



REG-142695-05

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Express Mail

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

LEGAL PROCESSING DIVISION  
PUBLICATION & REGULATIONS  
BRANCH

Re: Cafeteria Plan Proposed Regulations

Gentlemen:

The following are comments and questions that we have regarding the proposed cafeteria plan regulations under section 125 of the Internal Revenue Code (the "Code") published at 72 FR 43938 (August 6, 2007) (the "Proposed Regulations").

**Application of Experience Gains (Forfeitures)**

Section 1.125-5(o)(1) of the Proposed Regulations states that experience gains or forfeitures may be "retained by the employer maintaining the plan", or if not retained by the employer, used in one of three ways. Further, the preamble to the Proposed Regulations states that the "new proposed regulations...clarify that the employer sponsoring the cafeteria plan may retain forfeitures..." 72 FR 43943.

The Proposed Regulations (as well as the preamble) should only retain that language **if it made clear** that the retaining of forfeitures by the employer may violate other applicable Federal or state laws. For example, a medical flexible spending account under a cafeteria plan that is maintained by a private sector employer constitutes a group health plan that is subject to the Employee Retirement Income Security Act (ERISA). The U.S. Department of Labor stated its position that employee contributions to a medical flexible spending account are plan assets under ERISA in Technical Release 92-1. In this regard, the Technical Release states as follows:

“The Department [of Labor] cautions that the foregoing enforcement policy<sup>1</sup> in no way relieves plan sponsors and fiduciaries of their obligation to ensure that participant contributions are applied only to the payment of benefits and reasonable administrative expenses of the plan. Utilization of participant contributions for any other purpose may result not only in civil sanctions under Title I of ERISA but also criminal sanctions under 18 U.S.C. 664”.

Where ERISA does **not** apply, such as where the medical flexible spending accounts are a governmental plan or in the case of dependent care flexible spending accounts, the retaining of forfeitures by the employer could violate state law.<sup>2</sup> For example, New York State Labor Law section 193 provides, in pertinent part, that an employer may not make deductions from an employee’s wages unless the deductions are “expressly authorized in writing by the employee and **for the benefit of the employee...**” If a New York employer retains forfeitures from a dependent care flexible spending account that are attributable to employee wage deductions under a section 125 plan, it may violate this provision since the retention of the forfeitures would arguably not be for the benefit of the employee.<sup>3</sup>

The language of the Proposed Regulations should be changed to include a warning that retention of forfeitures by the employer, while not a violation of Section 125 of the Code, could be a violation of other laws.

### **Qualified Benefits and Deferral of Compensation**

In order to be a “qualified benefit” under the Proposed Regulations, the benefit must be attributable to employer contributions and (i) not be currently taxable to the employee by reason of an express provision of the Code; and (ii) not defer the receipt of compensation (except as otherwise permitted under the Proposed Regulations). Proposed Regulations section 1.125-1(a)(3). One type of qualified benefit is an accident or health plan excludible from gross income under Section 105 or 106 of the Code, provided there is no impermissible deferral of compensation. Proposed Regulations section 1.125-1(a)(3)(B). The Proposed Regulations do allow for certain practices with respect to benefits provided through a cafeteria plan, without the benefits being treated as deferring compensation. Once such practice is “reasonable premium rebates or policy dividends” so long as the rebates or dividends “are paid before the close of the 12-month period immediately following the cafeteria plan year to which such rebates and dividends relate”. Proposed Regulations section 1.125-1(p)(3)

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<sup>1</sup> The enforcement policy referred to is the DOL position that an employer’s failure to put participant contributions to health FSAs into a trust, as is normally required under ERISA and DOL regulations, will not be a violation of ERISA.

<sup>2</sup> Since the benefits are not subject to ERISA, the pre-emption of state laws by ERISA does not apply.

<sup>3</sup> I found nothing that addressed this specific issue.

