

## B. The Plan Document Requirement

### 1. Code §125 Requires a Written Cafeteria Plan Adopted by the Employer

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Code §125(d) requires that a cafeteria plan be in writing. The written document must incorporate the operating rules prescribed in Code §125 and the regulations thereunder. In addition, the plan must be formally adopted by the employer prior to the first day of the plan

<sup>1</sup> year. The 2007 proposed cafeteria plan regulations indicate that if there is no written cafeteria plan or the written plan does not comply with applicable requirements regarding content and timing of adoption, then the plan is not a cafeteria plan and employees' elections

between taxable and nontaxable benefits will result in gross income.<sup>2</sup> The regulations also provide that the same consequences will result if a cafeteria plan fails to operate according to its written terms. See subsection E.

Other Code sections require a written plan document for component benefits that may be funded under a cafeteria plan. For example, a written plan document is required for health flexible spending arrangements (FSAs) (under Code §105) and dependent care assistance programs (DCAPs) (under Code §129). These requirements can be satisfied through separate written documents, or the health FSA and DCAP documents can be combined with the cafeteria plan document.<sup>3</sup> A cafeteria plan can also be composed of multiple documents.<sup>4</sup>

According to the 2007 proposed regulations, a cafeteria plan document must contain all of the following information:

- description of available benefits;
- participation rules;
- election and election change procedures;
- manner of contributions;
- maximum amount of contributions;
- the plan year;
- if purchase or sale of paid time off (PTO) days is offered, the ordering rules for use of nonelective and elective PTO;
- if the plan includes flexible spending arrangements (FSAs), the plan's provisions complying with any additional requirements for those FSAs; and

- if the plan includes a grace period, the plan's provisions complying with IRS requirements regarding the grace period.

These items are discussed in greater detail in subsection C.

Other provisions may not be expressly required by the regulations, but are so desirable from a compliance standpoint that they are practically required. Examples include—

- A statement that the cafeteria plan is intended to qualify under Code §125 and that any component benefits are intended to qualify under their respective Code sections;
- Provisions addressing the effect of termination of employment and rehire;
- Any default or rollover rules that will apply if an employee fails to make an election;
- Provisions governing amendment, termination, and administration of the plan; and
- A statement that the plan administrator has the authority to change a participant's election during the coverage period to prevent violation of the nondiscrimination rules or maintain the plan's status under Code §125.

See Section XXXVI for further discussion.

In addition, the terms of the plan must apply uniformly to all participants.<sup>5</sup> Thus, unwritten exceptions to the plan's terms are not permitted.

## 2. By When Must the Plan Document Be Adopted?

The written plan document must be formally adopted by the employer on or before the first day of the first plan year (or short plan year) to which it relates and must be effective on or before that date.<sup>6</sup>

**Plan Document Must Be Adopted in Advance.** In *American Family Mutual Insurance Co. v. U.S.*,<sup>\*</sup> the IRS argued that a cafeteria plan was invalid because it was not formally adopted before its effective date. The IRS has incorporated this requirement in the 2007 proposed regulations.<sup>†</sup>

*American Family Mutual Ins. Co. v. U.S.*, 815 F. Supp. 1206, 16 EBC 1332 (W.D. Wis. 1992).

<sup>†</sup> Prop. Treas. Reg. §1.125-1(c)(1).

### **3. How Does the Employer Formally Adopt the Cafeteria Plan?**

Neither Code §125 nor the 2007 proposed regulations specify how an employer must adopt a cafeteria plan. However, it is important to follow the proper authorization process to prevent someone from later challenging whether the plan was validly adopted. In general, this will depend on the employer's governing documents and procedures. For example, if the employer is a corporation, its governing documents and procedures may require the board of directors to formally approve the plan's adoption. See Section XXXVI for further discussion.

### **4. IRS Does Not Issue Determination Letters for Cafeteria Plans**

The IRS does not issue rulings or determination letters on whether a cafeteria plan satisfies the requirements of Code §125.<sup>7</sup> Consequently, it is imperative that an employer adopting a cafeteria plan obtain sound legal advice that the plan being adopted meets all legal requirements specified in Code §125 and the regulations thereunder. Unless the plan, as written and in operation, meets these requirements, the favorable tax treatment that the plan is designed to achieve may be lost.<sup>8</sup>

Note also that the IRS will not issue rulings on whether amounts used to provide group term life insurance under Code §79, accident and health benefits under Code §§105 and 106, and dependent care assistance programs under Code §129 are includible in the gross income of participants and are considered wages for purposes of Code §§3401, 3121, and 3306 when the benefits are offered through a cafeteria plan.<sup>9</sup>

### **5. Plan Amendments Must Also Meet Content and Timing Requirements**

A cafeteria plan can be amended at any time during the plan year. However, any amendment must be in writing and will only be effective for periods after the later of the amendment's adoption date or effective date (unless otherwise specifically permitted under IRS rules for cafeteria plans).<sup>10</sup> If an amendment adds a new benefit, the cafeteria plan must pay or reimburse only those expenses for the new benefit that are incurred after the later of the amendment's adoption or its effective date.<sup>11</sup>

Note that several issues should be addressed as part of effectively amending a cafeteria plan and its component benefit plans: power to amend; form and timing of the amendment; legal action to adopt; and appropriate notifications. See Section XXXVI for further discussion.

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<sup>1</sup> Prop. Treas. Reg. §1.125-1(c)(1).

<sup>2</sup> Prop. Treas. Reg. §1.125-1(c)(6).

<sup>3</sup> See Prop. Treas. Reg. §1.125-1(c)(2). Note that many component benefits offered under a cafeteria plan are subject to ERISA, which establishes its own requirements regarding provisions that must be included in a plan document. See Section XXII.

<sup>4</sup> Prop. Treas. Reg. §1.125-1(c)(1).

<sup>5</sup> Prop. Treas. Reg. §1.125-1(c)(1).

<sup>6</sup> Prop. Treas. Reg. §1.125-1(c)(1).

<sup>7</sup> Rev. Proc. 2017-4, 2017-1 I.R.B. 146, §8.03(1).

<sup>8</sup> See Prop. Treas. Reg. §§1.125-1(c)(6) and 1.125-1(c)(7).

<sup>9</sup> Rev. Proc. 2017-3, 2017-1 I.R.B. 130, §3.01(27).

<sup>10</sup> The IRS has waived this rule on occasion, allowing a plan to change its operations prospectively and then adopt a retroactive amendment by the end of the plan year in which the change became effective. See, e.g., IRS Notice 2005-42, 2005-23 I.R.B. 1204 (grace period amendment) and IRS Notice 2013-71, 2013-47 I.R.B. 532 (health FSA carryover amendment).

<sup>11</sup> Prop. Treas. Reg. §1.125-1(c)(5).