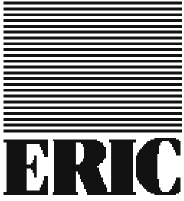

The
ERISA
Industry
Committee

November 16, 2007

CC:PA:LPD:PR (REG-142695-05)
Room 5203
Internal Revenue Service
Box 7604, Ben Franklin Station,
Washington, D.C., 20044

Ladies and Gentlemen:

The ERISA Industry Committee ("ERIC") is pleased to submit these comments on the proposed cafeteria plan regulations published in 72 Fed. Reg. 43938 (Aug. 6, 2007).

ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and welfare benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, incentive, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their costs and effectiveness, and the role of those benefits in the American economy.

Almost all of ERIC's members offer their employees a choice of benefits through a cafeteria plan. Cafeteria plans are an effective way for employees to choose the benefits that suit them best. It is imperative that the Department of Treasury, the Internal Revenue Service, and employers work together to ensure that these popular programs remain cost-effective and administrable. In that spirit, we appreciate the opportunity to offer the following comments.

I. Qualification of a Cafeteria Plan Under Section 125

a. Deferral of Compensation to Later Plan Year

Prop. Treas. Reg. § 1.125-1(b)(5) states: "Except as provided in paragraph (o) of this section, in order for a plan to be a cafeteria plan, the qualified benefits and permitted taxable benefits must not defer compensation. For example, a cafeteria plan may not provide for retirement health benefits for current employees beyond the current plan year or group-term life insurance with a permanent benefit, as defined under § 1.79-0." There is no definition of the term deferred compensation in Prop. Treas. Reg. § 1.125-1(a).

In order for an employer to determine whether and under what circumstances a feature of a cafeteria plan violates the prohibition against a plan providing deferred compensation to an employee, the regulations, the proposed regulations should define the term "deferred compensation."

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b. Written Plan Document

Prop. Treas. Reg. § 1.125-1(c)(6) states that:

> …if the written plan fails to satisfy any of the requirements in this paragraph (c) (including cross-referenced requirements), the plan is not a cafeteria plan and an employee's election between taxable and nontaxable benefits results in gross income to the employee.

The proposed regulation should make clear that the written plan document compliance requirement applies only to those requirements that are unique to the constructive receipt protection afforded by section 125 of the Internal Revenue Code of 1986, as amended (the "Code"). A written plan document compliance failure should result in a loss of section 125's constructive receipt protection only when such failure relates to a requirement unique to section 125: the status of the cafeteria plan should not be affected if an incorporated document fails to include a provision necessary to satisfy the requirements of another Code section.

Consistent with the statutory definition of a cafeteria plan in Code section 125(f), Prop. Treas. Reg. § 1.125-1(a) defines a cafeteria plan as a plan that permits an employee to elect between at least one taxable benefit and one qualified benefit. The term "taxable benefit" is defined in Prop. Treas. Reg. § 1.125-1(a)(2)(ii) to include any benefit currently taxable to an employee on receipt, for example the taxable cash an employee can receive by electing not to make a salary deferral under a cafeteria plan. The term "qualified benefit" is defined in Prop. Treas. Reg. § 1.125-1(a)(3) to mean any benefit "to the extent such benefit is not currently taxable to an employee" under a list of Code sections. Prop. Treas. Reg.§ 1.125-1(a)(3)(A)-(J).

Thus, a plan document error should not result in a loss of Code section 125 constructive receipt protection, unless: (1) the error relates to a requirement unique to Code section 125's constructive receipt protection or (2) the error results in no qualified benefits being available for election under the plan. Any other documentary compliance error may result in an employee receiving a benefit that is currently includible in taxable income. However, it is permissible for a cafeteria plan to provide a taxable benefit option to an employee, so long as the cafeteria plan provides at least one qualified benefit option. Thus, the mere fact that a documentary compliance error occurs in one of the benefit plans either set forth in a cafeteria plan document or incorporated by reference into such plan should not by itself, be sufficient to cause the plan as a whole to no longer be a cafeteria plan.

c. De Minimis Exception

Under Prop. Treas. Reg. § 1.125-1(c)(7), an operational failure causes a plan to fail to be a cafeteria plan, with the result that participating employees' elections between taxable and nontaxable benefits result in gross income to the employees. Cafeteria plans offered by ERIC's members serve many thousands of employees. It would be unnecessarily harsh for a minor operational failure to expose all participants in the plan to an unexpected tax liability. The proposed regulations should create a "de minimis" exception so that minor operational failures to not jeopardize the cafeteria plan's status.

