Tax Impact

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Tax Tips

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Is your cafeteria plan in compliance?

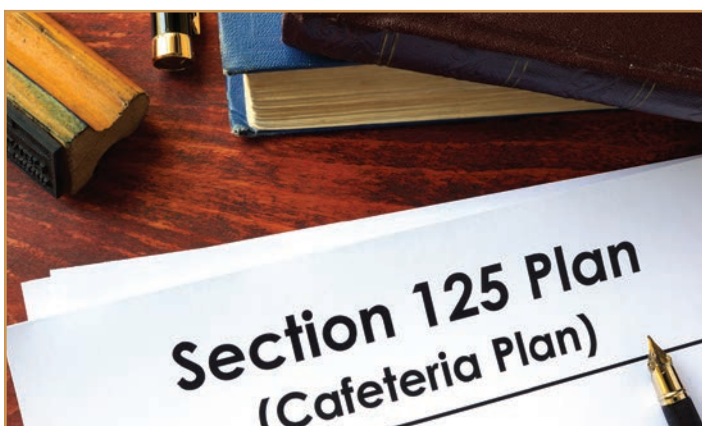
Common mistakes can be a recipe for disaster

Cafeteria plans can be an attractive and cost-effective tool for offering benefits to employees, providing substantial tax savings for employer and employees alike. But all too often, businesses fail to fully appreciate the requirements that must be met to achieve these savings. One misstep could turn years of pretax salary reductions into taxable compensation, with potentially disastrous results.

How cafeteria plans work

A cafeteria plan — also known as a Section 125 plan — gives employees a choice between receiving compensation in cash (which is taxable) or selecting from a menu of tax-free benefits. Benefits offered may include group term life insurance, accident and health plans, dependent care assistance, and adoption assistance. Benefits are funded by salary reductions, allowing employees to purchase them with pretax dollars (thereby avoiding both income and payroll taxes) and relieving the employer from payroll taxes on those amounts.

Many cafeteria plans are premium-only plans (POPs) or Flexible Spending Account (FSA) plans. With a POP, the employer sets aside a portion of employees' pretax earnings to pay, for example, health insurance premiums. FSAs are like savings accounts employees can use to pay unreimbursed medical expenses (for themselves and their dependents) or certain dependent care expenses. At the beginning of each plan year, employees estimate their expenses for the year and determine how much to contribute to their FSAs through salary reductions over the year (subject to applicable limits).



FSAs generally are subject to a "use it or lose it" requirement. In other words, a participant who overestimates his or her expenses for the year will forfeit any balance remaining in the account at the end of the year. However, at the option of the employer, a plan may provide relief in the form of either 1) a grace period of up to 2½ months after the end of the plan year in which participants can use the remaining funds to pay eligible expenses, or 2) a "rollover" of up to $500 in unused funds to the following plan year.

Mistakes to avoid

Cafeteria plans have become so common that employers — especially small businesses — often underestimate what's required to establish and maintain one. Here are some common mistakes to avoid:

Not putting it in writing. Some businesses don't realize that a cafeteria plan must be in writing. Sec. 125 requires that details of the plan be included in a written document signed by the employer on or before the first day of the plan year.

Offering benefits to ineligible employees. Only employees may participate in a cafeteria plan (although benefits are available for

IRS relaxes cafeteria plan rules in light of COVID-19

To help employees affected by the COVID-19 pandemic, the IRS recently issued guidance allowing businesses with cafeteria plans to relax certain requirements for 2020. Permitted changes include:

- Allowing participants to make certain midyear elections to change their health coverage prospectively — for example, by enrolling in or dropping coverage, changing coverage options, enrolling new dependents, or adjusting FSA contributions; ordinarily, these elections must be made before the plan year begins or in the event of certain changes in status, such as marriage, divorce, death or the birth of a child,

- Increasing the maximum FSA balance that may be rolled over to the following year from $500 to $550, and

- For grace periods or plan years ending in 2020, extending the period during which unused FSA funds may be applied to health or dependent care expenses through the end of the year.

Keep in mind that this relief is optional and is available only if an employer modifies its plan.

their spouses or dependents). For purposes of eligibility, employees don't include sole proprietors, partners in a partnership or more than 2% shareholders in S corporations. Businesses that offer benefits to nonemployees risk disqualification.

Failing to comply with ERISA requirements. Cafeteria plans are subject to the Employee Retirement Income Security Act (ERISA), which imposes a variety of recordkeeping, notice and reporting requirements. It may also require a trust fund to be established to hold certain plan assets.

