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Social Security Tax Treatment of Cafeteria Plans

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SOCIAL SECURITY TAX TREATMENT OF CAFETERIA PLANS

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I. INTRODUCTION

The conference report for the Social Security Amendments of 1983[1] states:

Present law

Cafeteria plans (Code section 125). — Under a cafeteria plan of an employer, an employee may choose among various benefits including cash, taxable benefits and nontaxable benefits ... offered under the plan. If certain requirements are met, amounts applied toward nontaxable benefits are excluded from the employee's taxable income and *generally from the social security wage base.*[2]

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The views expressed in this article are those of the author and do not necessarily represent the views of the Treasury Department or the Internal Revenue Service.

1. Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65.

2. H.R. REP. No. 47, 98th Cong., 1st Sess. 145-46 (conference report) (last emphasis added; other emphasis in original), *reprinted in* 1983 U.S. CODE CONG. & AD. NEWS 404, 435-36.

As a statement of present law, the above-quoted language purports to summarize the law as it existed before the Social Security Amendments of 1983. However, if the statement was a correct

Similar statements appear in the other committee reports for the Social Security Amendments of 1983.[3] Evidently influenced by these 1983 congressional committee report statements, officials of the Treasury Department,[4] commentators,[5] and private practitioners[6] have concluded that cafeteria plan benefits generally are not subject to social security taxes. However, this view is questionable. In particular, acceptance of the approach of the Treasury Department [hereinafter "Treasury"] and the Internal Revenue Service [hereinafter "Service"] regarding the principles applicable to cafeteria plans makes it difficult to conclude that cafeteria plan benefits are not subject to social security taxes.

This article will demonstrate that the social security tax treatment of cafeteria plans under current law is unclear. The article will begin with a discussion of background. Then, it will explore the two possible grounds for the 1983 congressional committee report statements and show why each of these grounds is open to question. Finally, the article will recommend legislative solutions to clarify the social security tax treatment of cafeteria plans based on the relevant policy considerations.

II. BACKGROUND

For income tax purposes, section 125[7] defines a cafeteria plan as a written plan under which all participants are employees and the participants may choose among two or more benefits consisting of cash and "statutory nontaxable ben-

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summary of pre-1983 law, then it would be a correct summary of the law today, since neither the 1983 amendments nor subsequent legislation changed the law governing the social security tax treatment of cafeteria plans. A provision passed by the House of Representatives in 1983 that would have made cafeteria plan benefits expressly subject to social security taxes was dropped in conference with the Senate. *Id.* at 146-47, 1983 U.S. CODE CONG. & AD. NEWS 436-37.

3. S. REP. No. 23, 98th Cong., 1st Sess. 39-40, *reprinted in* 1983 U.S. CODE CONG. & AD. NEWS 143, 180-81; H.R. REP. No. 25, 98th Cong., 1st Sess. 79, *reprinted in* 1983 U.S. CODE CONG. & AD. NEWS 219, 298.

4. *See Effects of Tax-free Employee Benefits on Revenues Discussed at Joint Hearing*, 11 PENS. REP. (BNA) No. 39, § 1, at 1202 (Sept. 24, 1984) (remarks of then Acting Assistant Treasury Secretary for Tax Policy Ronald A. Pearlman to the effect that cafeteria plans will cost the federal government about $3.2 billion in social security receipts over the next five years) [hereinafter cited as *Joint Hearing*]; *Finance Subcommittee Begins Hearings on Tax Treatment of Fringe Benefits*, 24 TAX NOTES (TAX ANALYSTS) 423 (July 30, 1984) (remarks of then Assistant Treasury Secretary for Tax Policy John E. Chapoton estimating the social security tax revenue loss attributable to cafeteria plans to be approximately $3 billion over the next five years) [hereinafter cited as *Hearings*].

5. Lassila, *The Applicability of Payroll Taxes to Employee Benefit Plans*, 16 TAX ADVISER 90, 92, 94-95 (1985) (stating that cafeteria plan benefits generally are not subject to payroll taxes, which include social security taxes).

6. *Section 401(k) Plans, Health Care Costs, Dependent Care Discussed at ECFC Meeting*, 12 PENS. REP. (BNA) No. 10, § 1, at 373, 374 (Mar. 11, 1985) (remarks of Steve Fein from Hewitt Associates to the effect that salary reduction through a cafeteria plan reduces social security taxes); *see Cafeteria Benefits Should Be Tested Individually for FICA Purposes, Says Hughes & Hill*, 24 TAX NOTES (TAX ANALYSTS) 836 (Aug. 27, 1984) (remarks of Karen K. Suhre from Hughes & Hill to the effect that social security taxes should apply to cafeteria plan benefits, only if an employee elects a benefit that would be subject to social security taxes if received apart from a cafeteria plan).

7. I.R.C. § 125 (West 1984 & Supp. 1985).

efits."[8] If a plan meets the section 125 requirements, a participating employee does not include in gross income any nontaxable benefits chosen, even though the employee could have elected to receive cash instead of the nontaxable benefits.[9] Nontaxable benefits that can be offered through a cafeteria plan include accident and health benefits,[10] group-term life insurance,[11] group legal services,[12] dependent care assistance,[13] and retirement plan contributions under a qualified cash or deferred arrangement.[14]

The Internal Revenue Code imposes social security taxes on both employers[15] and their employees[16] based on specified percentages of wages paid by employers and received by employees with respect to employment.[17] Section 3121(a)[18] defines the term "wages" to encompass, with certain exceptions, all remuneration for employment, including fringe benefits.[19] The Code does not exclude cafeteria plan benefits as such from the social security tax wage base. However, section 3121(a) provides specific exclusions from the social security tax wage base for many benefits that might be offered through a cafeteria plan.[20] The question is whether these specific exclusions apply or whether a special provision, similar to section 125 applicable to the income tax, is needed for social security tax purposes to avoid social security taxation of the amount of cash the employee could have elected.

The only position taken by the Service on this question was in General Counsel Memorandum 38787,[21] which the Service has revoked. The Service

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8. I.R.C. § 125(f) (West Supp. 1985) provides:

> For purposes of this section, the term "statutory nontaxable benefit" means any benefit which, with the application of [section 125(a)] is not includible in the gross income of the employee by reason of an express provision of this chapter [concerning normal income taxes and surtaxes] (other than section 117, 124, 127, or 132 [concerning scholarship and fellowship grants, employer-provided qualified transportation, educational assistance programs, and certain fringe benefits, respectively]). Such term includes any group term life insurance which is includible in gross income only because it exceeds the dollar limitation of section 79.

9. All "statutory nontaxable benefits" are not actually nontaxable. See, for example, *supra* note 8 with respect to excess group-term life insurance.

10. I.R.C. §§ 105, 106 (West 1984 & Supp. 1985).

11. *Id.* § 79.

12. *Id.* § 120.

13. *Id.* § 129.

14. I.R.C. § 125(d)(2) (West 1984); I.R.C. § 401(k) (West Supp. 1985).

15. I.R.C. § 3111 (1982 & Supp. I 1983).

16. *Id.* § 3101.

17. I.R.C. § 3121(b) (West 1979 & Supp. 1985) (defining the term "employment").

18. *Id.* § 3121(a).

19. *Id.*

20. *See, e.g., id.* § 3121(a)(2), (17) & (18) (with respect to accident and health benefits, group term life insurance, group legal services, and dependent care assistance). *See generally* Lassila, *supra* note 5 (which discusses various exclusions from the social security definition of "wages" for employee fringe benefits). Retirement plan contributions under a qualified cash or deferred arrangement are included in the social security tax wage base. I.R.C. § 3121(v) (West 1979 & Supp. 1985).

21. G.C.M. 38787 (Aug. 21, 1981).

based G.C.M. 38787 on *Rowan Cos. v. United States*,[22] in which the Supreme Court held that the value of meals and lodging furnished employees at the convenience of their employer is not "wages" subject to social security taxes because such value is excluded from the definition of "wages" for purposes of income tax withholding.[23] In arriving at this holding, the Court reasoned that the term "wages" means the same thing for income tax withholding and social security tax purposes, absent a clear indication of congressional intent to the contrary.[24] G.C.M. 38787 applied this reasoning to cafeteria plans, concluding that because income tax withholding does not apply to benefits excludible from gross income under section 125, these benefits are not subject to social security taxes.[25]

General Counsel Memorandum 39250[26] revoked G.C.M. 38787 as obsolete, because of a subsequent legislative development. The Social Security Amendments of 1983 codified the precise holding of *Rowan Cos.* that meals and lodging furnished for the convenience of the employer are not wages subject to social security taxes.[27] However, the Social Security Amendments of 1983 also added a provision to the Internal Revenue Code specifically rejecting the reasoning of *Rowan Cos.* that the term "wages" necessarily has the same meaning for purposes of income tax withholding and social security taxes.[28] The committee reports explaining this decoupling provision emphasize the distinction between the objectives of the social security system and the income tax withholding rules. Because the social security objective is to replace the income of retired or disabled beneficiaries, the term "wages" measures not only tax liability but also the income to be replaced. Therefore, the committee reports state that amounts exempt from income tax withholding should not be exempt from social security taxes unless Congress provides an explicit social security tax exclusion.[29]

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22. 452 U.S. 247 (1981).

