

# STATEMENTS OF POLICY

## Title 61—REVENUE

### DEPARTMENT OF REVENUE

#### [61 PA. CODE CH. 125]

#### Payments for Employee Welfare Benefit Plans and Cafeteria Plans

The Department of Revenue (Department) has adopted a statement of policy under the authority contained in § 3.2 (relating to statements of policy). This statement of policy adds §§ 125.21—125.33 (relating to payments for employee welfare benefit plans and cafeteria plans) and shall take effect immediately upon publication in the *Pennsylvania Bulletin*.

Sections 125.21—125.33 are being added to implement amendments to section 301(d) of the Tax Reform Code of 1971 (72 P. S. § 7306(d)) under Act 7-1997. The sections provide employers and employees with a detailed explanation of how nondiscriminatory employee welfare benefit programs such as self-insured medical reimbursement accounts or cafeteria plans are taxed under the Commonwealth's personal income tax. They also provide a detailed explanation of how programs that discriminate in favor of officers, owners and key employees are taxed.

The sections are also being added in order to notify employers and employees how the provisions of the personal income tax relating to employee compensation in the form of employer-provided facilities or services shall be enforced by the Department, commencing January 1, 1998.

Specific questions relating to information provided in this statement of policy may be directed to the Department of Revenue, Office of Chief Counsel, Department 281061, Harrisburg, PA 17128-1061.

ROBERT A. JUDGE, Sr.,  
*Secretary*

*(Editor's Note: The regulations of the Department, 61 Pa. Code Chapter 125, are amended by adding a statement of policy at §§ 125.21—125.33 to read as set forth in Annex A).*

**Fiscal Note:** 15-394. No fiscal impact; (8) recommends adoption.

#### Annex A

#### TITLE 61. REVENUE

#### PART I. DEPARTMENT OF REVENUE

#### Subpart B. GENERAL FUND REVENUES

#### ARTICLE V. PERSONAL INCOME TAX

#### CHAPTER 125. PERSONAL INCOME TAX PRONOUNCEMENTS—STATEMENTS OF POLICY

#### PAYMENTS FOR EMPLOYEE WELFARE BENEFIT PLANS AND CAFETERIA PLANS

#### § 125.21. General.

(a) This section and §§ 125.22—125.33 are intended to provide employers and employees with a detailed explanation of the Pennsylvania Personal Income Tax treatment of:

(1) Payments for employee welfare benefit plans, effective January 1, 1997.

(2) Internal Revenue Code section 125 cafeteria plans, effective January 1, 1997.

(3) Employer-provided day care facilities and services, air flights, cars, athletic, recreational or entertainment facilities and other employer-provided property or services, effective January 1, 1998.

(b) Beyond the scope of this section and §§ 125.22—125.33 are:

(1) Federally qualified medical savings accounts (MSAs).

(2) Old age or retirement benefit programs.

(3) Severance pay plans.

(4) Stock bonus or profit-sharing plans.

(5) Plans under which benefits are payable or subject to anticipation, assignment or pledge upon or after one or more of the following:

(i) Separation from service.

(ii) The completion of a fixed period of participation or employment.

(iii) The lapse of a fixed number of years.

(6) Plans that offer a benefit that defer the receipt of compensation or operate in a manner that enables participants to defer the receipt of compensation.

(7) Accident or health insurance plans whose benefits are taxable in whole or in part for Federal income tax purposes.

(8) Guaranteed pay.

(9) Wage continuation plans.

#### § 125.22. Definitions.

The following words and terms, when used in § 121.21 and §§ 121.23—121.33, have the following meanings, unless the context clearly indicates otherwise:

*Cafeteria plan*—A plan maintained by an employer for the benefit of its employees and under which all participants are employees and may choose among two or more benefits consisting of cash or benefits such as accident and health plans, dependent care assistance plans, group-term life insurance, adoption assistance plans and section 401(k) of the IRC plans. The term includes flexible benefit plans.

*Discriminatory plan*—An employee welfare benefit plan when excludable employer contributions or the benefits attributable to employer contributions discriminate in favor of highly compensated participants. In determining whether a cafeteria plan is discriminatory, the special rules of section 125(g) of the IRC (26 U.S.C.A. § 125(g)) is applicable.

