

**Comments Concerning Cafeteria Plan Regulations
Under Internal Revenue Code Section 125**

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

The comments were prepared by individual members of the Committee on Employee Benefits of the Section of Taxation. Principal responsibility for drafting the comments was exercised by Rose Marie J. Chidichimo, Mark Stember and Gina M. Boscarino. Additional contributions were made by Greta Cowart, Debbie Blackwell, Russell Greenblatt, Taina Edlund and Diane J. Fuchs. The Committee comments were reviewed by Diane J. Fuchs, Chair of the Section's Committee on Employee Benefits, Cynthia Benson of the Section's Committee on Government Submissions, and Stuart M. Lewis, Council Director for the Committee on Employee Benefits.

Although many of the members of the Section of Taxation who participated in the preparation of these comments necessarily have clients affected by federal taxation, including the federal tax rules applied in the subject area addressed by these comments, no such member (or the firm of such member) has been engaged by a client with respect to the specific subject matter of these comments.

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I. Purpose of Submission

The purpose of this submission is to raise and discuss issues in response to the Department of Treasury's request for comments in the preamble to the Prop. Treas. Reg. 1.125-4(f) published on March 23, 2000. The Prop. Treas. Reg. §1.125-4 (the "Proposed 2000 Regulations") would amend previously issued Prop. Treas. Reg. §§1.125-1 and 1.125-2 and supplement the Final Treas. Reg. § 1.125-4, also published in March 23, 2000 (the "Final 2000 Regulations") to (a) extend the change in status rules to dependent care and adoption assistance plans, and (b) include significant cost or coverage changes as permitted election changes in the Final 2000 Regulations. The Final 2000 Regulations replace the 1997 Temporary Regulations and provide guidance on permitted election changes for cafeteria plans.

This submission addresses issues raised by the discussion in the preamble to the Proposed 2000 Regulations with respect to situations in which participants may elect to change elections during the plan year for a "cafeteria plan" established under Section 125 of the Internal Revenue Code of 1986, as amended (the "Code"). We congratulate the Department of Treasury Department ("Treasury") and the Internal Revenue Service ("Service") on their efforts to address important issues of concern to employers and employees and appreciate their consideration of this matter.

II. Executive Summary

The comments suggest that when the Proposed 2000 Regulations are finalized, they should be revised as follows:

- A. expand and clarify the significant cost or coverage changes so that:
1. employees may make election changes that correspond with a change made under the plan of the employee's domestic partner;
 2. employees may make election changes when there is a significant decrease in the cost of coverage;
 3. the significant cost or coverage rules apply to Health FSAs;
 4. employees may change their elections when there is a substantial decrease or increase in the composition of the service providers of an HMO or Preferred Provider Network;
 5. the word "significant" is defined to require the use of uniform and objective standards; and

6. the permitted election change rules are a “safe harbor” and employers may allow other events to qualify as permitted election changes;
- B. expand the permitted election changes due to an individual’s eligibility or ineligibility for coverage under the State Children’s Health Insurance Program;
- C. simplify the Proposed and Final 2000 Regulations by combining them into one document; and
- D. provide employers with lead time of one (1) year to implement the changes in their benefits plans and corresponding documents and provide transition relief so that employers can immediately adopt the changes when they are finalized without plan amendments.

In addition, the comments briefly raise several issues in the Final Regulations that the IRS should consider as part of its project to clarify and streamline the cafeteria plan regulations.

III. Comments

A. Significant Cost or Coverage Changes

In Prop. Treas. Reg. §1.125-2, the Service permitted mid-year election changes as a result of significant cost or coverage changes in two limited circumstances. Automatic mid-year election changes were permitted if the cost of a health plan provided by an independent, third party provider increased or decreased. In addition, the Service permitted participants to change their premium payments or make prospective election changes if the premium amount under a health plan significantly increased. In the Proposed 2000 Regulations, the Service substantially revised the significant cost or coverage rules. We appreciate the added flexibility offered by the new rules. However, the Service should consider several issues concerning the Proposed 2000 Regulations, as described below.