23. *Id.* at 251-52, 263.

24. *Id.* at 254-63.

25. G.C.M. 38787 (Aug. 21, 1981).

26. G.C.M. 39250 (June 28, 1984), *reprinted in* 24 TAX NOTES (TAX ANALYSTS) 358-59 (July 23, 1984).

27. I.R.C. § 3121(a)(19) (West 1979 & Supp. 1985), *added by* Social Security Amendments of 1983, Pub. L. No. 98-21, § 327(a)(1), 97 Stat. 65, 126-27.

28. I.R.C. § 3121(a) (West 1979 & Supp. 1985) (first sentence of flush language) (added by Social Security Amendments of 1983, Pub. L. No. 98-21, § 327(b)(1), 97 Stat. 65, 127) provides: "Nothing in the regulations prescribed for purposes of chapter 24 (relating to income tax withholding) which provides an exclusion from 'wages' as used in such chapter shall be construed to require a similar exclusion from 'wages' in the regulations prescribed for purposes of this chapter."

29. The social security program aims to replace the income of beneficiaries when that income is reduced on account of retirement and disability. Thus, the amount of "wages" is the measure used both to define income which should be replaced and to compute FICA [social security] tax liability. Since the security system has objectives which are significantly different from the objective underlying the income tax withholding rules, the committee believes that amounts exempt from income tax withholding should not be exempt from FICA unless Congress provides an explicit FICA tax exclusion.

S. REP. NO. 23, *supra* note 3, at 42, *reprinted in* 1983 U.S. CODE CONG. & AD. NEWS 183; *accord* H.R. REP. NO. 25, *supra* note 3, at 80, *reprinted in* 1983 U.S. CODE CONG. & AD. NEWS 299.

Because the Social Security Amendments of 1983 preclude use of the reasoning in *Rowan Cos.* as a ground for excluding cafeteria plan benefits from the social security tax wage base, G.C.M. 39250 concludes that G.C.M. 38787 is obsolete. G.C.M. 39250 does not determine, however, the proper social security tax treatment of cafeteria plan benefits under current law. Thus, the Service now has no position on this matter.[30]

Since the Service has no position on the social security tax treatment of cafeteria plans, taxpayers must determine whether cafeteria plan benefits are subject to social security taxes. Apparently, most tax practitioners have assumed that cafeteria plan benefits generally are not subject to social security taxes,[31] and their assumptions are based on the statements in the 1983 congressional committee reports.[32] However, these statements require further examination.

The 1983 congressional committee reports do not disclose the basis for the statements that cafeteria plan benefits generally are not subject to social security taxes, but the statements have two possible grounds.[33] The first possible ground is that fringe benefits for which there are specific social security tax exclusions are not subject to social security taxes, even if the benefits are received through a cafeteria plan, because the specific exclusions, by themselves, prevent social security taxation of the fringe benefits. Thus, no special provision, similar to section 125 applicable to the income tax, is required for social security tax purposes to prevent a cafeteria plan participant who actually received excludible fringe benefits from being taxable on the amount of cash that could have been elected. The second possible ground for the committee report statements is that, assuming a special provision is necessary to prevent social security taxation of

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30. G.C.M. 39437 (Sept. 16, 1985), *reprinted in* 29 TAX NOTES (TAX ANALYSTS) 715-18 (Nov. 18, 1985), concurred in private letter ruling 8545030 (Aug. 8, 1985), which seemingly determines that certain cafeteria plan benefits are not subject to social security taxes. However, the G.C.M. and the letter ruling are concerned primarily with other issues, and neither analyzes this issue.

The Social Security Administration has taken the position that cafeteria plan benefits received by employees of state and local governments whose salaries are set by law are included in the social security benefits wage base under Social Security Act § 209, 42 U.S.C.A. § 409 (West 1983 & Supp. 1985). OFFICE OF RETIREMENT & SURVIVORS INS., SOCIAL SEC. ADMIN., U.S. DEP'T OF HEALTH & HUMAN SERVS., HANDBOOK FOR STATE SOCIAL SECURITY ADMINISTRATORS, INFORMATION RELEASE NO. 62, HOW TO DETERMINE WAGE STATUS OF PAYMENTS UNDER "SALARY REDUCTION AGREEMENTS" (Sept. 14, 1984) [hereinafter cited as HANDBOOK]. (Although state and local employees are not covered mandatorily by the social security system, a state may enter into an agreement with the Social Security Administration for such employees to be covered. Social Security Act, § 218, 42 U.S.C.A. § 418 (West 1983 & Supp. 1985).) The rationale for this position is that the law establishing the salary of such an employee determines its character as wages. Thus, an agreement by such an employee to take less salary in exchange for cafeteria plan benefits is ineffective to alter the character of the salary as wages. HANDBOOK, *supra*.

31. *Supra* notes 4-6 and accompanying text.

32. *See supra* notes 1-3 and accompanying text.

33. The 1983 congressional committee report statements concerning the social security tax treatment of cafeteria plans almost certainly were not based on the position in G.C.M. 38787. Nothing suggests that the drafters of the committee reports even were aware of that position. Moreover, had the drafters been basing their opinion on that position, presumably they would have commented on the fact that the rationale of that position was being eliminated by the enactment of a provision specifically rejecting the reasoning of *Rowan Cos.*

cafeteria plan benefits, section 125 serves as such a special provision by applying to social security taxes as well as the income tax. Because each of these possible grounds is open to question, the statements in the committee reports may be unfounded.[34]

III. The Causes of the Uncertainty

A. *First Ground — The Need for a Special Provision to Prevent Social Security Taxation of Cafeteria Plan Benefits*

1. Salary Reduction Arrangements — In General

The first possible ground for the 1983 congressional committee report statements conflicts with the approach of the Treasury and Service to taxation of salary reduction arrangements. A consideration of this possible ground requires both a recognition that a cafeteria plan is a form of salary reduction arrangement and an understanding of the government's approach to income and social security taxation of such arrangements. Essentially, a salary reduction arrangement is an arrangement between an employer and an employee under which the employee elects to reduce salary — or to forego an increase in salary — by a certain amount. Then, the payment of that amount is either deferred to some future date or taken currently in the form of fringe benefits. The object of such an arrangement is either to defer taxation on the deferred salary or to transform what otherwise would be taxable salary into nontaxable fringe benefits. Cafeteria plans are designed to achieve the latter objective by giving an employee the choice between fringe benefits excludible from income and social security taxes and cash. An employee election to take a fringe benefit under a cafeteria plan is also an election to reduce salary — or to forego an increase in salary — enough to pay for the fringe benefit.

On occasion, the Treasury and Service have allowed participants in salary reduction arrangements to achieve such tax objectives.[35] More commonly, however, the Treasury and Service have attempted to tax the participants currently on salary reduction amounts.[36] The motivation for these attempts undoubtedly is the belief that salary reduction arrangements pose a threat to the fisc because, if successful, such arrangements would allow the participants to determine when or whether compensation is taxable. However, the Treasury and Service never have explained exactly how the ability to elect the timing or form of compensation causes participants in salary reduction arrangements to be taxable currently.[37] At least one commentator has concluded that attempts to tax salary

34. In conversations with the author, persons involved in drafting the committee reports were unable to identify any authority for these statements.

35. *See, e.g.*, Rev. Rul. 68-89, 1968-1 C.B. 402; Rev. Rul. 63-180, 1963-2 C.B. 189; Rev. Rul. 56-497, 1956-2 C.B. 284 (all three Rev. Ruls. were declared obsolete by Rev. Rul. 80-16, 1980-1 C.B. 82).

36. *See infra* notes 41-70 & 100-06 and accompanying text.

37. However, the Treasury and Service have identified "constructive receipt" as the concept they are relying on to tax salary reduction amounts. *Infra* text accompanying notes 75-76.

reduction amounts are unjustified,[38] although the Treasury and Service approach to the taxation of salary reduction arrangements is not without defenders.[39]

This article will not try to resolve the conflict over whether the approach of the Treasury and Service is justified. Instead, the article will describe various attempts by the Treasury and Service to tax salary reduction amounts and note the theoretical grounds identified as supporting the approach of the Treasury and Service. Because this approach has been questioned, the proper tax treatment of salary reduction amounts is uncertain, except in the case of salary reduction arrangements that have been the subject of specific legislation.[40] This article will focus initially on the income tax treatment of salary reduction arrangements, since most developments concerning such arrangements have occurred in the income tax context. The discussion then will shift to the implications for the social security taxes.