*Employee welfare benefit plan*—

(i) A plan established or maintained by an employer or by an employee organization, or by both, in order to provide to eligible employees or their beneficiaries wage or salary supplements, such as:

(A) Medical, surgical or hospital care or benefits in the event of sickness, accident or disability.

(B) Benefits in the event of death.

(C) Benefits in the event of unemployment or a strike.

(D) Vacation benefits and other guaranteed pay.

- (E) Apprenticeship or other training plans.
- (F) Scholarships, tuition reductions or educational assistance.
- (G) Legal, accounting or other professional services or assistance.
- (H) Food, housing, or food or housing allowances.
- (I) Day care centers or dependent care assistance.
- (J) Athletic, recreational, or entertainment facilities, services or assistance.
- (K) The personal use of the employer's property or services.
- (L) Employee discounts.
- (M) Transportation and parking.

(ii) These plans afford eligible plan participants insurance against loss or damage, payment in reimbursement of expenses of, or in discharge of payments required from, these participants, personal use of the employer's property or services, paid leaves of absence or other plan benefit not contingent upon separation from service, the completion of a fixed period of participation or employment or the lapse of a fixed number of years or computed with regard to this period or number.

*Highly compensated participant—*

- (i) A plan participant who is one of the following:
  - (A) An officer.
  - (B) A shareholder owning more than 5% of the voting power or value of all classes of stock of the employer.
  - (C) An individual who, for the preceding taxable year:
    - (I) Received compensation from the employer in excess of the Federal limitation (after adjustment by the Secretary of the United States Treasury for inflation) set forth in section 414(q)(1)(B) of the IRC (26 U.S.C.A. § 414(q)(1)(B)).
    - (II) Is in the group consisting of the top 20% of all full-time employees of the employer with at least 3 years of service when ranked on the basis of compensation paid during the taxable year.
- (ii) A partner or other self-employed individual.
- (iii) A spouse or dependent of a highly compensated individual.

*Plan*—The term includes programs or arrangements.

**§ 125.23. Taxability of employee welfare benefit plan coverage.**

(a) *General rules.* Generally, the taxable compensation of an eligible plan participant includes the cost of employer-provided coverage under an employee welfare benefit plan. Likewise, generally, no deduction from compensation is allowed for the cost of employee-provided coverage.

(b) *Cost of employer-provided coverage.* The cost of employer-provided coverage under an employee welfare benefit plan shall be the total amount of payment made during the year by the employer on account of the plan and plan participant, except in the following situations:

- (1) In the case of tangible property owned or leased by the employer and personally used by a participant or beneficiary after December 31, 1997, the cost shall be its fair rental value.
- (2) In the case of self-insured insurance plans, the cost shall be the annual cost for financial accounting purposes.

(3) The amount of reportable compensation paid in the form of Federally taxable noncash fringe benefits shall be determined in the same manner as is prescribed by the Internal Revenue Service under Federal statutes and regulations.

(4) In the case of section 125 of the IRC (26 U.S.C.A. § 125) cafeteria plans, amounts specified in the plan document as being available to the participant for the purpose of selecting or purchasing benefits, when so used, shall be included in the total amount of payment made during the year by the employer on account of the plan and plan participant.

(c) *Exceptions.* The only exclusions are as follows:

(1) Payments made by an employer or elective contributions made under a cafeteria plan qualifying under section 125 of the IRC for a nondiscriminatory employee welfare benefit plan covering hospitalization, sickness, disability or death (See § 125.30 (relating to programs covering hospitalization, sickness, disability or death)).

(2) Payments made by an employer for a collectively bargained for or nondiscriminatory supplemental unemployment benefit or strike benefit plan.

(3) Payments to reimburse expenses allowable as an ordinary, reasonable and necessary business expense.

(4) Federally excludable no-additional-cost services, employee discounts, working condition fringes, qualified transportation fringes, and de minimis fringes.

(5) Benefits realized from an employee's personal use, before January 1, 1998, of his employer's property or services.