For example, if a prepayment for orthodontia services, reimbursed by a health flexible spending arrangement, results in the availability of a free parking space at the orthodontist's office—worth $5 dollars an hour—for which a patient might otherwise be required to pay a metered rate, it might be inferred that a deferred benefit was received in the free parking space. In such a situation, or others involving similarly low-value benefits, corrective action by the participant should be allowed. The deferral of that benefit should not result in a broad failure of the cafeteria plan to comply with Section 125.

d. Changes in Benefit Elections

Prop. Treas. Reg. § 1.125-2(a) provides that an employee's benefit elections must become irrevocable at the election deadline (with limited exceptions set forth in Treas. Reg. § 1.125-4). An exception should be made to allow an employer to change an employee's benefit election unilaterally in order to comply with the cafeteria plan requirements. For example, a cafeteria plan should be permitted to provide that an employer may reduce or cancel the benefit election of a highly compensated participant to the extent necessary to satisfy an applicable nondiscrimination test under section 125, or to comply with nondiscrimination requirements under another Code section that determines the status of qualified benefits. It should also be made clear that such an action does not violate the rules in Treas. Reg. § 1.125-4 that describe that describe the circumstances in which a participant may change an election under a cafeteria plan.

An exception also should be made if an employee makes an election that is erroneous on its face. For example, if an employee who has no dependents elects to contribute to a dependent care FSA, the employee should be permitted to revoke the election.

II. Flexible Spending Accounts (FSAs)

FSAs are an important feature in many cafeteria plans. They provide an appropriate incentive for employees to save for both anticipated and unexpected expenses. The proposed regulations should be modified and clarified to ensure that they do not inappropriately restrict FSAs.

a. Flex Credits

Prop. Treas. Reg. § 1.125-5(b)(1) defines employer "flex-credits" as "non-elective employer contributions that the employer makes for every employee eligible to participate in the employer's cafeteria plan, to be used at the employee's election for one or more qualified benefits (but not as cash or a taxable benefit)."

The proposed regulation should be revised to make clear that an employer may provide a flex credit that an employee may use only for a specific qualified benefit. For example, the proposed regulation should make clear that an employer may offer a flex credit as an incentive to employees who participate in a wellness assessment program or who enroll in a smoke-ender program. The employer should not be required to make the flex credit available to be used at the employee's election for any qualified benefit the employee chooses.

b. Reimbursement for Services to be Rendered

The proposed regulations identify two specific circumstances in which a health FSA may reimburse a participant for expenses that extend beyond the current year. Under Prop. Treas. Reg. 125-5(k)(3), the FSA may reimburse an actual advance payment for orthodontia services, and a payment for durable medical equipment.

These are not the only situations in which a health FSA should be permitted to reimburse pre-payment for medical procedures, however. By specifically identifying orthodontia and durable medical equipment as exceptions to the rule prohibiting deferred compensation, the proposed regulations imply that any other reimbursement for a product or service that extends beyond the current year is prohibited.

The proposed regulations should be revised to make clear that an FSA may reimburse any medical expense actually incurred by a participant where it is reasonable or customary to pay in advance, without regard to whether the good or service might extend beyond the current year. For example, if a participant refills a prescription that will last beyond the end of the current year, or pays in advance for a course of treatment (such as fertility treatments or physical therapy) that will last beyond the current year, the proposed regulations should make clear that these expenses may be reimbursed by an FSA.