1. Election Change Based on Change in Other Family Member’s Plan.

a. Explanation of New Rule

During a period of coverage, a cafeteria plan may permit an employee to make a prospective election change that is on account of and corresponds with a change made under the plan of the spouse’s, former spouse’s, or dependent’s employer if: (i) a cafeteria plan or qualified benefits plan of the spouse’s, former spouse’s, or dependent’s employer permits participants to make an election change that would be permitted under the Proposed and Final 2000 Regulations; or (ii) the employee’s cafeteria plan permits

participants to make an election for a period of coverage that is different from the period of coverage under the cafeteria plan or qualified benefits plan of the spouse's, former spouse's, or dependent's employer. Prop. Treas. Reg. §1.125-4(f)(4). Similarly, the Final 2000 Regulations do not recognize relationships between domestic partners.

b. Concerns

Due to the recent and substantial increase in the number of employers offering benefits to domestic partners of employees, a greater number of individuals have the opportunity to receive their benefits through the plans of their domestic partners. Unless a domestic partner is a dependent under Section 152 of the Code, an event that would otherwise meet the requirements of the change in status rules would not constitute a change in status because the current change in status rules do not recognize relationships between domestic partners. Hence, an employer may permit the domestic partners of its employees to participate in the employer's qualified benefits plans but such employees will not be eligible for the favorable tax treatment available under the Code.

c. Recommendation

We recommend that the Service expand this provision in the final regulations to permit an employee to make an election change that is on account of and corresponds with a change made under the plan of the spouse's, former spouse's, dependent's or domestic partner's employer.

2. Significant Cost Decrease

a. Explanation of New Rule

If the cost of a benefits package option significantly increases during a period of coverage, a cafeteria plan may permit employees to either make a corresponding prospective increase in their payments, or to revoke their elections and, in lieu thereof, to receive on a prospective basis coverage under another benefits package option providing similar coverage. Prop. Treas. Reg. §1.125-4(f)(2)(ii).

b. Concerns

In contrast to automatic changes in an employee's elective contributions under a cafeteria plan if the cost of a benefits option increases or decreases during a period of coverage, the Proposed 2000 Regulations do not allow employees to make an election change (or a new election for an option) upon a significant decrease in the cost of a benefits package option. Because of the lack of flexibility in this new rule, many employees may hesitate to participate in cafeteria plans since their wages may be reduced by more than the actual cost of the coverage. Expanding the scope of the significant cost changes to include a significant decrease in the cost of coverage would be helpful in two areas.

First, in some cases coverage may first become affordable upon a significant decrease in cost. Many employers contribute towards health insurance (as well as other benefits) at a higher rate for full-time employees as compared to part-time employees, thereby making the net cost of the coverage lower for full-time employees. If a part-time employee who is already eligible for benefits switches to full-time status mid-year, his or her net cost of the coverage may now be decreased. Such a change is not currently covered by Treas. Reg. 1.125-4(c)(2)(iii) because that provision would only cover the situation of an ineligible part-time employee first becoming eligible under the plan mid-year.

Second, in the case of a Dependent Care FSA, the fees of most dependent care providers are based on the level of care rendered to the child, which in most cases are based upon the developmental abilities of the child. For example, dependent care fees could be reduced mid-year because a child moved from the infant room to the toddler room. Since levels of care are mostly based upon the developmental progression of the child, most employees participating in the Dependent Care FSA will not be able to anticipate any change in their dependent care provider fees at the beginning of the year with any level of certainty. Based on Examples 5 and 6 in the Proposed 2000 Regulations it is unclear whether the above reasons for such a cost decrease would be a change in a benefit package option allowing for an election change under Prop. Treas. Reg. 1.125-4(f)(3)(ii).

c. Recommendation

We recommend that the rules regarding significant cost or coverage changes be expanded in the final regulations to permit an employee to change his or her election if there is a significant decrease in the cost of coverage. Since employees who change their elections based upon a cost decrease will, in most instances, be turning prior nontaxable income into taxable wages, allowing such a change should satisfy the reasons for the constructive receipt rule and should not be a “subterfuge” to circumvent the permitted election change rules.

3. Health FSA Election Changes

a. Explanation of New Rule

Prop. Treas. Reg. §1.125-4(f)(1) provides that the rules for significant cost or coverage changes do not apply to an election change under a Health FSA (or on account of a change in cost or coverage under a Health FSA). Presumably, this ensures that any election changes will not be inconsistent with the requirement that Health FSAs exhibit the risk-shifting and risk-distribution characteristics of insurance.

b. Concerns

Many employers have expressed an interest in allowing mid-year changes in Health FSA elections due to a significant cost or coverage change. The large majority of these employers are small and medium-size companies. The reason for such interest is that many small employers have very few health options available to their employees. The cost of the available health care options to small employers is high because of the size of the small employers yet the coverage available to small employers is typically not as comprehensive as coverage offered by large employers. Therefore, many employees of small employers utilize Health FSAs in order to reduce the cost of their health care expenses.

