

FOR YOUR INFORMATION

News for School Clients

**ELECTION BETWEEN HEALTH
INSURANCE BENEFITS OR CASH
IN RETIREMENT**

February 2004



740 Regent Street
P.O. Box 1507
Madison, Wisconsin
(608) 257-7766

Joanne H. Curry care of info@lathropclark.com

February 2004
News For Clients

ELECTION BETWEEN HEALTH INSURANCE BENEFITS OR CASH IN RETIREMENT

Often school districts provide some form of health insurance to their former employees in retirement. Districts may wish to offer retiring employees the ability to elect between the retirement health insurance benefit or cash.

Normally, where an employee has the ability to elect between cash (a taxable benefit) or health insurance (a non-taxable benefit), the employee is deemed to be in constructive receipt of the cash. *Internal Revenue Code ("IRC") section 451*. In other words, the employee is taxed on the value of the cash that can be elected, regardless of the election made.

Generally, constructive receipt is dealt with by offering the election inside a cafeteria plan under IRC section 125. If the requirements of IRC section 125 are met, the employees who elect health insurance will not be subject to taxation on their health insurance benefit.

A cafeteria plan cannot be established primarily for the benefit of retirees. IRC section 125(d)(1)(A). Therefore, in order to give retirees a choice between taxable and non-taxable benefits in a cafeteria plan, that same cafeteria plan must offer

benefits to active employees. Further, the cafeteria plan must provide equal or greater benefits to active employees.

Cafeteria plans are subject to the rule against the deferral of compensation under IRC section 125. Basically, the rule against the deferral of compensation in a cafeteria plan requires that elections in year one cannot be used to fund a benefit in year two or later years.

Guidance on cafeteria plans is limited, because the IRS has declined to issue private letter rulings or determination letters on this topic. See *Revenue Procedure 2002-4*. However, an IRS information letter dated December 22, 1999, which was recently made public, contains important information about the IRS position regarding cafeteria plans and retiree health insurance. Specifically, the information letter discusses the taxation of the retiring employees' election of applying his or her accumulated sick leave balance to fund future health insurance or cash. The IRS took the position that the benefit offered does not meet the requirements of section 125 because it violates the rule against the deferral of compensation. The rule against the

deferral of compensation is violated because the retiree can elect in year one (year of retirement) to apply the accumulated sick leave balance to fund a benefit to be purchased in later years (health insurance premiums in retirement). The informational letter ruling does provide IRS approval where the retirees upon retirement may elect between cash or health insurance for the remainder of the cafeteria plan year.

Based on the IRS information letter and IRS regulations, school districts may have an additional solution to the cash election problem. On an employee's retirement, the district can create a credit for the retiree based on accumulated sick leave or other methods. Then, in a cafeteria plan that is not predominantly for the benefit of retirees, provide the retiree the ability to annually elect between a contribution to fund health insurance for that year or cash in an amount limited to the retiree's contribution to fund health insurance in that year. The election must be made prior to the start of the cafeteria plan year. Some health insurance providers will not allow a retiree back into the health insurance plan if after retirement that retiree elects out of the health insurance.

In those situations, the school district should consider providing the retiree with the ability to elect between health insurance, a flexible spending arrangement contribution for medical expenses, or cash. Then, if the former employee who elects cash in the first year of retirement cannot re-enter the health plan, the former employee still has the ability to elect between the flexible spending arrangement contribution (a non-taxable benefit) or cash. It must be noted that the IRS has not specifically approved such a plan; as a result, adopting such a plan does have risk for the district.

In light of the previously noted IRS information letter, school districts have the following options to provide non-taxable retiree health insurance: (1) provide a no cash election, (2) provide a cash election under a cafeteria plan not established primarily for the benefit of retirees, which is limited to the remainder of the cafeteria plan year in retirement, or (3) create a credit from which the retiree may annually elect under a cafeteria plan between health insurance or cash, limited to the retiree's annual contribution toward health insurance. As noted, the IRS has not specifically approved the third option.

If you have any questions regarding this topic, please call David Weller of Lathrop & Clark LLP at 608-286-7235. Attorney Weller, who is also a CPA, provides counsel in the areas of taxation and employee benefits, among other areas.

Disclaimer: Lathrop & Clark LLP provides this material for information about legal issues and not to give legal advice. However, material may quickly become outdated. Anyone referencing this material must update the information presented to ensure accuracy. The use of this material does not establish an attorney-client relationship, and Lathrop & Clark LLP recommends the use of legal counsel on specific matters.