2. Income Tax Treatment of Salary Reduction Arrangements

In an early attempt to subject salary reduction amounts to current income taxation, the Treasury and Service addressed retirement annuity contracts purchased for employees of tax-exempt organizations. Before the enactment of section 403(b)[41] in 1958,[42] section 403(a)[43] permitted contributions by a tax-exempt organization described in section 501(c)(3)[44] to purchase a retirement annuity contract for an employee to be excluded from the employee's gross income without dollar limitation. However, the income tax regulations then in effect under section 403(a) provided that such contributions were excludible only if the purchase of the annuity contract was merely a "supplement to past or current compensation."[45] The regulations also provided that a contribution under a salary reduction agreement was current compensation and not a "supplement to past or current compensation."[46] Thus, the regulations generally treated contributions to purchase retirement annuity contracts for employees of tax-exempt organizations under salary reduction agreements as taxable income to employees at the time of the contributions.[47]

In 1958 Congress passed section 403(b), which contains rules limiting the dollar amount of contributions excludible from gross income under retirement annuity plans for employees of tax-exempt organizations. The legislative history

38. Irish, *Cafeteria Plans in Transition*, 25 TAX NOTES (TAX ANALYSTS) 1127 (Dec. 17, 1984).

39. Metzer, *Constructive Receipt, Economic Benefit and Assignment of Income: A Case Study in Deferred Compensation*, 29 TAX L. REV. 525 (1974).

40. *Infra* notes 48-49, 56-63, 69-70, 119 & 125 and accompanying text.

41. I.R.C. § 403(b) (West 1978 & Supp. 1985).

42. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 23(a), 72 Stat. 1606, 1620-21 (adding the original version of section 403(b)).

43. I.R.C. § 403(a) (Supp. V 1958).

44. I.R.C. § 501(c)(3) (1970) (amended 1976).

45. Treas. Reg. § 1.403(a)-1(a)(3), T.D. 6203, 1956-2 C.B. 219, 249-50.

46. *Id.*

47. *See* Treas. Reg. § 1.403(b)-1(a), T.D. 6203, 1956-2 C.B. 219, 252.

of section 403(b) indicated that the new statutory rules were to be a complete substitute for the approach of the regulations under section 403(a) regarding "supplements to past or current compensation."[48] Accordingly, when the Treasury and Service issued new income tax regulations reflecting the 1958 amendment, the regulations expressly permitted exclusion of section 403(b) contributions under a salary reduction agreement from gross income.[49]

Another attempt to tax salary reduction amounts occurred in 1972, when the Treasury and Service issued proposed income tax regulations concerning contributions to qualified retirement plans under salary reduction agreements.[50] These proposed regulations set into motion a series of events that eventually gave rise to section 125 and also to section 401(k),[51] which concerns qualified cash or deferred arrangements, another form of salary reduction arrangement.[52] Generally, the 1972 proposed regulations treated amounts contributed to a qualified retirement plan under a salary reduction agreement as employee contributions.[53] Consequently, such amounts would be taxable income to employees at the time of contribution to the plan rather than tax-deferred employer contributions.[54]

These proposed regulations were controversial, partly because they would have reversed the prior Service position on which many taxpayers had begun to rely.[55] Congress responded in 1974 by imposing a temporary moratorium on final adoption of the proposed regulations.[56] The moratorium applied not only to salary reduction agreements under qualified retirement plans but also to cafeteria plans, because Congress discerned no differences between cafeteria plans and salary reduction plans.[57] Even though the 1972 proposed regulations did not mention cafeteria plans, Congress was concerned that the Service might apply a similar rule to cafeteria plans because cafeteria plans contain a salary reduction element.[58]

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48. S. REP. No. 1983, 85th Cong., 2d Sess. 36, *reprinted in* 1958 U.S. CODE CONG. & AD. NEWS 4791, 4825.

49. Treas. Reg. § 1.403(b)-1(b)(3)(i), T.D. 6783, 1965-1 C.B. 180, 190.

50. Prop. Reg. §§ 1.402(a)-1(a)(1)(i), .403(a)-1(a), .405-3(a)(1), 37 Fed. Reg. 25,938 (1972), *withdrawn*, 43 Fed. Reg. 30,308 (1978) [hereinafter cited as 1972 Prop. Regs.].

51. I.R.C. § 401(k) (West Supp. 1985).

52. Generally, a qualified cash or deferred arrangement is an arrangement meeting certain requirements under which an employee may elect to receive a direct cash payment in lieu of a contribution to one of three specified types of qualified retirement plans. *See id.* Contributions to a retirement plan under a qualified cash or deferred arrangement are treated as tax-deferred employer contributions. I.R.C. § 402(a)(8) (1982).

53. 1972 Prop. Regs., *supra* note 50.

54. *See id.*

55. *See* Metzer, *supra* note 39, at 526-29.

56. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2006, 88 Stat. 829, 992-93. Originally, the moratorium was to have run until Dec. 31, 1976. *Id.* § 2006(b), 88 Stat. 992-93. However, it was extended twice. *Infra* notes 59, 62 and accompanying text.

57. H.R. REP. No. 807, 93d Cong., 2d Sess. 144, *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS 4670, 4809; *see* H.R. REP. No. 1280, 93d Cong., 2d Sess. 355-56 (conference report), *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS 5038, 5135.

58. 120 CONG. REC. 29,202-03 (1974) (statement of Mr. Broyhill).

In 1978, after an extension of the moratorium,[59] Congress enacted section 125 to deal with cafeteria plans.[60] At the same time, Congress passed section 401(k)[61] and again extended the moratorium,[62] which then effectively applied only to salary reduction arrangements other than cafeteria plans and qualified cash or deferred arrangements. The moratorium finally expired in 1980.[63]

The Treasury and Service withdrew the 1972 proposed regulations in 1978.[64] In 1981, however, the Treasury and Service issued a new set of proposed income tax regulations covering contributions to qualified retirement plans under salary reduction agreements.[65] These 1981 proposed regulations, which remain outstanding, essentially restate the position in the 1972 proposed regulations but narrow the scope of that position to reflect the enactment of section 401(k). Thus, under the 1981 proposed regulations, the only amounts contributed to a qualified plan under a salary reduction agreement treated as tax-deferred employer contributions are amounts satisfying the requirements of section 401(k).[66]

In another attempt to tax salary reduction amounts, the Treasury and Service in 1978 proposed regulations concerning the income tax treatment of elections to defer compensation by means of salary reduction agreements under nonqualified, unfunded retirement plans.[67] These proposed regulations, which remain outstanding, treat the deferred amounts as taxable in the year they would have been payable absent the election to defer.[68] However, if adopted, the regulations would apply only to nonqualified, unfunded plans maintained by private tax-exempt organizations;[69] in response to these proposed regulations, Congress enacted legislation governing the income tax treatment of amounts deferred under nonqualified, unfunded plans maintained by other types of employers.[70]

Neither the former regulations under pre-1958 section 403, nor any of the former or current proposed regulations discussed identify the theoretical grounds

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59. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1506, 90 Stat. 1520, 1739, extended the moratorium to Dec. 31, 1977.

60. Revenue Act of 1978, Pub. L. No. 95-600, § 134(a), 92 Stat. 2763, 2783-85 (adding the original version of § 125).

61. Revenue Act of 1978, Pub. L. No. 95-600, § 135(a), 92 Stat. 2763, 2785-87 (adding the original version of § 401(k)).

62. Tax Treatment Extension Act of 1977, Pub. L. No. 95-615, § 5, 92 Stat. 3097, 3097 (1978), extended the moratorium to Dec. 31, 1979.

63. *See id.*

64. *Supra* note 50.

65. Prop. Reg. § 1.402(a)-1(d), 1981-2 C.B. 753, 759 (proposed Nov. 10, 1981).

66. Prop. Reg. § 1.402(a)-1(d)(1), (2), 1981-2 C.B. 759. The effective date and transitional rule contained in the proposed regulations takes into account the moratorium, discussed *supra* text accompanying notes 56-63. *See* Prop. Reg. § 1.402(a)-1(d)(3), 1981-2 C.B. 759.

67. Prop. Reg. § 1.61-16, 43 Fed. Reg. 4638, 4639 (1978) (proposed Feb. 3, 1978).

68. *Id.*

69. INTERNAL REVENUE SERVICE INFORMATION RELEASE No. 2135 (June 11, 1979).

70. I.R.C. § 457 (West 1978 & Supp. 1985) (original version added by Revenue Act of 1978, Pub. L. No. 95-600, § 131(a), 92 Stat. 2763, 2779-82) (concerning nonqualified plans maintained by state and local governments); Revenue Act of 1978, Pub. L. No. 95-600, § 132, 92 Stat. 2763, 2782-83 (concerning nonqualified plans maintained by private, for-profit organizations).

for their treatment of salary reduction amounts.[71] However, the approach under each is essentially the same. Each treats an employee as having received and being taxable currently on an amount that the employee actually has not received, because the employee has elected to defer receipt. This treatment evokes the label "constructive receipt," if not constructive receipt principles themselves.[72] Thus, observers have assumed that the Treasury and Service were basing their treatment of salary reduction arrangements on the constructive receipt doctrine.[73]

The Treasury and Service in 1984 issued proposed regulations under section 125[74] suggesting that constructive receipt is indeed the concept being used by the Treasury and Service to justify their approach to income taxation of salary reduction arrangements. The proposed section 125 regulations state that section 125 is an exception to the principles of "constructive receipt."[75] In other words, absent section 125, otherwise nontaxable fringe benefits chosen by a cafeteria plan participant would be taxable to the participant, because the ability to elect cash instead of the fringe benefits would cause the participant to be in "constructive receipt" of the cash.[76]

By expressly relying only on "constructive receipt," the proposed section 125 regulations may be underplaying the possible theoretical grounds for taxation of salary reduction amounts. A commentator analyzing the 1972 proposed salary reduction regulations for qualified retirement plans concluded that the 1972 proposed regulations generally could be sustained either under a tandem application of agency and constructive receipt principles or under economic benefit principles.[77] This commentator also observed that the application of the

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71. The notice of proposed rulemaking accompanying the proposed regulations concerning elections to defer compensation under nonqualified plans did acknowledge, however, that the proposed regulations signaled a shift in position by the Treasury and Service. 43 Fed. Reg. 4638-39 (1978).