**§ 125.24. Federal income tax differences.**

(a) The Pennsylvania Personal Income Tax law has no provisions similar to section 21 of the IRC ("Expenses for household and dependent care services necessary for gainful employment"), section 105(b) of the IRC ("Amounts expended for medical care"), section 120 of the IRC ("Amounts received under qualified group legal services plans"), section 127 of the IRC ("Educational assistance programs"), section 129 of the IRC ("Dependent care assistance programs"), section 137 of the IRC ("Adoption assistance programs") or section 213 of the IRC ("Medical, Dental, etc., expenses"). Accordingly, unless allowable as an ordinary, reasonable and necessary business expense, legal or accounting, educational, household, dependent care, medical or adoption expenses are not deductible for personal income tax purposes.

(b) Likewise, unless allowable as a working condition, no-additional-cost, qualified transportation or de minimis fringe benefit, any of the following are taxable as compensation:

- (1) Amounts paid by an employer for day care facilities furnished to an employee's child or for child or dependent care.
- (2) Amounts paid by an employer for nonjob-related legal, accounting or other professional services or educational assistance provided to the employer's employees or their dependents.
- (3) Amounts paid by an employer to reimburse employees for expenses incurred for medical care, unless paid under a qualifying self-insured medical reimbursement account, or adoptions.

(c) Beginning January 1, 1998, there will also be no exclusion for the personal use, at no or reduced cost, of employer-owned or leased property such as living quar-

ters, day care centers, company cars or recreational facilities or the personal use of employer-provided services such as apprenticeships or other training or educational programs, legal, accounting or other professional services, or dependent care, unless excludable as a working condition, qualified transportation or de minimis fringe benefit for Federal income tax purposes or provided for the convenience of the employer.

**§ 125.25. Self-insured medical reimbursement accounts; taxability.**

Employer payments to reimburse employes for uninsured medical or dental expenses are taxable as compensation if the employe is assured of receiving (in cash or any other benefit) amounts available but unused for covered reimbursement during the year without regard to whether he incurred covered expenses or not. If the amounts available for covered reimbursement cannot be cashed out or used for any other purpose during the taxable year or be carried over to any other taxable year, normal cash compensation that is forgone by an employe under a spending account or otherwise, and credited to a self-insured medical reimbursement account and drawn upon to reimburse the employe for uninsured medical or dental expenses to which section 105(b) of the IRC (26 U.S.C.A. § 105(b)) applies is excludable from tax.

**§ 125.26. Wage and salary supplements; taxability.**

(a) In addition to their normal cash compensation and the plan benefits payable under employe benefit plans, the earnings of most employes also include wage and salary supplements consisting of monetary employer payments to:

(1) Independently controlled trusts or pooled funds established or maintained for the purpose of funding or providing welfare benefit plan benefits under the plans.

(2) Insurance companies for the purchase of insurance.

(b) For Personal Income Tax purposes, these wage and salary supplements are taxable as compensation when so paid, unless the payment was made by the employer under:

(1) A nondiscriminatory plan covering hospitalization, sickness, disability or death (see § 125.30 (relating to programs covering hospitalization, sickness, disability or death)).

(2) A collectively bargained for or nondiscriminatory supplemental unemployment benefit plan or strike benefit plan.

*Example.*

(i) P is a Philadelphia-based partnership that is engaged in providing accounting services. On a nondiscriminatory basis, it offers the following fringe benefits to both employes and partners of the firm: (1) Blue Cross/Blue Shield medical coverage; (2) dental and eyeglass coverage with a deductible; and (3) group term life insurance with coverage up to the equivalent of the employe's annual salary.

(ii) P pays the premiums on behalf of all employes and partners for all medical, dental, eyeglass and insurance coverage directly to the insurance carrier or benefit provider. P does not add the premium costs for the benefits to any employe's gross wages and it accounts for the benefit costs as nonsalary fringe benefit expenses. In other words, the value of the benefits are not shown as an addition to any employe's wages on the paystubs furnished to employes.

(iii) The plan is not a Federally qualifying cafeteria or flexible benefit plan.