Failing to test for nondiscrimination. Like other ERISA plans, cafeteria plans must meet nondiscrimination requirements and test regularly for compliance. In general, employers must ensure that their plans don't discriminate in favor of highly compensated or key employees with respect to eligibility, contributions or benefits. Nondiscrimination testing should be performed at least annually, although interim testing is advisable if changing circumstances indicate a risk of noncompliance.

Businesses with fewer than 100 employees may be eligible to establish a "simple cafeteria plan." These plans offer simplified discrimination testing, so long as the employer provides a minimum level of benefits to all eligible rank-and-file employees.

> ***Cafeteria plans have become so common that employers often underestimate what's required to establish and maintain one.***

Review your plan

If your business has a cafeteria plan, it's a good idea to review it periodically to ensure that it complies with IRS requirements. If you're uncertain about your obligations under Sec. 125, ask your tax advisor for assistance. ■

The spousal lifetime access trust

Uncertain economic times call for flexibility

One of the many lessons resulting from the COVID-19 pandemic and resulting economic downturn is that it's imperative to build flexibility into your estate plan. Indeed, many people had been taking advantage of the current, record-high gift and estate tax exemption by gifting assets tax-free to family members.

But then circumstances drastically changed earlier this year, and many are now much more reluctant to give away substantial amounts of wealth, for fear that they may need access to it down the road. This is where a spousal lifetime access trust (SLAT) may work to your advantage.

What is a SLAT?

Under the right circumstances, a SLAT allows you to remove significant wealth from your estate tax-free while providing a safety net in the event your needs change in the future. This trust type is an irrevocable trust that permits you, as trustee, to make distributions to your spouse, during his or her lifetime, if a need arises.

Typically, SLATs are designed to benefit your children or other heirs, while paying income to your spouse during his or her lifetime. You can make completed gifts to the trust, removing those assets from your estate. But you continue to have *indirect* access to the trust by virtue of your spouse's status as a beneficiary. Usually, this is accomplished by appointing an independent trustee with full discretion to make spousal distributions.

SLATs must be designed carefully to ensure that they achieve your objectives and that the trust assets aren't included in your spouse's estate.

What are the pitfalls?

SLATs provide welcome flexibility in uncertain times, but they must be planned and drafted carefully to avoid potential pitfalls. For example, to ensure that the assets are removed from your estate, you shouldn't serve as trustee. It's possible to name your spouse as trustee, but be aware that, if you do, distributions from the trust generally will be limited to those necessary for his or her health, education, maintenance or support. The trust should also prohibit distributions that would satisfy *your* legal obligation of support to your spouse.

To avoid inclusion of trust assets in your spouse's estate, your gifts to the trust must be made with your separate property. This may require additional planning, especially if you live in a community property state. And after the trust is funded, it's critical to ensure that the trust assets aren't commingled with community property or marital assets.

Keep in mind that a SLAT's benefits depend on indirect access to the trust through your spouse, so your marriage must be strong for this strategy

to work. There's also a risk that you'll lose the safety net provided by a SLAT if your spouse predeceases you. One way to hedge your bets is to set up two SLATs: one created by you with your spouse as a beneficiary and one created by your spouse naming you as a beneficiary.

If you and your spouse each establish a SLAT, you'll need to plan carefully to avoid the reciprocal trust doctrine. Under that doctrine, if the IRS concludes that the two trusts are interrelated and place you and your spouse in about the same economic position as if you had each created a trust for your own respective benefit, it may undo the arrangement. In other words, the IRS may treat each trust as if the grantor had named him- or herself as a life beneficiary, thereby erasing the tax benefits. To avoid this outcome, the trusts' terms should be varied so that they're not substantially identical.

Revisit your estate plan

Building flexibility into your estate plan is well worth your time — especially during times of economic uncertainty. A SLAT provides you the option of retaining some access to your money while taking advantage of tax-free wealth transfers. Talk to your estate planning advisor to learn whether a SLAT is right for you. ■

Year-end tax planning for investors

For investors, 2020 has been marked by volatility and uncertainty. As we approach the end of the year, it's a good idea to review your portfolio and consider strategies for reducing your tax bill, improving your cash flow and positioning yourself for future growth. Let's take a closer look at a few tax planning moves worth exploring.

Convert to a Roth IRA

If you've been considering converting a traditional IRA or 401(k) plan into a Roth IRA account, now may be an ideal time. Roth accounts offer many benefits, including tax-free earnings and withdrawals and no required minimum distributions (RMDs) after you reach a certain age.

Contributions to these plans are nondeductible, however, so it's important to weigh the benefits of a Roth down the road against the loss of deductions up front. Generally speaking, you're better off with a Roth account if you expect your income tax rate to be higher when you withdraw the funds than it is when you contribute them. And some experts predict that the government will raise tax rates in the future to help pay for the debt incurred to address the COVID-19 pandemic.