72. Treas. Reg. § 1.451-2(a), T.D. 6723, 1964-1 (pt. 1) C.B. 73, 74, provides:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during 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. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

73. Skillman, *How Would the New Proposed Regs Affect Deferred Compensation Arrangements*, 48 J. TAX'N 258, 261 (1978) (discussing the proposed regulations concerning elections to defer compensation under nonqualified plans); *see* PENSION DIV., PROVIDENT LIFE & ACCIDENT INS. CO., BULL. No. 28 (Apr. 21, 1972) (anticipating that the 1972 proposed regulations were to be based on constructive receipt principles), *quoted in* Metzer, *supra* note 39, at 528 n.11.

74. Prop. Reg. § 1.125-1, 1984-1 C.B. 563 (questions and answers relating to cafeteria plans) (proposed May 7, 1984) [hereinafter cited as Prop. Reg. 125].

75. *See, e.g., id.* question and answer 9, 1984-1 C.B. at 566. This article uses the literal form, "constructive receipt," because the reference to "constructive receipt" in the proposed regulations may not directly correspond to the principle commonly known as constructive receipt.

76. *See id.*

77. Metzer, *supra* note 39, at 548-50, 578, 583-84. Under economic benefit principles, an employee is taxable on the actual receipt of any economic benefit, regardless of form or mode, conferred as compensation. Commissioner v. Smith, 324 U.S. 177, 181 (1945).

assignment-of-income doctrine by certain deferred compensation cases[78] supported the 1972 proposed regulations, but this commentator maintained that the assignment-of-income doctrine is irrelevant to the timing of deferred compensation taxation and that the courts in these cases improperly applied the doctrine to resolve questions of timing.[79] Thus, the concept "constructive receipt" in the proposed section 125 regulations in fact may embrace any or all of these three theoretical grounds.[80]

Regardless of whether the theoretical grounds identified as supporting the approach of the Treasury and Service to income taxation of salary reduction amounts actually do support that approach, the Treasury and Service continue to adhere to that approach, except with regard to the taxation of salary reduction arrangements governed by statute. Both the 1981 proposed regulations concerning contributions to qualified plans under salary reduction agreements[81] and the 1978 proposed regulations concerning elections to defer compensation by means of salary reduction agreements under nonqualified, unfunded plans[82] remain outstanding. Moreover, the position in the proposed section 125 regulations that "constructive receipt" principles would apply to a cafeteria plan election in the absence of section 125 is not purely of academic interest. First, by describing the effect of such an election, the proposed section 125 regulations, in effect, set forth the position of the Treasury and Service regarding the income taxability of benefits received through cafeteria plans that do not meet the requirements of section 125.[83] Second, even if a plan qualifies under section 125, a highly compensated participant receiving discriminatory benefits under the plan does not qualify for the protection of section 125[84] and would be taxable according to "constructive receipt" principles.[85] Finally, the proposed regulations rely on "constructive receipt" to justify imposing certain requirements: that elections be made before the beginning of the period of coverage and that elections for the period of coverage be irrevocable after the beginning of this period absent a change in family status.[86]

Just as the Treasury and Service continue to adhere to their approach to income taxation of salary reduction amounts, some tax practitioners challenge that approach as invalid. One commentator has argued that neither constructive receipt nor any other legal principle supports the treatment of cafeteria plans under the proposed section 125 regulations.[87] This commentator maintains that

78. United States v. Basye, 410 U.S. 441, *reh'g denied*, 411 U.S. 940 (1973); Hicks v. United States, 314 F.2d 180 (4th Cir. 1963); Llewellyn v. Commissioner, 295 F.2d 649 (7th Cir. 1961).

79. Metzer, *supra* note 39, at 580-82.

80. For convenience, this article will refer to "constructive receipt" principles as the basis for taxation of salary reduction arrangements, including cafeteria plans. However, these references should be understood to incorporate all the principles identified above that might be relevant to such taxation.

81. *Supra* text accompanying notes 65-66.

82. *Supra* text accompanying notes 67-70.

83. *See* Prop. Reg. 125, *supra* note 74, question and answer 7, 1984-1 C.B. at 565-66.

84. I.R.C. § 125(b) (West Supp. 1985).

85. *See* Prop. Reg. 125, *supra* note 74, question and answer 10, 1984-1 C.B. at 566.

86. *See id.* question and answer 15, 1984-1 C.B. at 567.

87. Irish, *supra* note 38. However, the commentator states that the substance of Prop. Reg.

nothing supports treating an individual as though the individual received cash merely because he had an election to receive cash, if he made a binding and irrevocable election before becoming entitled to the cash to receive instead a benefit specifically excluded from gross income.[88] Under this view, if the election is made early enough — at least before the time the individual has earned the right to immediate payment — the individual should be treated as receiving what he actually did receive under the cafeteria plan, the excludible benefit.[89] Similarly, this commentator challenges the theoretical basis for the proposed regulations concerning other types of salary reduction arrangements.[90]

3. Social Security Tax Treatment of Salary Reduction Arrangements

The approach of the Treasury and Service to the income taxation of salary reduction arrangements not governed specifically by statute has implications for the social security tax treatment of cafeteria plans. If correct for income tax purposes, then this approach should apply for social security tax purposes to make taxable otherwise nontaxable fringe benefits received through a cafeteria plan, unless section 125 applies to social security taxes.[91] If incorrect for income tax purposes, then this approach should not apply for social security tax purposes, in which case any elected cafeteria plan benefits for which there are specific social security tax exclusions would not be subject to social security taxes. These two conclusions follow, because the principles identified as supporting the approach of the Treasury and Service to the income taxation of salary reduction arrangements[92] all have social security tax counterparts. Thus, these same principles would govern the social security tax treatment of salary reduction arrangements, including cafeteria plans.

The principles identified as supporting the approach of the Treasury and Service to the income taxation of salary reduction arrangements are the doctrines of constructive receipt, economic benefit, and assignment of income.[93] The social security tax doctrine of constructive payment is similar to the income tax doc-

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125 has received implicit congressional endorsement, as evidenced by references to the proposed regulations in the transitional rules for section 125 adopted by the Tax Reform Act of 1984, Pub. L. No. 98-369, § 531(b)(5), 98 Stat. 494, 883. Irish, *supra*, at 1132.

88. Irish, *supra* note 38, at 1135-36.

89. *See id.*

90. *Id.* at 1133-36.

The point of this discussion is not to resolve the question of whether constructive receipt or any other legal principle provides a sound theoretical basis for the position of the Treasury and the Service with respect to cafeteria plans, or salary reduction arrangements generally. Rather, it is to note that the Treasury and the Service repeatedly have proposed to currently tax for income tax purposes amounts subject to a salary reduction agreement (that is, compensation deferred or received in the form of otherwise nontaxable benefits at an employee's election) because the employee could have elected to receive the amounts currently in cash; to note the theoretical grounds that have been identified as supporting this treatment; and to note that this treatment has been challenged.

91. For a discussion of the possible application of section 125 for social security tax purposes, see *infra* notes 107-27 and accompanying text.

92. *Supra* notes 74-80 and accompanying text.

93. *Id.*

trine of constructive receipt.[94] Not only is the wording of these two doctrines similar,[95] but, in published revenue rulings, the Service has treated them as essentially equivalent. For example, Revenue Ruling 73-99[96] took the position that constructive payment for social security tax purposes occurs at the same point in time as constructive receipt for income tax purposes. Revenue Ruling 73-99 equates the concepts so much that it relies on an income tax revenue ruling applying constructive receipt principles without explaining or attempting to justify its use of the income tax ruling as authority.[97] In addition, other social security tax principles are analogous to the income tax principles of economic benefit[98] and assignment of income.[99]

Because income tax and social security tax principles relevant to the taxation of salary reduction arrangements are similar, and salary reduction arrangements pose revenue concerns for both the income tax and social security taxes, it is not surprising that the approach of the Treasury and Service to social security taxation of salary reduction arrangements not governed by statute parallels their approach to income taxation of such arrangements. For instance, the Treasury and Service proposed similar treatment for income tax and social security tax purposes with respect to contributions to qualified retirement plans under a salary reduction agreement. The 1972 proposed regulations would have treated such contributions as employee contributions for income tax purposes.[100] Although the 1972 proposed regulations did not address the social security tax treatment, a technical information release issued by the Service shortly after the proposed regulations indicated that the social security tax treatment would be the same as the income tax treatment.[101] Thus, the Service considered the

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94. Treas. Reg. § 31.3121(a)-2(b), T.D. 6190, 1956-2 C.B. 605, 620, provides:
Wages are constructively paid when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not then actually reduced to possession. To constitute payment in such a case the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that they may be drawn upon at any time, and their payment brought within his own control and disposition.