(iv) Conclusion: For the employes of P (but not partners), the employer-provided hospitalization (Blue Cross/Blue Shield), eyeglass, dental coverage and group life insurance benefits are excludable from compensation and are therefore not subject to withholding.

**§ 125.27. Wage and salary deductions; taxability.**

(a) Employers commonly agree to make deductions of amounts from their employes' earnings and to pay the wage and salary deductions over, as payments of its employes, to the employes' labor union or to a trust or pooled fund established or maintained for the purpose of funding or providing plan benefits under employe welfare benefit plans.

(b) Unless specified in a written cafeteria plan document as being available to the participant for the purpose of selecting or purchasing benefits under a plan or as additional cash remuneration received in lieu of coverage under a plan, any amount lawfully deducted and withheld by an employer from the remuneration of an employe after December 31, 1996, and accounted for as a part of the employe's total remuneration shall be considered to have been paid to the employe as taxable compensation at the time the deduction is made. These amounts shall also be treated as payments made by the employe from whose compensation they were deducted and withheld when paid over to trusts, pooled funds or insurance companies by the employer.

*Example.*

(i) Employer M is a manufacturing company situated in this Commonwealth and under its collective bargaining agreement with a union, all nonmanagement personnel must contribute \$15 per week from their gross salary toward the purchase of Blue Cross/Blue Shield coverage and \$3 per week toward the purchase of group life insurance.

(ii) The plan is not a Federally qualifying cafeteria plan or flexible benefit plan.

(iii) Conclusion: M must withhold Pennsylvania Personal Income Tax from the \$18 contributed by each nonmanagement employe toward benefits.

**§ 125.28. Cafeteria plans; taxability.**

(a) Payments made after December 31, 1996, for employe welfare benefit plans under a cafeteria plan qualifying under section 125 of the IRC (26 U.S.C.A. § 125) will be deemed to be an "employer contribution" for Pennsylvania Personal Income Tax purposes if the following apply:

(1) They were not actually or constructively received, after taking section 125 of the IRC into account.

(2) They were specified in a written cafeteria plan document as being available to the participant:

(i) For the purpose of selecting or purchasing benefits under a plan.

(ii) As additional cash remuneration received in lieu of coverage under a plan.

(3) The benefits selected or purchased are nontaxable under the IRC when offered under a cafeteria plan.

(4) The payments made for the plan would be nontaxable under the Pennsylvania Personal Income Tax if made by the employer outside a cafeteria plan.

(b) If these conditions are satisfied, cafeteria plan contributions are taxed under the same Pennsylvania Personal Income Tax rules as apply to employer payments for employe welfare benefit plans. However, as under Federal rules, if the benefits are taxable for Federal income tax purposes when offered under a cafeteria plan, the payments will also constitute taxable compensation for Pennsylvania Personal Income Tax purposes. For example, coverage under a section 132(f) of the IRC (26 U.S.C.A. § 132(f)) transportation plan is nontaxable under the IRC when offered separately but is taxable for both Federal Income Tax and Pennsylvania Personal Income Tax purposes if offered under a cafeteria plan. Payments also will constitute taxable compensation if they would be taxable under the Pennsylvania Personal Income Tax if made by the employer outside a cafeteria plan. For example, although not taxable under the IRC, coverage under a dependent care plan would constitute taxable compensation under the Pennsylvania Personal Income Tax because it would be taxable if made by an employer outside a cafeteria plan.

(c) Likewise, payments would constitute taxable compensation if they were:

(1) Not specified in a cafeteria plan document as being available to the participant either:

(i) For the purpose of selecting or purchasing benefits under a plan.

(ii) As additional cash remuneration received in lieu of coverage under a plan.

(2) Lawfully deducted and withheld by the employer from the remuneration of the employe.

(3) Accounted for as a part of the employe's total remuneration.

(d) Whether an amount is specified in a cafeteria plan document as being available to a participant shall be determined using Federal rules.

(e) Examples are as follows:

(1) *Example 1.* Under his employer's Federally qualifying cafeteria plan, A has the option of receiving his normal cash compensation or reducing his gross pay requirements and having the amount of that reduction applied by the employer toward health insurance in lieu of normal cash compensation payments. Conclusion: For Personal Income Tax purposes, A is taxable only if he opts to receive his normal cash compensation.

