

MEMORANDUM OF LAW

DATE: March 21, 1988

TO: D. Cruz Gonzalez, Risk Management Director
FROM: City Attorney
SUBJECT: IDS Financial Planning/Prudential Legal
Services

You have asked this office the following questions concerning the effect of the Tax Reform Act of 1986, Public Law 99-514 100 Stats. 2085 on The City of San Diego's Flexible Benefits Plan.

1. May group legal services be included as a tax exempt benefit in the FY 1989 Flexible Benefits program?
2. Should the FY 1989 Flexible Benefits program exclude all taxable benefits other than cash?

At the present time, the term "cafeteria plan" is defined by Subsection 125(d)(1) of the Internal Revenue Code as ". . . a written plan under which - (A) all participants are employees, and (B) the participants may choose among 2 or more benefits consisting of cash and qualified benefits."

Subsection (f) of Section 125 defines qualified benefits as follows:

For purposes of this section the term "qualified benefit" means any benefit which, with the application of subsection (a), is not includible in the gross income of the employee by reason of an expressed provision of this chapter (other than section 117, 124, 127 or 132). Such term includes any group term life insurance which is includible in gross income only because it exceeds the dollar limitation of section 79 and such term includes any other benefits included under regulations.

After December 31, 1987, amounts received under a qualified group legal service plan are no longer exempt from gross income of an employee under Section 120 of Chapter 1 of the Internal Revenue Code. Because this benefit is no longer exempt by reason of an express provision of Chapter 1 of the Internal Revenue Code, we believe that it is not a qualified benefit under Section 125 and should not be offered in The City of San Diego's Flexible Benefits Plan.

In previous years, The City of San Diego included a financial planning service in the Flexible Benefits Plan but, because it was not a benefit that was specifically excluded from gross

income under the Internal Revenue Code, it was subject to withholding in the same manner as a cash distribution. We no longer believe that the inclusion of such a benefit in the Flexible Benefits Plan is prudent.

Section 1151 of the Tax Reform Act of 1986 provides that certain amendments to Section 125 become effective either three months after the date the Secretary of the Treasury issues regulations necessary to carry out Section 89 of the Internal Revenue Code, or December 31, 1988, whichever is earlier. One of these amendments provides that the participants in a cafeteria plan may choose only among two or more benefits consisting of cash and qualified benefits or among two or more qualified benefits.

It appears clear from the language of these amendments that a plan that contains a nonqualified benefit will fail to meet the new requirements of Section 125 of the Internal Revenue Code. We therefore recommend that The City of San Diego not offer any taxable benefits except cash in the FY 1989 Flexible Benefits program.

JOHN W. WITT, City Attorney

By

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Deputy City Attorney

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