Another situation in which a reimbursement might be inappropriately prohibited on the ground that it defers compensation is the case of services to be rendered in assistance of a qualified adoption, which are reimbursed by an adoption assistance FSA on a prepaid basis before services have actually been rendered. For example, a plan participant must retain legal counsel at the beginning of an adoption process that might extend over two or more calendar years. The proposed regulations should make clear that reasonable or customary advance payments for adoption services may be reimbursed by an FSA as long as the plan participant is not entitled to a refund from the service provider in a later year.

The rule should clarify that contributions to an adoption assistance FSA are not subject to forfeiture; and that the plan may permit contributions to may be used for expenses incurred after the current year of coverage. Moreover, the fact that the adoption fails to materialize should not disqualify the right of reimbursement. Contributions should not be required to be made prior to the date the expense is incurred.

III. Non-Discrimination Tests

a. Eligibility to Participate

A cafeteria plan must not discriminate in favor of highly compensated individuals as to eligibility to participate. The proposed regulations define “highly compensated individuals” to include the spouse or dependent of any highly compensated individual. Prop. Treas. Reg. §§ 1.125-7(a)(3)(ii). Under Prop. Treas. Reg. §§ 1.125-1(g)(4), however, a spouse or dependent is not

eligible to participate in a cafeteria plan unless the spouse or dependent is also an employee of the employer.

The proposed regulations should make clear that an employer is not required to take into account the spouse or dependents of a highly compensated individual in applying the nondiscriminatory eligibility test unless the spouse or dependent is also an employee of the employer. A large employer has no practical way to determine the number of non-employee spouses and dependents associated with its highly-compensated employees. Since non-employee spouses and dependents are not eligible to participate in the cafeteria plan in any event, it is not appropriate to take them into account in the eligibility test.

Examples 2, 3, and 4 in Prop. Treas. Reg.§ 1.125-7(b)(3)(iv) should be deleted. In each example, the cafeteria plan does not discriminate in favor of highly compensated individuals as to eligibility to participate in the plan, and the plan therefore satisfies the eligibility test. These examples illustrate situations in which *benefits* available under the plan—not eligibility to participate in the plan—favor highly-compensated individuals. There is nothing in the eligibility test to indicate that the test is applied on a benefit-by-benefit basis; to the contrary, the eligibility test by its terms applies to the cafeteria plan as a whole. Discrimination as to the availability of particular benefits is addressed in the "contributions and benefits" test in Prop. Treas. Reg.§ 1.125-7(c).

b. Contributions and Benefits Test

Prop. Treas. Reg.§ 1.125-7(c)(2) describes the nondiscrimination tests that apply to benefit availability and benefit election. A cafeteria plan may demonstrate compliance with these requirements on either a contributions or a benefits basis. The proposed regulations do not provide even the most basic information necessary to apply these tests, however. For example:

- A plan that demonstrates compliance on a benefits basis must test aggregate benefits as a percentage of compensation; but the proposed regulations do not explain how the value of benefits is to be determined for this purpose.

- A plan must give "similarly situated" participants a uniform opportunity to elect qualified benefits or employer contributions, but the proposed regulations do not explain how to determine which participants are "similarly situated."

- A plan must show that the utilization of contributions or benefits is not discriminatory, but the proposed regulations do not explain how (or whether) to adjust for neutral factors that affect utilization, such as family size, geographical differences in the cost of coverage, or different benefits available to "similarly situated " individuals (for example, employees who work for different lines of business).

The proposed regulations also do not correctly interpret the statutory nondiscrimination requirement. For example:

- Prop. Treas. Reg. §§ 1.125-7(a)(2) defines "compensation" by reference to section 415(c)(3) of the Code. The Service has recently interpreted this definition to include the

limit on compensation under section 401(a)(17) of the Code. *See* Treas. Reg. §§ 1.415(c)-2(f). This compensation limit applies only to qualified plans and VEBAs; there is no justification for extending it to cafeteria plans.