(2) *Example 2.*

(i) Under the Federally qualifying cafeteria plan offered by B's employer, amounts are available as an addition to B's normal cash compensation which, at the option of B, are either applied by the employer toward providing day care facilities and services or paid directly to B in cash as additional gross pay. Conclusions: For Personal Income Tax purposes, the benefit selected by B is taxable if:

(A) He opts to receive the additional gross pay.

(B) The amount is applied in reimbursement of an expense B incurred for household or dependent care services.

(C) The amount is applied in discharge of a payment required from B for household or dependent care services.

(ii) B's benefits will also be subject to Personal Income Tax if he opts to receive employer-provided day care facilities and services after January 1, 1998.

(3) *Example 3.*

(i) Under C's Federally qualifying cafeteria plan, amounts are available as an addition to C's normal cash compensation, which at the option of C, are either applied by the employer toward providing adoption assistance or paid directly to C in cash as additional gross pay.

(ii) Conclusions: For personal income tax purposes, C is taxable if:

(A) He opts to receive the additional gross pay.

(B) The amount is applied in reimbursement of an adoption expense C incurred.

(C) The amount is applied in discharge of any payment required from C related to the adoption of a child.

(4) *Example 4.*

(i) Under the Federally qualifying cafeteria plan of D's employer, each employe is provided with \$4,000 in flexible dollars that can be used to purchase certain benefits or which can be taken in cash in lieu of benefits. An individual who elects no benefits can receive cash only in an amount not exceeding \$2,000. An individual who elects benefits which have a total cost for the taxable year that does not equal or exceed \$4,000 must allocate the flex dollars first to the selected benefits and any remaining flex dollars can be received as cash but only up to \$500. In addition, the plan specifies that the maximum amount that can be contributed by an employe as an elective contribution is \$2,500.

(ii) For the 1997 taxable year, D's employer offers the following benefits under its cafeteria plan:

Benefit	Cost	
	Individual	(Individual and Spouse)
Medical Insurance	\$2,500	\$4,000
Dental Plan	\$500	\$750
Group Life Insurance	\$500	\$750
Dismemberment/ Disability Insurance	\$500	\$750
Dependent Care Service	\$1,500	\$1,500
Cash	\$2,000	\$2,000

(iii) Employes who elect benefits with a total cost exceeding the allocated flex dollars (\$4,000) agree to have the necessary additional amounts deducted from their base salary or wages each payroll period during 1997 in order to pay for the benefits.

(iv) Employe D selects individual coverages under the medical insurance, the dental plan, and group term life insurance and \$500 in cash for the 1997 taxable year. The total cost for these benefits is \$3,500.

(v) *Conclusions:* The \$3,500 of employer-provided flex dollars used to purchase nontaxable benefits are not compensation and are not subject to withholding notwithstanding that D could have applied the flex dollars toward dependent care (a taxable benefit) or taken the benefits in the form of cash up to \$2,000. The \$500 D received as cash in lieu of benefits under the cafeteria plan is taxable compensation.

(5) *Example 5.* Assume the same facts as in Example 4, except that Employe D is married and selects the following benefits for both his spouse and himself: 1) medical insurance; 2) dental; 3) group life insurance; and 4)

dismemberment/ disability insurance. Conclusions: For D, the employer is not required to withhold Pennsylvania Personal Income Tax on the flexible dollars totaling \$4,000. Because the total cost of benefits selected by D is \$6,250 and the employer-provided flexible dollars (\$4,000) are insufficient to pay for all of the benefits, D agrees to have additional sums deducted from his salary. D's employer pays him bi-weekly and the employer must deduct an amount totaling \$86.54 (\$86.54 X 26 pay periods = \$2,250) from D's biweekly salary to pay for the benefits. The \$86.54 deducted from the salary of D each payroll period, which totals \$2,250 for the calendar year, is not subject to Pennsylvania Personal Income Tax and withholding.

(6) Example 6.