95. *Compare id. with* Treas. Reg. § 1.451-2(a), *supra* note 72.

96. Rev. Rul. 73-99, 1973-1 C.B. 412.

97. Rev. Rul. 68-126, 1968-1 C.B. 194.

98. *See* Rev. Rul. 57-37, 1957-1 C.B. 18 (concluding that an employer's contributions to trusts to fund certain benefits for its employees, whose interests in the trusts are fully vested and nonforfeitable, are subject to social security taxes in the year the contributions are made), *modified on another issue*, Rev. Rul. 57-528, 1957-2 C.B. 263.

99. *See* Rev. Rul. 71-116, 1971-1 C.B. 277 (concluding that a married employee's liability for social security taxes is based on the total wages of the employee, even though the wages are community property of the employee and the employee's spouse); Rev. Rul. 68-216, 1968-1 C.B. 413 (concluding that prizes awarded by an employer to its retail commission salespersons as incentives are wages subject to social security taxes, irrespective of whether the employer gives the prizes directly to the salespersons or to their spouses).

100. *Supra* text accompanying notes 50-54.

101. INTERNAL REVENUE SERVICE TECHNICAL INFORMATION RELEASE No. 1222 (Dec. 29, 1972). The effective dates would have been different for social security and income tax purposes.

approach of the 1972 proposed regulations perforce applicable to the social security taxes.

Another example of the Treasury and Service applying their income tax "constructive receipt" approach to salary reduction arrangements in the social security tax context involves retirement annuities purchased for employees of tax-exempt organizations. Before the enactment of section 403(b) in 1958, the Treasury and Service took the position that contributions to such annuities under a salary reduction agreement were not excludible from an employee's gross income under section 403.[102] Congress added section 403(b) in 1958 in part to allow salary reduction amounts to qualify for exclusion from gross income.[103] However, the Service took the position in Revenue Ruling 65-208[104] that amounts paid to a section 403(b) annuity plan under a salary reduction agreement are to be treated for social security tax purposes as the employee's payments. Hence, the ruling concludes the payments are taxable wages under section 3121(a), even though for income tax purposes the amounts are excludible employer contributions.[105] Although Revenue Ruling 65-208 did not identify the grounds for its position, the ruling is following the "constructive receipt" approach that the Treasury and Service applied for income tax purposes under these circumstances, until Congress amended the income tax statute to permit excludible contributions under a salary reduction agreement.[106]

In summary, specific exclusions from social security taxes for fringe benefits received through a cafeteria plan may not be sufficient to prevent a participant in the plan from being taxable on receipt of those benefits. A cafeteria plan is a salary reduction arrangement, and under the approach of the Treasury and Service to income and social security taxation of such arrangements, an employee is taxable currently on salary the employee could have elected to receive, even if the employee in fact elected to defer receipt of the salary or to take it in the form of otherwise nontaxable fringe benefits. If the approach of the Treasury and Service to the taxation of salary reduction arrangements is valid, then a special provision, like section 125, would be necessary to prevent social security taxation of cafeteria plan benefits.

B. *Second Ground — The Applicability of Section 125 to Social Security Taxes*

The other possible ground for the statements in the 1983 congressional committee reports is that, assuming a special provision is necessary to prevent social

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102. *Supra* notes 41-47 and accompanying text.

103. *Supra* note 48 and accompanying text.

104. Rev. Rul. 65-208, 1965-2 C.B. 383.

105. *Supra* note 49 and accompanying text.

106. *Supra* notes 41-49 and accompanying text. The existence of Revenue Ruling 65-208 may help to explain why the Treasury and Service did not propose a regulation to address the social security tax treatment of contributions to qualified plans under a salary reduction agreement and merely mentioned that treatment in a 1972 technical information release. With Revenue Ruling 65-208 outstanding, the Service already had adopted the "constructive receipt" approach to determine the effect of salary reduction agreements for social security tax purposes.

security taxation of cafeteria plan benefits, section 125 serves as such a special provision. This is a valid ground only if section 125, which the proposed section 125 regulations interpret as an exception to income tax "constructive receipt" rules,[107] also applies to create an exception to the analogous social security tax "constructive receipt" rules. The argument that section 125 applies for social security tax purposes is difficult to make.

It is one thing to say that the "constructive receipt" concept is common to both income and social security taxes because it is derived from nonstatutory doctrines common to both.[108] It is quite another to say that a specific statutory exception to "constructive receipt" applicable to the income tax applies as well to social security taxes with no statutory counterpart. Section 125 is an income tax provision which by its terms applies only to prevent qualifying benefits from being included under the term "gross income."[109] To be a cafeteria plan under section 125, the plan must offer "statutory nontaxable benefits,"[110] defined, in part, as benefits excludible from gross income by reason of an express provision of chapter 1 of the Code, which includes only income taxes.[111] Thus, the language of section 125 does not lend itself to application for social security tax purposes.

The legislative history of section 125, like the language of the statute itself, is devoid of any indication that Congress even considered the possibility of making the section applicable to the social security taxes.[112] Although the moratorium passed by Congress in 1974 in response to the 1972 proposed salary reduction regulations applied to both the income tax and social security taxes,[113] Congress evidently did not consider social security taxes when legislating income tax rules for cafeteria plans in 1978.

The best argument in favor of interpreting section 125 to cover social security taxes is that the 1983 congressional committee report statements might support such an interpretation. However, these statements can provide only limited authority for this interpretation, since the statements were made five years after the enactment of section 125 and are not part of its legislative history.[114] More-

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107. *Supra* notes 74-76 and accompanying text.

108. *Supra* text accompanying notes 91-106.

109. I.R.C. § 125(a) (1982).

110. I.R.C. § 125(d)(1) (West Supp. 1985).

111. *Id.* § 125(f) (quoted *supra* note 8).

112. *See* H.R. REP. No. 1800, 95th Cong., 2d Sess. 206 (conference report), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 7198, 7211-12; S. REP. No. 1263, 95th Cong., 2d Sess. 74-76, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 6761, 6837-39; H.R. REP. No. 1445, 95th Cong., 2d Sess. 63-64, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 7046, 7099-7101.

113. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 2006, 88 Stat. 829, 992-93.

114. United States v. Vogel Fertilizer Co., 455 U.S. 16, 34 (1982) (the intent of the Congress that enacted the provision, not the views of a subsequent Congress, controls) (citing International Bhd. of Teamsters v. United States, 431 U.S. 324, 354 n.39 (1977)); 2A A. SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 49.11, at 266 (C. Sands 4th ed. 1973) ("Although comments about an earlier act in a legislative committee report on a subsequent bill are not part of the legislative history of the earlier act and therefore have less probative force than legislative history, they are entitled to consideration as an expert opinion concerning its proper interpretation.")

over, interpreting section 125 to cover social security taxes would conflict with other statements in the 1983 congressional committee reports to the effect that amounts exempt from income tax withholding should not be exempt from social security taxes, unless Congress provides an explicit social security tax exclusion.[115]

The pre-1983 social security tax treatment of section 401(k) plan benefits is not a useful guide for determining the social security tax treatment of cafeteria plans. Section 401(k), like section 125, was an outgrowth of the 1972 proposed salary reduction regulations.[116] And, as with statements regarding cafeteria plans, statements in the 1983 congressional committee reports indicated that section 401(k) plan benefits were not subject to social security taxes.[117] However, unlike cafeteria plan benefits, section 401(k) plan benefits had a clear basis for exclusion from social security taxes under the language of section 402(a)(8).[118] By referring to "this title," that is, the entire Internal Revenue Code, section 402(a)(8) made the section 401(k) exclusion applicable to social security taxes as well as the income tax. Thus, until Congress enacted a provision as part of the Social Security Amendments of 1983 making section 401(k) plan benefits subject to social security taxes,[119] those benefits were excluded from social security taxes.[120] No provision comparable to section 402(a)(8) applies section 125 to social security taxes.

The best guide to the social security tax treatment of cafeteria plans seems to be the contrast between the social security tax treatment of contributions to section 403(b) retirement annuity plans under a salary reduction agreement and the income tax treatment of such contributions. Before the enactment of section 403(b) in 1958, the income tax regulations took the position that such contributions were not excludible from gross income under section 403.[121] However,

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(footnote omitted) (citing Bobsee Corp. v. United States, 411 F.2d 231, 237 n.18 (5th Cir. 1969)).

115. *Supra* note 29 and accompanying text. See also Temple Univ. v. United States, 769 F.2d 126 (3d Cir. 1985) (discussed in greater detail *infra* note 127), *pet. for cert. filed,* 54 U.S.L.W. 3584 (Mar. 4, 1986) (No. 85-1401) where one of the grounds the court gave for holding in the Service's favor was the lack of an explicit social security tax exclusion for the salary reduction amounts at issue in that case. *Id.* at 130.

116. *Supra* notes 50-62 and accompanying text.