- Prop. Treas. Reg. §§ 1.125-7(a)(9) defines "highly compensated" to include individuals whose compensation exceeds the relevant compensation limit in the year they are hired. This rule is directly contrary to the definition of "highly compensated employee" in Code section 414(q), which allows an employer to determine highly compensated status based on an individual's prior-year compensation. It is unduly burdensome and expensive to require a large employer to reprogram its benefit and payroll systems to identify highly-compensated employees using a different definition from the one that applies for purposes of all other nondiscrimination tests under the Code.

- Prop. Treas. Reg. §§ 1.125-7(c)(2) states that a cafeteria plan "must" demonstrate that benefit availability and benefit utilization are nondiscriminatory, and "must also" demonstrate that contribution availability and contribution utilization are nondiscriminatory. Under the Code, the tests clearly are alternative tests. The proposed regulation should make clear that the cafeteria plan may demonstrate compliance using either test, but is not required to pass both tests.

- The proposed regulations require a cafeteria plan to demonstrate that the aggregate utilization of benefits or contributions by highly compensated participants does not exceed the aggregate utilization by non-highly-compensated participants by any margin. There is no justification for applying such a restrictive standard to cafeteria plans: the test should allow the utilization of highly compensated participants to exceed that of non-highly-compensated participants by a reasonable margin. In view of the substantial differences in nondiscriminatory factors that affect utilization, such as family size, age, and geographic location, the margin should be substantially greater than the two-percentage-point margin allowed under the test for section 401(k) contributions.

IV. Paid Time Off

Prop. Treas. Reg. § 1.125-1(o)(4)(i) states the basic requirements for paid time off as follows:

> A cafeteria plan is permitted to include elective paid time off (that is, vacation days, sick days or personal days) as a permitted taxable benefit through the plan by permitting employees to receive more paid time off than the employer otherwise provides to the employees on a nonelective basis, but only if the inclusion of elective paid time off through the plan does not operate to permit the deferral of compensation.

All that should be necessary for the arrangement to avoid the deferral of compensation is that any unused elective paid time be either forfeited or included in the employee's taxable income for the applicable tax year. The proposed regulations state, however, that any unused time that is not forfeited must be *paid to the employee* in the current year. For example, Prop. Treas. Reg. §

1.125-1(o)(4)(iii)(A) states, “The employee must receive the cash on or before the last day of the cafeteria plan’s plan year to which the elective contributions used to purchase the unused elective paid time off relate.”

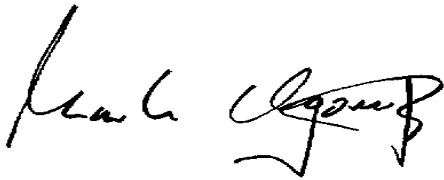
In many cases, it will not be possible for a large employer to determine whether its employees have actually used elective paid time off until the year is over, especially since this time off is often used at the very end of the calendar year. Even if the employer determines that an employee will have unused elective paid time for a year, it is often impossible for the employer actually to process a check to pay the employee before the end of the year.

As long as the employer’s cafeteria plan provides that an employee may apply for and receive unused paid time off during a specified period at the end of the year (for example, during the last two weeks of the calendar year), the employee will be in constructive receipt of the value of unused paid time off even if he fails to apply for it. In these circumstances, the value of the paid time off will be included in the employee’s income and reported on his Form W-2 for the current year. Accordingly, there will be no “deferral of compensation” even if the employee does not receive a check for the unused paid time until early in the following year.

The proposed regulations should make clear that the employee’s constructive receipt of the value of paid time off by the end of the plan year is sufficient to satisfy the rule prohibiting deferred compensation. An employer that reports the value of the paid time off as income on the employee’s Form W-2 for the current year should not be required to make an actual payment before the end of the year.

ERIC appreciates the opportunity to submit these comments. We will continue to solicit member analysis of these and other proposed regulations to assist the Department of Treasury and Internal Revenue Service in fashioning cafeteria plan rules that are clear, allow for the equitable tax treatment of all participants, and encourage responsible saving and benefit planning. If we can be of any further assistance, please let us know.

Very truly yours,



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