's summary of the legislative history does not refer to either of these statements. One can only speculate that these statements were overlooked because they impeded Treasury's desire to administer the taxation of cafeteria plans (and similar salary reduction arrangements) in a simple ''black or white'' manner, without the messiness of constructive receipt and similar fact-based doctrines.

THE *EXPRESS OIL* CASE

The exclusivity position, staked out by Treasury in the 1984 proposed regulations, has been challenged successfully by at least one taxpayer. *Express Oil Change Inc. v. United States* currently stands as the sole case in which a court examined the limits of Treasury's position that an employee's choice of a nontaxable benefit in lieu of a taxable benefit, outside the confines of a cafeteria plan, results in a taxable event, i.e., taxable wages to the employee in the amount of the taxable benefit.[27]

In *Express Oil*, the company maintained a fully insured health plan for its employees under which the company was responsible for all premiums. Prospective employees were offered the following choice: enroll in the company's health plan or decline enrollment and receive a higher salary. This choice was offered informally (not pursuant to a written plan) in the context of pre-employment negotiations between the company and each prospective employee. Although the diminution in salary for an employee choosing to enroll was dependent upon whether he chose individual or family coverage, the amount of the diminution did not correlate dollar-for-dollar with the amount of premium that the company was required to pay for the coverage. The facts also revealed that once employed, an employee could change his mind regarding coverage under the health plan and, if he chose to do so, an upward or downward adjustment would be made to his salary depending upon whether he was declining or enrolling in coverage.

The company did not treat an employee's election to receive health coverage as a taxable event. On audit, the IRS disagreed. It viewed the employee as constructively receiving additional salary (i.e., the extra pay he would have received had he not elected medical coverage) and assigning that salary to the company as the employee's share of the premium payment. Based on this characterization, the IRS treated the additional salary as wages and issued a proposed assessment for the failure to withhold income and FICA taxes and failure to pay its share of FICA and applicable FUTA taxes. The company paid the proposed assessment and then sued for a refund.

The company's refund claim was based on two theories. First, the employee's election of medical coverage resulted in the company's paying a premium on his behalf, which was excludible from gross income under §106. Second, even if the election did result in income to the employee, the income was not wages for employment tax purposes. The district court sided with the company, and, on appeal, the Eleventh Circuit affirmed the lower court's decision *per curiam*.

The district court decided this case on the wages issue and therefore found it unnecessary to reach the reach the question of whether the employee's election of medical coverage resulted in gross income to the employee.[28] On the FICA tax question, the court concluded that §3121(a)(2) excluded the employer's premium payments from wages. In doing so, it rejected the government's argument that a distinction existed between a ''salary supplement plan'' and a ''salary reduction plan.''

The government asserted, based on Rev. Rul. 65-208, that a salary supplement did not result in wages because the employee did not control the amount of compensation expended by the employer to provide the benefit. In contrast, a salary reduction did result in wages because it offered the employee a choice between salary or some other benefit. The court refused to accept the government's distinction for the following reasons: first, it noted that Rev. Rul. 65-208 was inconsistent with the Supreme Court's decision in *Rowan Cos. v. United States*.[29] This was because the ruling concluded that the subject salary reduction arrangement (associated with a 403(b) plan) produced wages for FICA tax purposes, but not for income tax purposes. The *Rowan* Court held that when interpreting the meaning of ''wages,'' the meaning should be the same for both purposes.

The court also noted that while Congress, in enacting the Social Security amendments of 1983, changed the withholding rules for §403(b) plans[30] (making them consistent with the holding in Rev. Rul. 65-208)

Act of 1978, 79 (1979).

[27] 25 F. Supp. 2d 1313 (N.D. Ala. 1996), *aff'd per curiam*, 162 F.3d 1290 (11th Cir. 1998). Note that an earlier case, *American Family Mutual Insurance Co. v. United States*, dealt with §125 and the proposed regulations thereunder, but only tangentially. 815 F. Supp. 1206 (W.D. Wis. 1992). The court found that reimbursements were includible in employee gross income not because the plan failed to meet §125, but because the reimbursements failed to meet the exclusion requirements under §105(b) and §129. Treasury first took the position it espoused in *Express Oil* in a letter ruling with nearly identical facts. PLR 9406002.

[28] On the income question, the court threw a bone to the IRS when it said: ''Defendant argues persuasively that because plaintiff's employees had the choice of accepting a salary reduction in exchange for health insurance coverage . . ., they effectively assigned the amount of the salary reduction to the plaintiff, controlling that income.'' *Express Oil*, 25 F. Supp. 2d at 1319. However, the court stopped short of deciding that issue, stating that '' [t]he question in this case . . . is not whether the salary reduction amounts constitute gross income to the employees, but rather, whether they constitute 'wages' for purposes of income tax withholding.'' *Id.* at 1319–20.

[29] 452 U.S. 247, 263 (1981).

[30] *See* Social Security Amendments of 1983, Pub. L. No. 98-

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and "decoupled" FICA wages from income tax wages,[31] it did not expressly endorse the holding of the ruling with respect to medical plans. Consequently, the court decided to disregard the ruling and turn its attention directly to the place the authors believe should have been the focus of its inquiry from the inception — the wording of the statutory exclusion in §3121(a)(2). In doing so, it observed that the provision excludes from wages "any payment" made by an employer in connection with the provision of medical benefits under a plan established by the employer. Put another way, the statutory language made no express or implied distinction between payments characterized as a "salary supplement" and payments derived from a "salary reduction."