117. H.R. REP. No. 47, *supra* note 2, at 145-46, *reprinted in* 1983 U.S. CODE CONG. & AD. NEWS 435-36; S. REP. No. 23, *supra* note 3, at 39, *reprinted in* 1983 U.S. CODE CONG. & AD. NEWS 180; H.R. REP. No. 25, *supra* note 3, at 78-79, *reprinted in* 1983 U.S. CODE CONG. & AD. NEWS 297-98.

118. For purposes of this *title,* contributions made by an employer on behalf of an employee to a trust which is a part of a qualified cash or deferred arrangement (as defined in section 401(k)(2)) shall not be treated as distributed or made available to the employee nor as contributions made to the trust by the employee merely because the arrangement includes provisions under which the employee has an election whether the contribution will be made to the trust or received by the employee in cash.

I.R.C. § 402(a)(8) (1982) (emphasis added).

119. I.R.C. § 3121(v) (West 1979 & Supp. 1985) (original version added by Social Security Amendments of 1983, Pub. L. No. 98-21, § 324(a)(1), 97 Stat. 65, 122).

120. The Service relied on section 402(a)(8) to exclude section 401(k) plan benefits from social security taxes in private letter ruling 8213157 (Dec. 31, 1981).

121. *Supra* notes 41-47 and accompanying text.

after the 1958 amendment of the income tax statute, the Treasury and Service issued revised income tax regulations permitting exclusion of such contributions from gross income.[122]

In 1965 the Service published Revenue Ruling 65-208,[123] concerning the social security tax treatment of contributions to section 403(b) annuity plans under a salary reduction agreement. At that time, a general exclusion from the social security tax definition of "wages" covered employer payments for annuities under a retirement plan or system established by the employer.[124] This exclusion did not refer specifically to section 403(b) plans but was broad enough to encompass employer payments to such plans. Notwithstanding this exclusion and the position in the revised income tax regulations regarding salary reduction agreements, Revenue Ruling 65-208 concluded that for social security tax purposes, contributions to section 403(b) plans under a salary reduction agreement are taxable wages as employee payments.[125]

Cafeteria plans parallel in several ways section 403(b) annuities funded by a salary reduction. Both plans have a salary reduction element, and, in both cases, the salary reduction element would have subjected amounts to current income taxation under the approach of the Treasury and Service, because taxable amounts would have been "constructively received." Finally, in both cases Congress passed legislation permitting income tax exclusion of the amounts but not addressing the social security tax consequences.[126]

These parallels suggest that if Revenue Ruling 65-208 was correct in concluding that contributions to section 403(b) plans under a salary reduction agreement are subject to social security taxes, then cafeteria plan benefits also are subject to social security taxes. The statutes prevent only the application of "constructive receipt" principles for income tax purposes. Those principles would continue to apply for purposes of the social security taxes.[127]

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122. *Supra* notes 48-49 and accompanying text.

123. Rev. Rul. 65-208, 1965-2 C.B. 383.

124. I.R.C. § 3121(a)(2)(A) (1982), *repealed by* Social Security Amendments of 1983, Pub. L. No. 98-21, § 324(a)(3), 97 Stat. 65, 123.

125. The result in Rev. Rul. 65-208 was codified by Social Security Amendments of 1983, Pub. L. No. 98-21, § 324(a)(2), 97 Stat. 65, 122-23, *adding* I.R.C. § 3121(a)(5)(E) (Supp. I 1983) (renumbered in 1984 as I.R.C. § 3121(a)(5)(D) (West Supp. 1985)).

126. Congress eventually addressed the social security tax consequences of section 403(b) annuities funded by a salary reduction in 1983. *Supra* note 125.

127. Temple Univ. v. United States, 769 F.2d 126 (3d Cir. 1985), *pet. for cert. filed,* 54 U.S.L.W. (Mar. 4, 1986) (No. 85-1401), determined that Revenue Ruling 65-208 is a correct interpretation of law. *Accord* University Health Center, Inc. v. United States, 1985-2 U.S. TAX Cas. (CCH) ¶ 9746 (D. Vt. Oct. 7, 1985) (which incorporates the reasoning of *Temple University* by reference).

In *Temple University*, the taxpayer filed a claim for refund of social security taxes paid on amounts contributed to section 403(b) annuities under salary reduction agreements in years before 1983, arguing that Revenue Ruling 65-208 was invalid and that the provision codifying it in 1983 (see *supra* note 125) applies only prospectively. 769 F.2d at 128-33. The Third Circuit disagreed with the taxpayer on both these points and denied the taxpayer's refund claim. *Id.* at 129-36. The court found Revenue Ruling 65-208 to be valid for several reasons. First, the ruling has been outstanding and has been applied consistently by the Service since its publication in 1965. *Id.* at 129. Second, Congress considered Revenue Ruling 65-208 to be correct, as evidenced by congressional committee

IV. RECOMMENDATIONS

Although the 1983 congressional committee reports purport to describe the social security tax treatment of cafeteria plans, Congress has not legislated on this subject. Uncertainty remains regarding the social security tax treatment of cafeteria plans under current law. Congress should act to resolve this uncertainty with respect to both future and prior years.

A. *Prospective Social Security Taxation of Cafeteria Plan Benefits*

Congress should enact legislation applicable to future years providing that cafeteria plan benefits are subject to social security taxes, because policy considerations favoring social security taxation of these benefits outweigh policy considerations for exempting them from social security taxes. The policy considerations carrying the greatest weight in determining whether or not cafeteria plan benefits should be subject to social security taxes in the future are those related to the objectives of the social security taxes. These objectives are not the same as the objectives of the income tax.[128] In general, social security taxes are designed to collect the revenue necessary to fund retirement, survivors, disability, and health benefits provided by the social security system. The principal policy concerns are the financial integrity of the system, considering both revenues and expenditures, and the administrability of the system. Other policy concerns should have less significance in decisionmaking.

In weighing these policy concerns, it is important to consider the essential nature of a cafeteria plan. Under a cafeteria plan, employees choose between cash and nontaxable benefits. The nontaxable benefits must be nontaxable under specific provisions of the Code. Thus, a cafeteria plan provision merely prevents

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report statements indicating an intent to codify it. *Id.* Third, the ruling was justified in subjecting salary reduction amounts under section 403(b) plans to social security taxes, even though such amounts are not subject to income tax, because of the different objectives of social security taxes and the income tax and the lack of an explicit social security tax exclusion for the salary reduction amounts at issue. *Id.* at 130. Alternatively, the court determined that even if Revenue Ruling 65-208 were invalid, the codifying provision should be applied retroactively to the years in question. *Id.* at 130-35.

The result in *Temple University* does not necessarily support the social security taxation of cafeteria plan benefits. The Third Circuit's opinion never identifies or analyzes the theoretical grounds for Revenue Ruling 65-208. Thus, the opinion does not consider the correctness of applying "constructive receipt" principles to tax salary reduction amounts. In addition, only one of the three above-mentioned reasons identified by the court for sustaining the validity of Revenue Ruling 65-208 would apply in the case of cafeteria plans: namely, the differing objectives of the income tax and social security taxes coupled with the lack of an explicit social security tax exclusion for cafeteria plans. The Service has no position, let alone a long-standing position, on the social security tax treatment of cafeteria plans. And, rather than endorsing the position that cafeteria plan benefits are subject to social security taxes, congressional committee reports express the opinion that such benefits are not subject to social security taxes. *Supra* text accompanying notes 1-3. Finally, as noted above, the Third Circuit had an alternative ground for its holding, a statutory provision that the court determined was applicable to the years in question, that would not pertain to cafeteria plans.

128. *Supra* note 29 and accompanying text.

the ability to elect between cash and nontaxable benefits from making the otherwise nontaxable benefits taxable. Congress already has made a policy decision in favor of nontaxability relating to each specific exclusion from social security taxes for benefits that might be offered through a cafeteria plan.[129] The only additional policy questions raised by cafeteria plans are those peculiar to the ability to elect between cash and the benefits.[130]

Cafeteria plans have significant implications for the social security revenue base. The flexibility afforded by these plans permits employers to provide a greater variety of nontaxable fringe benefits than would be possible otherwise. The greater variety of benefits available results in an overall higher level of nontaxable benefits for employees, with correspondingly less taxable compensation. Furthermore, this flexibility effectively decentralizes — from the employer to individual employees — the decisionmaking process that determines the amount of nontaxable benefits an employee will receive. The decentralized decisionmaking increases the difficulty of predicting the ultimate revenue loss from cafeteria plans.[131]

Under the assumption that cafeteria plans are not now subject to social security taxes, the Treasury has estimated that such plans will cost the government roughly three billion dollars in social security tax revenues over the five-year period from 1984 to 1989.[132] However, the revenue loss may be larger, if cafeteria plan use grows as more employers and employees become acquainted with the mechanics and tax advantages of such plans.[133] The importance of this

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129. *See, e.g., supra* note 20 and accompanying text.

130. It might be argued that, by themselves, the policy justifications underlying the specific social security tax exclusions for individual benefits that might be offered through a cafeteria plan would justify not taxing these benefits if provided through a cafeteria plan. However, this argument overlooks several considerations.