(i) Assume that E's employer offers a Federally qualified flexible benefits plan under which an employee is required to select some level of medical coverage unless the employee can provide the company's benefits administrator with proof of coverage under another medical insurance plan, for example that of a spouse's employer. The monthly benefit is based upon the number of family members whom the employee chooses to cover under a medical plan. The flexible benefits plan contains the following features:

**Flex Dollars to Purchase Benefits**

If you elect this coverage:	You receive this number of Flex Dollars each month
Employee Only	\$152.44
Employee + Children	\$247.44
Employee + Spouse	\$298.80
Employee + Family	\$395.56

**Medical Plan Features**

	<b>Plan A</b>	<b>Plan B</b>
<b>Deductible</b> Per Person/Family Per Year	\$150/\$300	\$500/\$1,000

**What the Plan Pays**

Network Provider/Other Provider	90%/75%	80%
---------------------------------	---------	-----

<b>Out-of-Pocket Maximum</b>	\$1,150/\$2,875	\$5,500
------------------------------	-----------------	---------

(not including deductible) Per Family Unit Per Year

Network Provider/Other Provider

<b>Accident Coverage</b>	\$500	\$300
--------------------------	-------	-------

<b>Well Baby Care</b>	Yes	No
-----------------------	-----	----

**1. Medical Plan Prices and Election**

	<b>Plan A</b>	<b>Plan B</b>
Employee Only	\$168.94	\$142.34
(Your cost/extra pay)	(-\$16.50)	(+\$10.10)
Employee + Children	\$280.94	\$237.34
(Your cost/extra pay)	(-\$33.50)	(+\$10.10)
Employee + Spouse	\$339.30	\$288.70
(Your cost/extra pay)	(-\$40.50)	(+\$10.10)
Employee + Family	\$452.51	\$385.46
(Your cost/extra pay)	(-\$56.95)	(+\$10.10)

**2. Dental Election/Flex Dollars**

	What You Pay
Basic Plan Coverage	\$0.00
Optional Plan Coverage	
Employee Only	\$6.02
Employee + Children	\$11.56
Employee + Spouse	\$11.33
Employee + Family	\$18.12

**3. Vision Features**

**Prices and Election**

	What You Pay
Employee Only	\$6.30
Employee + Family	\$13.86
No coverage	\$ 0.00

**4. Spending Accounts**

**Health Care Account Election**

You may deposit from \$10 to \$208.33 per month in this Account

**Dependent Care Account Election (Child Care or Elder Care)**

You may deposit from \$10 to \$416.66 per month to this Account if you are single or married.

**5. Life Insurance**

**Prices and Election**

	What You Pay
Basic coverage only	\$0.00
<b>Additional Life</b>	
1x base annual pay	\$ 5
2x base annual pay	\$10
3x base annual pay	\$15

**6. Dependent Life**

**Prices and Election**

	What You Pay
\$10,000 spouse/\$5,000 child	\$1.49
\$20,000 spouse/\$5,000 child	\$2.34
No coverage	\$0.00

(ii) Under the plan, the maximum amount available as elective contributions is \$20,000.

(iii) E is married and has one child. E receives flex dollars totaling \$395.56 each month or (\$395.56 x 12 mo. = \$4,746.72 annually). E elects the following benefits:

<i>Benefit</i>	<i>Option</i>	<i>Monthly Cost</i>
Medical	Plan A	\$452.51
Dental	Employee & Family	\$ 18.12
Life Insurance	Basic Coverage Only	\$0.00

(v) Conclusion: Because E selected excludable benefits for Pennsylvania Personal Income Tax purposes, the monthly, employer-provided flex dollars in the amount of

\$395.56 are not subject to tax or withholding. The monthly flex dollars are not subject to tax or withholding irrespective of whether they are added to E's salary or shown as a deduction from his gross pay on each paystub.

(vi) Because the total monthly cost of the benefits selected is \$470.63 and the allotted flex dollars are \$395.56, E makes up the difference by agreeing to have the additional necessary funds (\$75.07) deducted from his pay each month as an elective contribution. The \$75.07 is excludable from tax because:

(A) It was not actually or constructively received by E, after taking section 125 of the IRC into account.