If you've been considering converting a traditional IRA or 401(k) plan into a Roth IRA account, now may be an ideal time.

When you complete a Roth conversion, the amount converted is fully or partially taxable. However, if the value of your account has declined this year, you have an opportunity to minimize the tax cost. And that cost may decrease even further if a reduction in income this year has dropped you into a lower tax bracket.

Harvest losses

Tax-loss harvesting simply means selling poor-performing investments to realize capital losses you can offset against capital gains you realized earlier in the year or expect to realize during the remainder of the year. If you end up with a net loss, you can use it to offset up to $3,000 in ordinary income, such as wages or interest.

Harvesting losses can be an effective strategy for reducing your tax bill, but that doesn't mean you should sell off all your losing investments strictly for tax purposes. Rather, it's an opportunity to rid yourself of investments that are unlikely to bounce back and replace them with investments whose long-term prospects are strong.

Diversify

Diversification is a fundamental principle of sound investing. By investing in a variety of asset classes, funds, companies, industries and geographical regions, you minimize the risk that poor performance in one area will have a negative impact on your overall portfolio. Although there are no guarantees, a properly diversified portfolio, which includes assets that tend to perform differently under various market conditions, improves the chances that some investments will perform well at any given time.

Even the most carefully diversified portfolio can get out of balance over time, so it's important to monitor your asset allocation and rebalance your portfolio periodically to ensure the right mix of investments. Doing so can come at a tax cost, however, as you sell some assets and invest the proceeds in others. An economic downturn may create an opportunity to make changes to your portfolio while minimizing the tax cost.

Donate appreciated stock

If you plan to make charitable contributions this year, consider donating appreciated publicly traded stock that you otherwise planned to sell. Even if a stock's value has declined this year, it may be worth more than you originally paid for it and, therefore, would trigger capital gains taxes and possibly net investment income taxes. By donating the stock directly to a qualified charity, you'll avoid those taxes while still claiming a charitable deduction equal to the stock's market value.

Note, however, that this year there are additional considerations. The CARES Act temporarily increased, to 100%, the deduction limit for certain cash contributions. Depending on the specifics, therefore, tax-wise you may be better off selling the stock and donating the cash.

Look at the big picture

Tax planning is important, but it's just one of many factors to examine as you review your investment choices. As you explore the potential strategies, don't lose sight of the big picture: Investment decisions should be based on your overall financial situation and should never be driven by tax considerations alone. Before taking action, talk to your tax advisor about the right year-end strategies for your specific situation. ■

Refund opportunity for excess business losses

The Tax Cuts and Jobs Act (TCJA) limited the ability of noncorporate taxpayers — such as sole proprietors, partnerships and S corporations — to offset business losses against income from other sources. For 2018 through 2025, the TCJA limits deductions of "net business losses" to $250,000 ($500,000 for joint filers), adjusted for inflation. Disallowed losses may be carried forward to future tax years according to net operating loss (NOL) rules.

This year's Coronavirus Aid, Relief and Economic Security (CARES) Act suspended these limits for 2018 through 2020, making business losses fully deductible in those years. If your losses were reduced on your 2018 or 2019 tax returns, you may have an opportunity to amend those returns and claim a refund of overpaid taxes during those years. ■

Extra time to invest in Qualified Opportunity Funds

If you recognized capital gains in late 2019 or early 2020, it's not too late to reinvest those gains in a Qualified Opportunity Fund (QOF). QOFs are funds that invest in one of nearly 9,000 economically distressed Qualified Opportunity Zones designated by the Tax Cuts and Jobs Act. QOF investors enjoy a variety of benefits, including deferral of tax on reinvested gains and permanent reduction of gains on investments that meet certain holding period requirements.

Generally, to qualify for these benefits, you must invest gains in a QOF within 180 days after the sale or exchange of the capital assets that generated them. But in Notice 2020-39, the IRS extended this deadline. If you sold assets for a gain that's eligible for investment in a QOF, and the 180th day would have fallen on or after April 1, 2020, and before December 31, 2020, you now have until December 31, 2020, to invest that gain in a QOF. ■

Retirement plan elections may be signed remotely

In response to the COVID-19 pandemic and the need for social distancing, the IRS issued Notice 2020-42, providing temporary relief from the requirement that certain retirement plan elections, including spousal consents, be signed in the physical presence of a plan representative or notary public. Through the end of 2020, this requirement will be deemed satisfied for elections executed using live audio-video technology, provided certain procedures are followed. The guidance is intended to facilitate coronavirus-related distributions and plan loans according to the CARES Act. However, the temporary relief applies to any election that requires a signature in the presence of a plan representative or notary. ■

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