First, assuming that sound social security tax policy justifications support excluding all of these individual benefits from wages, whether these justifications are adequate to justify the additional revenue loss implicated by cafeteria plans is questionable. *See infra* notes 131-34 and accompanying text. Second, it is doubtful that sound social security tax policy justifications support excluding all of these benefits from wages. *Infra* notes 153-54 and accompanying text. Thus, allowing these benefits to be received free of social security taxes through a cafeteria plan would compound the policy infirmity. Finally, the administrative policy justifications underlying specific exclusions for certain benefits, *see, e.g., infra* note 150 and accompanying text, do not carry over to cafeteria plans. The valuation and factual problems that might justify not taxing these benefits if received individually would disappear if the benefits were offered through a cafeteria plan, since the measure of the taxable amount under a cafeteria plan would be the cash that could have been received, not what actually is received. *Infra* text accompanying note 150.

131. Concern about the revenue impact of flexible compensation led Congress to adopt the 1983 amendments making contributions to section 401(k) plans subject to social security taxes, *supra* note 119 and accompanying text, and codifying the result in Revenue Ruling 65-208 with regard to salary reduction contributions to section 403(b) plans, *supra* note 125. If contributions to these two types of plans were not subject to social security taxes, then "individuals could, in effect, control which portion of their compensation was to be included in the social security wage base. This would make the system partially elective and would undermine the FICA tax base." S. REP. No. 23, *supra* note 3, at 40, *reprinted in* 1983 U.S. CODE CONG. & AD. NEWS 181; H.R. REP. No. 25, *supra* note 3, at 79, *reprinted in* 1983 U.S. CODE CONG. & AD. NEWS 298.

132. *Joint Hearing, supra* note 4, at 1202; *Hearings, supra* note 4, at 423.

133. See *Fringe Benefits: Most Employees Favor Flexible Plans, But Firms Need Worker Feedback, Hewitt*

revenue loss and its unpredictability is magnified by the financial integrity problems of the social security system. Twice in the last decade Congress has had to revisit the issue of social security funding to put the system on a stable course.[134]

Part of the social security tax is dedicated to funding health benefits through the medicare system.[135] Proponents of cafeteria plans claim that such plans can promote health cost containment. If this claim is true, then cafeteria plans could serve a policy related to a social security tax objective by helping to hold down medicare expenditures, thereby improving the fiscal integrity of the system.

Cafeteria plan proponents argue that cafeteria plans can facilitate the goal of shifting employees from a high-cost health plan to a less generous one. Such a change would mean greater employee cost-sharing of medical expenses through plan excludibles, deductibles, and co-insurance and, consequently, would cause the employees to spend less on health care. This lessened demand for health care, in turn, would cause the cost of health care to decline. Proponents argue that the flexibility of a cafeteria plan can facilitate such a health plan redesign by reducing employee resistance to the change. Under a cafeteria plan, employees who are so inclined could swap some health coverage[136] for more salary, while others who want more health coverage could forego the greater salary to obtain that coverage.[137]

However, a recent report prepared by the Department of Health and Human Services[138] determines that cafeteria plans undermine rather than foster health care cost containment. The report concludes that certain types of cafeteria plans — those without flexible spending accounts[139] — could help contain health costs,[140]

Survey Shows, Daily Tax Rep. (BNA), June 7, 1985, at G-1 (summarizing findings of an employee survey conducted by Hewitt Associates), which states that in new flexible programs employees generally favor plans most similar to their old (nonflexible) plans, rather than plans with the highest benefits or the cheapest cost, but that in subsequent years, when given a choice between cash and additional flexible benefits, 30% of employees elect the extra benefits as they begin to understand the tax-effectiveness of benefits.

134. Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65; Social Security Amendments of 1977, Pub. L. No. 95-216, 91 Stat. 1509.

135. I.R.C. §§ 3101(b), 3111(b) (1982).

136. As used here, health coverage includes not only health plan benefits but also reimbursements through a "flexible spending account" (defined *infra* note 139) for an employee's share of medical expenses under the health plan (that is, excludibles, deductibles, and coinsurance).

137. *See generally* OFFICE OF THE ASSISTANT SECRETARY FOR PLANNING & EVALUATION, U.S. DEP'T OF HEALTH & HUMAN SERVS., A STUDY OF CAFETERIA PLANS AND FLEXIBLE SPENDING ACCOUNTS 20-25 (1985) (discussing the facilitation role for "flexible spending accounts" (defined *infra* note 139)) [hereinafter cited as STUDY].

138. *Id.* The report was mandated by Tax Reform Act of 1984, Pub. L. No. 98-369, § 531(b)(6), 98 Stat. 494, 883-84.

139. STUDY, *supra* note 137, at 3, states:

> A flexible spending account is an arrangement providing for a dollar-denominated account in an employee's name available for reimbursement of certain of the employee's personal expenses. Qualifying expenses include out-of-pocket health spending, dependent care, employee health insurance premium contributions, and certain other expenses. (The study investigates FSAs only as they are used to reimburse health care expenses.)

140. *Id.* at 36-43, 50.

but that those with flexible spending accounts increase health costs.[141] On balance, the report finds that most cafeteria plans are likely to have flexible spending accounts,[142] so the overall effect of cafeteria plans is to significantly increase health costs.[143] Moreover, the report determines that preventing flexible spending accounts from being included in cafeteria plans that provide health benefits would be impossible.[144]

The report acknowledges that an employer might introduce a cafeteria plan with a flexible spending account to facilitate a shift to a lower-cost health care plan.[145] However, a flexible spending account counteracts the health cost containment effect of such a shift by permitting employees to pay the higher excludibles, deductibles, and coinsurance under the less generous plan with before-tax dollars, giving employees an incentive to spend more on health care.[146] For employers with high-cost health plans (those with little or no employee cost sharing), the combination of the shift to a lower-cost health plan and the flexible spending account could produce net health cost containment.[147] But for employers who currently have less generous plans, the report estimates that the amount of cost-sharing increase necessary to offset the effect of the flexible spending account far exceeds the amount of cost sharing employers or employees are likely to find acceptable.[148] Since the great majority of employees work for firms with less generous health plans, the aggregate effect of introducing cafeteria plans with flexible spending accounts to facilitate a shift to lower-cost health plans would be to significantly increase health care spending and, thus, health care costs.[149]

The policy goal of better administration of social security taxes would not be advanced measurably by excluding cafeteria plan benefits from those taxes. Taxability would hinge on the relatively simple determination of whether benefits were being offered through a cafeteria plan, that is, whether employees had a choice between cash and otherwise nontaxable benefits. If so, the em-

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141. *Id.* at 16-32, 49-50.

142. *Id.* at 43.

143. *See id.* at 43-44.

144. Essentially, the report concludes that since salary reduction is the basis for both cafeteria plans and flexible spending accounts, flexible spending accounts are inherent in the concept of cafeteria plans permitted under section 125. Thus, eliminating health care flexible spending accounts would require prohibiting health benefits from being included in cafeteria plans. *Id.* at 43-44, 50-51. *See generally id.* at A1-5 to A1-10 (discussing the relationship between flexible spending accounts and cafeteria plans).

145. *Id.* at 25.

146. *Id.* at 16-25. A flexible spending account that is part of a qualified cafeteria plan permits an employee to obtain nontaxable reimbursements for the employee's share of the cost (excludibles, deductibles, and coinsurance) under the employee's health plan, a cost that would otherwise be paid by the employee in after-tax dollars.

147. *Id.* at 21-25.

148. *Id.* at 24-25.

149. *See id.* at 25. An industry group has contested the findings of the report. *Fringe Benefits: HHS Report Blasts Cafeteria Plans for Raising Health Costs, Reducing Revenues*, Daily Tax Rep. (BNA), Aug. 6, 1985, at G-1 (report called "theoretical" and "not based on reality" by William Sollee, counsel to the Employer's Council on Flexible Compensation).

ployees would be subject to social security taxes to the extent of the cash they could have received, even if they chose otherwise nontaxable benefits. This determination does not entail difficult factual inquiries or valuation problems of the sort that have prompted Congress in recent years to exclude certain types of fringe benefits from social security taxes.[150] True, any differences between the rules governing income taxation and those governing social security taxation complicate administration of both types of taxes to some extent. However, because income taxes and social security taxes have different objectives,[151] the rules will differ. This source of complexity is unavoidable.

Cafeteria plans can help to achieve a broad societal goal of making privately financed welfare benefits more generally available to lower-paid workers. These workers do not have the bargaining power characteristic of highly compensated individuals to negotiate a benefits package suited to their needs. The flexibility of a cafeteria plan offers these workers an opportunity to trade off a reduction in salary for desired benefits. Providing tax incentives for plans that serve this goal may be an attractive alternative to direct government funding of needed welfare benefits that, absent the tax incentives, would not be made available by private sector sources. The necessary prerequisite would be that qualification for the preferred tax treatment requires that the plan not discriminate in favor of highly compensated individuals.[152]

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150. *See* H.R. REP. No. 432, 98th Cong., 2d Sess. 1591-92, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 697, 1215-16; STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 840-43 (Comm. Print 1984) (both reports explaining the administrative considerations that led to the enactment of I.R.C. § 3121(a)(20) (West Supp. 1985), which excludes certain categories of fringe benefits from the social security tax definition of "wages"); S. REP. No. 1263, *supra* note 112, at 100-01, 103, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 6863-64, 6866 (discussing the administrative considerations that led to the enactment of I.R.C. § 3121(a)(18) (Supp. IV 1980) (amended 1981), which excludes qualified educational assistance from wages).

