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LEGAL PROCESSING DIVISION  
PUBLICATION & REGULATIONS  
BRANCH

October 26, 2007

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CC:PA:LPD:PR (REG-142695-05) Room 5203  
Internal Revenue service  
P.O. Box 7604  
Ben Franklin station  
Washington, DC 20044

RE: Section 125 Proposed Rules (IRS REG-142695-05)

Dear Sir/Madam:

Thank you for providing the opportunity to comment on the proposed Section 125 regulations. As a benefit consulting firm, Charon Planning Corporation assists employers with the designing of their benefit programs. Based on our experience with our clients and their plans, we have the following comments.

1. Section 1.125-1 (a) (1) – The proposed definition of a cafeteria plan is that the Section 125 plan is a “*separate* written plan” Further, the regulations indicate that only qualified benefits may be offered under the plan. These comments also apply to 1.125-1(c)(7)(ii)(B), 1.125-1(i), and 1.125-1(q) (vii).

Could you please clarify whether or not the following plan would comply with all of the above sections of the proposed regulations? An employer sponsors one plan that covers all the company’s health and welfare benefits (the 401(k) plan is separate and no 401(k) benefits run through the health and welfare plan).

The plan document clearly identifies which benefits are paid fully by the employer, i.e. group term life, business travel accident, etc. The plan also describes which can be paid pre-tax, which benefits if paid pre-tax will result in taxation upon receipt of the benefit, and those benefits that can only be paid post-tax, i.e. employee voluntary life and *supplemental life for spouses/children*.

Would this plan be a compliant “cafeteria plan”. If not, it is hoped that such an approach will be reconsidered and adopted when the proposed regulations are finalized.

2. Section 1.125-1(4) – Election by participant. Examples 4 (ii) and (v). Could you please clarify the difference where under (ii) it appears that the employer can require certification of other coverage or require the employee to take health coverage and that would apply to Section 125 but where (v) a participant cannot certify other coverage, it is not covered under Section 125/

3. Section 1.125-2(d) – Optional election for new employees.
  - a. Could you please clarify or provide an example of what the phrase “compensation not yet currently available” means?
  - b. Please consider permitting the new hire “retroactive” 30-day benefit provision to be extended to annual elections and when there has been any qualified status event change.
4. Section 1.125-5(2) – Maximum amount of reimbursement. Could you please provide examples of what phrase “maximum amount of reimbursement is not substantially in excess of the total salary reduction and employer flex credit if such maximum is less than 500 percent of the combined salary reduction and employer flex credit means?” Does this mean that if an employee has a total pre-tax annual election amount of \$5,000 the employer could not offer flex credits of more than \$20,000?
5. Section 1.125-5 (k)(3) Application of prohibition against deferred compensation to medical expenses. Given the similarity between how orthodontia is paid and how pre-natal care is paid, consideration should be given to extending the same reimbursement schedule to pre-natal care.
6. Section 1.125-7 Cafeteria plan nondiscrimination rules.
  - a. It would be helpful if the same definition of highly compensated individual, participant, and employee was consistent for Section 125 and the underlying benefits permitted to be offered under a Section 125 plan, i.e. 79, 105, and 129,
  - b. Also it would be helpful if the same employee classes could be excluded from all the tests (Section 125, 105, 129, etc.)
  - c. The testing of the plan on the last day of the plan year does not afford the employer the ability to correct any deficiencies. For example, if the dependent care plan fails the 55% test, it would be helpful to know this during the year.
  - d. Could the Section 129 discrimination testing be revised so that only those employees with eligible dependents would be subject to the testing?
  - e. Please provide examples of the how to determine the penalty for discriminatory Section 125 plan. Specifically how is the “value of the taxable benefit with the greatest value that the employee could have elected to receive even if the employee elects to receive only the nontaxable benefits offered.”
    - i. Does this mean that if an HCE does not receive any tax benefit from the plan and the plan fails the discrimination tests, that HCE is taxed again on the cash he received for not participating? For example, the highest cost medical plan is \$5,000 per year, an HCE does not elect any medical benefit and receives the \$5,000 as taxable income, i.e. cash. If the Section 125 plan fails, is the HCE taxed again on the \$5,000?
    - ii. If the HCE does not have any dependents but there is a dependent care spending account benefit offered under the cafeteria plan with a

maximum benefit of \$5,000 and the plan fails, is the HCE given the \$5,000 as imputed income?

- iii. A cafeteria plan offers several medical plan options with the most costly being \$11,000 for family coverage, a healthcare spending account benefit with a maximum of \$5,000, and a dependent care spending account benefit with a maximum of \$5,000 and the plan fails. An HCE receives no pretax benefit, will s/he receive \$21,000 in imputed income?
7. This is not specifically addressed in the proposed regulations. A number of states are requiring that certain individuals must be able to continue health coverage in an employer's plan even if they are not the employee's tax dependent. For example, in New Hampshire, divorced spouses must be allowed to continue coverage after the divorce and the cost must be the same as for "spouses"; therefore there is employer subsidy involved and, under the tax regulations cannot be paid with pretax dollars plus the employee receives imputed income. This is the same situation when the state requires that children continue under the group plan up to a certain age and the state does not require that the "child" is the employee's tax dependent.

Since this is a state mandate, it seems improper that the employee and the employer should be penalized with the inability to pay these benefits pretax and also receive imputed income these amounts. Therefore, it is suggested that when a state mandates that benefits be extended to certain individuals who are not the employee's federal tax dependent that such benefits be permitted to be paid pretax and that imputed income would not be incurred.

Thank you again and if you have any questions concerning these comments please contact me.

Sincerely,



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