(B) It was specified in a written cafeteria plan document as being available to E for the purpose of selecting or purchasing benefits under the plan and as additional cash remuneration received in lieu of coverage under the plan.

(C) The benefits selected or purchased are nontaxable under the IRC when offered under a cafeteria plan.

(D) The payments made for the plan would be nontaxable under the Pennsylvania Personal Income Tax if made by the employer outside a cafeteria plan.

(7) *Example 7.* Assume that the employer offers the same flexible benefits plan as in Example 6, except that employee E is a single individual with no dependents and she selects the least expensive medical plan for a single individual, Plan B. E places the leftover flex dollars into the spending account to help defer the cost of medical expenses not paid for by Plan B. Under the flexible benefits plan, E may not withdraw funds from the spending account for any purpose other than to pay for uninsured medical expenses. If E does not utilize the amounts placed into the spending account during the calendar year, she forfeits the benefits. Conclusion: The flex dollars totaling \$152.44, which includes the monthly contribution of \$10.10 to the spending account, are not subject to tax or withholding.

(8) *Example 8.*

(i) Assume that the employer offers the same flexible benefits plan as in Example 6, except that employee E has a husband and two children. E's husband, but not the children, is covered under the husband's employer's health insurance plan. E receives monthly flex dollars for herself and children (\$247.44) and selects the following items under the employer's plan:

<i>Benefit</i>	<i>Option</i>	<i>Cost (monthly)</i>
Medical	Plan B Employe & Children	\$237.34
Dental	Employe & Children	\$11.56
Vision	Employe Only	\$6.30
Dependent Life	\$10,000 spouse/ \$5,000 child	\$1.49

(ii) Conclusion: The employer-provided flex dollars in the amount of \$247.44 are not subject to tax because E selected medical insurance coverage and dental coverage for herself and the children and the cost of these benefits exceeded the amount of employer-provided flex dollars.

(iii) E must contribute the sum of \$9.25 each month toward the purchase of benefits not paid for the employer-provided flex dollars. Therefore, \$7.76 of the \$9.25 monthly contribution is excludable from tax because:

(A) It was not actually or constructively received by E, after taking section 125 of the IRC into account.

(B) It was specified in a written cafeteria plan document as being available to the participant for the purpose of selecting or purchasing benefits under the plan and as additional cash remuneration received in lieu of coverage under the plan.

(C) The benefits selected or purchased are nontaxable under the IRC when offered under a cafeteria plan.

(D) The payments made for the plan would be nontaxable under the Pennsylvania Personal Income Tax if made by the employer outside a cafeteria plan. However, the dependent life insurance coverage would be taxable as a currently taxable benefit treated as cash for both Federal income tax and Pennsylvania Personal Income Tax purposes when offered under a cafeteria plan. Thus, the \$1.49 monthly cost would be taxable even if it had been paid by E's employer.

#### **§ 125.29. Discriminatory plans.**

Compensation includes the entire cost of employer-provided coverage provided to a highly compensated participant under any discriminatory employee welfare benefit plan.

#### **§ 125.30. Programs covering hospitalization, sickness, disability or death.**

(a) To qualify as a program covering hospitalization, sickness, disability or death, an employee benefit plan shall satisfy both of the following requirements:

(1) No program benefits are payable or subject to anticipation, assignment or pledge until the commencement of a covered sickness or disability or death, except:

(i) The return of the participant's own contributions and taxable income or gains thereon.

(ii) Amounts paid for the prevention of sickness or disability.

(iii) Amounts paid for a policy of accident or health insurance.

(2) The only means of obtaining entitlement to program benefits other than the return of the participant's own contributions and taxable income or gains thereon or amounts paid for the prevention of sickness or disability or for insurance is proof of hospitalization, sickness, disability or death.

(b) Programs under which benefits are payable either upon hospitalization, sickness, disability or death or separation from employment or some other contingency do not qualify as covering hospitalization, sickness, disability or death.

#### **§ 125.31. Vacation days.**

(a) Special rules apply if, under a cafeteria plan, plan participants may choose between benefits consisting of cash, additional paid vacation days, and other benefits or if, outside a cafeteria plan, plan participants can purchase additional paid vacation days. If additional paid vacation days are elected or purchased and they are used before the next calendar year, the following apply:

(1) The amount of cash foregone in exchange for the paid vacation day is excluded from income.