A regional health insurance carrier has introduced a new health insurance coverage option that contains a feature which allows the member (and his or her spouse, if spousal coverage is provided) to earn up to \$500 annually for engaging in certain health related activities. If spousal coverage is provided, both the member and his or her spouse can each earn up to \$500 annually. Under the feature, a member (or spouse) will earn “dividends” for engaging in certain activities such as (i) fitness and nutrition programs; (ii) researching health topics and taking health quizzes; (iii) stop smoking programs (or being a non-smoker); (iv) management of chronic health conditions; and (v) certain preventive health screenings, exams and tests. The dividends earned under the feature can be used by the member (or spouse) to obtain a reloadable Visa card (a debit card), a gift card, or various health and wellness products, or may be paid in cash to the member (or spouse). Promotional materials issued by the health insurance carrier also provide that the dividends earned can be rolled over from year to year.<sup>4</sup> Promotional materials of the health insurance carrier state that “The dollars sent to the member are subject to applicable income taxes in the year in which they were paid to the member (a 1099 will be sent to the member for purposes of filing their taxes)”.

Would a health insurance coverage option which includes this feature be a “qualified benefit” under the Proposed Regulations? Are the dividends under the feature “reasonable premium rebates or policy dividends”? Would the ability of a member to rollover dividends “from year to year” be an impermissible deferral of compensation? If an employer included the health insurance coverage option with this feature in its group health plan and employees contributed to the cost of coverage under the health insurance coverage option through a cafeteria plan, would it cause the cafeteria plan to fail to satisfy section 125 of the Code?

### **Non-discrimination Rules**

One requirement of the non-discrimination rules in the Proposed Regulations is that each similarly situated employee must be given a uniform opportunity to elect qualified benefits. Proposed Regulations section 1.125-7(c)(2). Further, the Proposed Regulations provide that the cafeteria plan “must also give each similarly situated participant a uniform election with respect to employer contributions.”

Do these provisions of the Proposed Regulations require that non-highly compensated employees be able to make the same maximum dollar contribution under the cafeteria plan that the highly compensated employees can make? If so, these provisions can operate to cause an employer’s cafeteria plan to be discriminatory under circumstances where the employer is providing more favorable benefits to lower paid employees than to higher paid employees.

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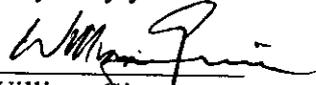
<sup>4</sup> The description of the feature on the health insurance carrier’s website states that “You can cash in your dividends for payment by check – or roll them over to a new year.” Promotional materials issued by the health insurance carrier state “Dividends roll over from year to year so long as the member is still enrolled in [a coverage option that includes the feature].”

For instance, a client's group health plan offers one type of health insurance coverage with an option for single coverage and an option for family coverage. Single coverage is approximately \$3,091 per year and family coverage is approximately \$7,882 per year. The employer has established a sliding scale whereby lower paid employees contribute a lower amount towards the cost of coverage than do more highly paid employees. Under the sliding scale, an employee who is paid from \$350 to \$399 per week would be responsible for paying approximately \$379 annually for single coverage and \$961 annually for family coverage. At the other end of the spectrum, an employee who is paid over \$2,300 weekly is responsible for paying approximately \$650 annually for single coverage and \$4,368 annually for family coverage. The employer allows all employees the ability to pay their share of the cost of health insurance coverage through a cafeteria plan.<sup>5</sup> If one were to look at this portion of the cafeteria plan in isolation, it would appear that the plan favors highly compensated employees since they are allowed to contribute a larger dollar amount under the cafeteria plan toward the cost of health insurance coverage. However, doing so distorts the true nature of this arrangement under which the employer provides greater benefits for lower paid employees than for higher paid employees.

The cafeteria plan regulations should explicitly provide that where highly compensated employees are eligible to contribute a larger dollar amount under a cafeteria plan solely because the employer requires them to pay a larger portion of a qualified benefit, such as group health insurance, the arrangement will not cause the cafeteria plan to be discriminatory.

Should you have any questions regarding the issues raised and questions asked in this letter please contact me at 716-992-2022 or by email at [wgiroux@hradvisorsinc.net](mailto:wgiroux@hradvisorsinc.net).

Very truly yours,

  
William Giroux

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<sup>5</sup> The cafeteria plan also includes a medical flexible spending account feature and a dependent care flexible spending account feature. There is a uniform maximum contribution amount that applies to each of those features.