151. *Supra* note 29 and accompanying text.

152. Nondiscrimination requirements are designed to counteract the natural tendency of lower-paid workers to choose compensation in the form of cash rather than nontaxable benefits. These workers have less resources to commit to benefits and, because of their lower tax brackets, are less likely to respond to tax incentives than are highly compensated individuals. Making nondiscrimination a condition for qualification of a plan requires employers to induce sufficient participation by lower-paid employees by encouragement, education, or other means. Halperin, *Cash or Deferred Profit-Sharing Plans and Cafeteria Plans*, 41 INST. ON FED. TAX'N §§ 39.01-.03 (1983).

I.R.C. § 125(b), (c), (e) & (g) (West 1984 & Supp. 1985) contains nondiscrimination rules applicable to cafeteria plans for income tax purposes. In addition, various income tax exclusions for the specific benefits that might be offered through a cafeteria plan have their own nondiscrimination rules which also must be satisfied if the benefits are to be received free of income tax. *See, e.g., id.* §§ 79(d), 105(h), 120(c), 129(d) (prescribing nondiscrimination requirements for employer-provided group-term life insurance, self-insured medical expense reimbursement plans, qualified group legal services plans, and dependent care assistance programs, respectively).

The specific social security tax exclusions for benefits that might be offered through a cafeteria plan are less likely to contain their own nondiscrimination rules than are their income tax counterparts. For example, group-term life insurance and self-insured medical expense reimbursement plans need not be nondiscriminatory to qualify for exclusion from social security taxes. I.R.C. § 3121(a)(2)(C), (B) (Supp. I 1983) (respectively). On the other hand, certain exclusions from social security taxes incorporate the corresponding income tax exclusion by reference, thereby establishing

Yet this worthwhile policy goal has, at best, a tenuous relationship to the objectives of social security taxes. Improving the general welfare of the working-age population is not a mission of the social security system. Moreover, granting cafeteria plans social security tax-preferred treatment to stimulate private sector initiatives creates a drain on the social security revenue base without a corresponding financial benefit to the system. Any direct government funding of welfare benefits designed to compensate for the lack of private sector initiatives most likely would come from general revenues rather than from social security funds. Thus, the tax incentives for cafeteria plans should be financed from income taxes, the revenue source that would be relieved of the direct funding burden by the private sector initiatives.[153]

Thus, cafeteria plan benefits should be subject prospectively to social security taxes. Not taxing these benefits means a substantial revenue loss for the social security system. That revenue loss cannot be justified, given the failure of cafeteria plans to advance policy goals related to the objectives of the social security taxes.[154]

B. *Retroactive Relief from Social Security Taxation of Cafeteria Plan Benefits*

Congress should enact legislation applicable to prior years excepting benefits received through a cafeteria plan from social security taxes, if the plan satisfied the requirements of section 125 and a specific exclusion from the definition of "wages" under section 3121(a) applied to the benefits received. Although Con-

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the income tax nondiscrimination rule as a requirement for the social security tax exclusion as well. *See, e.g., id.* § 3121(a)(17), (18) (referring respectively to I.R.C. §§ 120, 129 (West 1984 & Supp. 1985)).

153. Some of the exclusions from the social security tax wage base added by Congress in recent years no doubt are designed to encourage private general welfare initiatives. *See, e.g.*, I.R.C. § 3121(a)(17) (Supp. I 1983) (providing an exclusion for qualified group legal services); *id.* § 3121(a)(18) (providing exclusions for qualified educational assistance and dependent care assistance). However, the two exclusions contained in § 3121(a)(18) arguably also serve policies related to social security tax objectives, because they provide upward mobility and work incentives that in the long run can produce higher earnings for individuals and, hence, an enlarged social security tax wage base. *See* STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 53-54, 56 (Comm. Print 1981) (mentioning the work incentive justification in discussing the dependent care assistance exclusion); S. REP. No. 1263, *supra* note 112, at 101, 103, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 6864, 6866 (noting the upward mobility justification for qualified educational assistance). See *infra* note 154 with respect to the exclusion provided by § 3121(a)(17).

154. Admittedly, not all exclusions from the social security tax wage base meet this standard. *See, e.g.*, I.R.C. § 3121(a)(17) (Supp. I 1983) (excluding employer payments for qualified group legal services). However, that existing exclusions fail to meet this standard does not mean that more should be added. In 1983 when Congress codified the holding of Rowan Cos. v. United States, 452 U.S. 247 (1981), that the value of meals and lodging furnished for the convenience of the employer are not wages for social security tax purposes, Congress also rejected the broad dictum of that case that wages are necessarily the same for purposes of social security taxes and income tax withholding. Congress indicated that social security tax exclusions should serve social security tax objectives. *Supra* notes 27-29 and accompanying text. That, in essence, is the standard being used here.

gress ordinarily does not enact legislation clarifying the tax treatment of items for prior years, the social security tax treatment of cafeteria plans is a special case. The 1983 congressional committee report statements evidently have led many to believe that cafeteria plan benefits generally are not subject to social security taxes.[155] In the interest of fairness, the social security tax treatment of cafeteria plans for prior years should be consistent with these statements. These statements, which follow a citation to section 125, apparently referred to cafeteria plan benefits that qualify under section 125. Moreover, because section 125 only operates as an exception to "constructive receipt," specific social security tax exclusions for the benefits received are necessary to render the benefits nontaxable. This reading is consistent with the use in the statements of the word "generally," which suggests that not all cafeteria plan benefits that qualify for exclusion from income tax qualify for exclusion from social security taxes. Thus, these two requirements — satisfaction of section 125 and the existence of specific social security tax exclusions for benefits received — together should determine whether benefits received in prior years are subject to social security taxes.[156]

V. Conclusion

The social security tax treatment of cafeteria plans under current law is unclear, notwithstanding statements in the 1983 congressional committee reports to the effect that cafeteria plan benefits generally are not subject to social security taxes. Section 125 provides an income tax exclusion for cafeteria plan benefits, but Congress enacted no social security tax counterpart to section 125. Whether a special provision similar to section 125 is necessary to prevent social security taxation of cafeteria plan benefits and whether section 125 serves as such a special provision by applying to social security taxes as well as the income tax are open questions. These open questions give rise to the uncertainty over the social security tax treatment of cafeteria plans.

The Treasury and Service currently have no position concerning the social security tax treatment of cafeteria plans. However, a cafeteria plan is a form of salary reduction arrangement, and, under the Treasury and Service approach, salary reduction amounts are subject to income and social security taxes, except in the case of salary reduction arrangements that have been the subject of specific legislation. If this approach is correct, then cafeteria plan benefits are subject to social security taxes, absent a special provision excluding cafeteria plan benefits from social security taxes. If the approach of the Treasury and Service concerning the taxation of salary reduction arrangements is incorrect, then such a special provision is unnecessary, and cafeteria plan benefits are not

155. *See supra* notes 1-6 and accompanying text.

156. Although most taxpayers apparently have been treating cafeteria plan benefits as not subject to social security taxes, some taxpayers may have paid social security taxes with respect to these benefits. Therefore, Congress might want to determine the potential refund claim liability before deciding whether to provide retroactive relief from social security taxes for cafeteria plan benefits.

subject to social security taxes. Whether the approach of the Treasury and Service to the taxation of salary reduction arrangements is correct remains unclear. Thus, whether a special provision similar to section 125 is necessary to prevent the social security taxation of cafeteria plan benefits likewise remains uncertain.

Assuming that such a special provision is necessary to prevent the social security taxation of cafeteria plan benefits, then arguably section 125 serves as such a special provision by applying to social security taxes as well as the income tax. This argument is not supported by the language or the legislative history of section 125 and appears to be inconsistent with the Service's approach to the social security tax treatment of salary reduction amounts under section 403(b) retirement annuity plans. The best argument to be made in favor of applying section 125 to social security taxes is that the 1983 congressional committee report statements support this application. However, these statements should be accorded only limited weight in interpreting section 125, since they are not part of its legislative history.

Because the social security tax treatment of cafeteria plans is unclear, Congress should act to resolve the uncertainty by passing legislation governing this treatment for both future and prior years. With respect to future years, the legislation should provide that cafeteria plan benefits are subject to social security taxes, based on an analysis of the social security tax policy considerations implicated by cafeteria plans. Not taxing these benefits means a substantial revenue loss for the social security system that is unjustifiable in view of the failure of cafeteria plans to advance policy goals related to the objectives of the social security taxes. With respect to prior years, the legislation should provide that cafeteria plan benefits are not subject to social security taxes, if certain conditions are met. Because the 1983 congressional committee report statements evidently have led many to believe that cafeteria plan benefits generally are not subject to social security taxes, fairness mandates that the social security tax treatment of cafeteria plans for prior years be consistent with these statements.