(2) The vacation pay is includible in income when paid.

(b) If additional paid vacation days are purchased outside a Federally qualifying cafeteria plan and they are not used before the next calendar year, the amount of cash foregone in exchange for the paid vacations days is excludable for Pennsylvania Personal Income Tax purposes only if both of the following apply:

(1) The value of the vacation day cannot be cashed out or used for any other purpose.

(2) The vacation day cannot be carried over to the next taxable year.

(c) Examples are as follows:

(1) Under the Federally qualified cafeteria plan offered by F's employer, employees are provided with \$4,500 in benefit dollars that can be used to purchase benefits. If the employee wishes to purchase benefits which cost in excess of the employer-provided benefit dollars, the employee must execute a salary reduction agreement. The cafeteria plan contains the following benefits:

<i>Item</i>	<i>Cost</i>
Medical/Accident Insurance	\$2,000 (individual) \$3,250 (family)
Life Insurance	\$150
Dependent Care	\$2,000
Additional Vacation	\$40/day
Days Cash	\$2,000 (cash limit)

(2) F selects individual medical coverage, dependent care and purchases three additional paid vacation days for the 1997 taxable year. F's employer provides 2 weeks of paid vacation to all employees. The total cost of F's benefits is \$4,120 and, as noted above, F received benefit dollars totaling \$4,500 from his employer.

(3) During 1997, F uses his 2 weeks of vacation time and the 3 additional vacation days that he purchased under the cafeteria plan.

(4) Conclusion: The employer is not required to withhold Personal Income Tax on \$2,000 which represents the employer-provided benefit dollars F used for medical/accident insurance, a nontaxable benefit. This amount is excludable from compensation even if F's employer shows or otherwise accounts for it as a periodic deduction from F's wages or a reduction of gross wages.

(5) The employer shall withhold tax on the employer-provided benefit dollars totaling \$2,380. This represents the amounts paid for dependent care (\$2,000) and the extra benefit dollars that were paid to F in the form of cash (\$380). However, the benefit dollars totaling \$120 that were used to purchase the extra paid vacation days are not subject to tax. F is taxed on the 3 paid vacation days when the days are used in 1997.

#### § 125.32. 401(k) plans.

Contributions made by an employer for 401(k) plans under a cafeteria plan under which the employee unilaterally may elect to have the employer either make the payments as contributions to a 401(k) plan or other plan on behalf of the employee or to the employee directly in cash are not excludable from the employee's taxable compensation and may be subject to withholding (see § 125.33 (relating to withholding; miscellaneous compensation)).

#### § 125.33. Withholding; miscellaneous compensation.

(a) Taxable payments to a third party insurer, trust or pooled fund for the benefit of an employee, expense allowances or advancements, and payments to reimburse expenses constitute "miscellaneous compensation." Employers are required to deduct and withhold the tax on miscellaneous compensation only if, and to the extent that, the employer can collect the tax by deducting it from the normal cash compensation of the employee. Employers may elect for withholding purposes to treat miscellaneous compensation as paid on a payroll period or other basis, so long as the compensation is treated as paid no less frequently than quarterly and taxes are deducted and withheld therefor as provided in this subsection.

(b) The act of May 7, 1997 (P.L. 85, No. 7) (Act 7) makes the changes respecting cafeteria plans retroactive to January 1, 1997. Employers shall repay resultant overcollections to employees only if the following exist:

(1) The tax has not yet been deposited.

(2) The employer obtains a written receipt from the employees showing the date and amount of the repayment.

(c) Employers shall prepare their Federal Form W-2 wage and tax statements for 1997 consistent with the changes. They shall also begin withholding consistent with the changes as of the first payroll period ending in 1998. Although adjustment is not required, employers are encouraged to make compensating reductions in their withholding for payroll periods in the third and fourth quarters of 1997 for overcollections in the first and second quarters that result from the retroactive effect of Act 7.

[Pa.B. Doc. No. 97-1543. Filed for public inspection September 26, 1997, 9:00 a.m.]