Furthermore, the court concluded that inferring such a distinction (as the IRS was pressing it to do based in Rev. Rul. 65-208) would be inconsistent with the legislative history underlying §3121(a)(2). The relevant House Report had this to say about the provision:

> These payments will be excluded even though the amount or possibility of such payments is taken into consideration in fixing the amount of remuneration and even though such payments are required, either expressly or impliedly, by the contract of employment.[32]

Based on the foregoing and the fact that, in enacting the 1983 Social Security Act amendments, Congress explicitly changed the rules for §403(b) plans (treating salary reduction contributions as wages for FICA purposes) but left intact the rules for medical plans, the court held that an employee's election of medical coverage did not result in wages for FICA purposes.

Next, the court considered whether the election resulted in wages for income tax purposes. Here, the court showed little respect for the government's argument that the additional salary amount — forgone as a result of the employee's election of medical coverage — should be considered as taxable gross income to the employee and therefore wages for purposes of income tax withholding. Relying on *Central Illinois*, the court said that "an employee's gross income is not the same as his 'wages' for purposes of income-tax withholding" and that many items that qualify as income are not wages. The court then agreed with the plaintiffs that Rev. Proc. 80-53 provided a firm basis for excluding the additional salary amount as wages for income tax purposes. In this regard, the court found that "no statute, regulation, revenue ruling, revenue provision or court decision" supported the government's position. Additionally, the court found that the company had a reasonable basis for not treating the salary reduction amount as wages subject to income tax withholding, namely that the FICA regulations (echoing the legislative history) expressly provided that the impact of the election on an individual's remuneration was "immaterial."[33]

The government's appeal to the Eleventh Circuit was unsuccessful. The court affirmed the district court's decision *per curiam*, saying only that its affirmation was based on the reasons stated in the lower court's "thorough and well-reasoned order."

It is unfortunate that the Eleventh Circuit did not issue a full-blown opinion. Although we believe that the lower court reached the correct result, we find it difficult to reconcile that result with the court's statement that the government argued "persuasively" that the employees' choice of accepting salary reduction in exchange for medical benefits resulted in an effective assignment of that salary to their employer. If the court truly believed that these employees were assigning their wages, why was this assignment not a taxable event for withholding purposes? The lower court opinion reflects that the judge, early on, had mixed feelings about this case. Footnote 1 of the court's opinion states that the judge, at oral argument on the summary judgment motions, expressed to counsel that he would rule in favor of the government. However, as can be observed from the outcome of the case, he later changed his mind when he sat down to write the opinion.

In summary, although *Express Oil* is not clear on all points, it undeniably represents a victory for the taxpayer in a case involving the government's application of the exclusivity rule.[34] By concluding that the employer's non-cafeteria plan salary reduction arrangement did not result in taxable wages to the employees, the decision arguably stands in direct conflict with Treasury's view that offering such an arrangement outside of the §125 requirements results in an immediate tax event to the employees. As for the court's isolated comment regarding the persuasiveness of the government's assignment argument, it should be considered *dicta* and therefore not part of the court's holding.

21, §324, 97 Stat. 65 (1983) (excluding from FICA wages any amount paid by employer to a §403(b) annuity contract unless payment is pursuant to salary reduction agreement); S. Rep. No. 98-23, at 41 (1983) (stating that the amendments intended to codify Rev. Rul. 65-208).

[31] Section 3121(a); S. Rep. No. 98-23, at 41 (explaining that Congress enacted the provision because it believed that the objectives of the social security system differed from those of the income tax withholding system).

[32] H.R. Rep. No. 728, *reprinted in* 1939-2 C.B. 565, 575–76 (1939). It is important to note here that Treasury's own regulations reflect this statement of Congressional intent by reiterating it in slightly different words: "It is immaterial for purposes of this exclusion whether the amount or possibility of such benefit payments is taken into consideration in fixing the amount of an employee's remuneration or whether such payments are required, expressly or impliedly, by the contract of service." Treas. Reg. §31.3121(a)(2)-1(f).

[33] Treas. Reg. §31.3306(b)(2)-1(d).

[34] *See* Rosina B. Barker & Kevin P. O'Brien, *Nontaxable Benefit Elections: Do They Trigger Taxable Income? More Confusion After Express Oil Change*, 12 Benefits L. J. 1 (1999).

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CONCLUSION

Based on the wording of §125, the integrated set of ‘‘deferred compensation provisions’’ enacted contemporaneously and the legislative history, the authors believe that Treasury’s exclusivity rule is inconsistent with Congress’s intention that §125 provide a safe harbor for written plans seeking to operate within its protective confines. Treasury’s position that choices offered to employees under plans and arrangements operating outside of those protections result in immediate gross income is at odds with the existing constructive receipt rules and therefore does not represent a ‘‘permissible construction of the statute’’ under *Chevron*.[35] The authors recommend that the exclusivity rule not be included in the final regulations and predict that if Treasury decides to include the rule, it may not survive judicial review.

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[35] *Chevron U.S.A. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843 (1984).

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