For example, if the cost of a health option significantly increases during the year, employees are permitted to drop that option, and if desired, elect another health option. However, many small employers have only one or two health options, and the cost increase may rise to the level that employees can no longer afford the coverage. In such a circumstance, since the increase in cost is beyond the control of the employees, they should be allowed to increase their coverage under the Health FSA if they do not want to elect (or cannot elect) another health option.

In addition, if coverage is significantly curtailed or ceases under a health option, the plan may permit employees to revoke their elections and elect a new similar option. If a small employer's health plan option eliminates vision coverage during a period of coverage, as an example, most often another similar option is not available. In such a circumstance, employees should be able to increase their Health FSA coverage during a period of coverage in order to make up for the loss in benefits.

c. Recommendation

We recommend that the significant cost or coverage change rules be extended to apply to Health FSAs. Allowing such a limited change should still allow the Health FSA to exhibit the risk-shifting and risk-distribution characteristics of insurance, while allowing employees to make a change on account of circumstances that are beyond their control. Further, since most employers annually limit Health FSA coverage (typically to no more than \$5,000 or some lesser amount), the effect of allowing such a change would be nominal.

4. Substantial Change in Network Providers.

a. Explanation of New Rule

Prop. Treas. Reg. §1.125-4(f)(3)(i) provides that if coverage under a plan is significantly curtailed during a period of coverage, affected employees may revoke their elections and may make new elections under other options providing similar coverage. Coverage under a health plan is significantly curtailed only if there is an overall reduction in coverage provided to participants so as to constitute reduced coverage generally.

b. Concerns

Many employers offer health coverage through HMOs and Preferred Provider Networks with a closed list of service providers for in-network services. In these cases, employees frequently choose a health care plan based on the availability of specific service providers. However, given the nature of the healthcare industry, it is increasingly common that large groups of providers or all providers in a particular geographic area may leave a particular plan during the course of the plan year. In such circumstances, it appears that the above provision would not allow a change in election during a period of coverage.

Just as a large group of providers or all providers in a particular geographic area may leave a particular plan during the course of the plan year, large groups of providers also may join a plan during the course of the plan year. In such a circumstance, an employee may want to switch benefits package options, when a particular physician or group of physicians has become available to the employee. Prop. Treas. Reg. §1.125-4(f)(3)(i) does not permit mid-year election changes in these circumstances.

In addition, employers may improve coverage under their health plan, introduce an additional network or a substitute network. Prop. Treas. Reg. §1.125-4(f)(3)(i) does not permit a change in election during a period of coverage consistent with these plan changes. Allowing employees to change elections in all of these limited circumstances, where the need for the change is triggered by circumstances outside the employee's control, would not appear to violate the underlying objectives of the change in status rules (i.e., the limited exception from the constructive receipt rules).

c. Recommendation

We recommend that when finalized, the Proposed 2000 Regulations should be expanded to specifically allow an election change in the event of a substantial decrease or increase in the composition of the service providers of an HMO or Preferred Provider Networks with a closed list of service providers for in-network services. In addition, changes in elections during a period of coverage should be allowed if employers change the networks offered under their health plans or implement improvements to the coverage offered under their health plans.

Because the events triggering the need for such change are beyond the control of the employees, we believe that allowing a change in election would not violate the underlying objectives of the permitted election change rules and would ensure the continued provision of quality health care to employees. Furthermore, such a change is already allowed in the case of a Dependent Care FSA. Based upon Example 5 of the Proposed 2000 Regulations at Prop. Treas. Reg. §1.125-4(f)(5), an employee-initiated, voluntary change in a daycare provider would allow such employee to change his or her Dependent Care FSA election.

5. Definition of “Significant”

a. Explanation of New Rule

A number of provisions in the section of the Proposed 2000 Regulations regarding significant cost or coverage changes require a “significant” change in order to permit the employee to make an election change. For example, changes may be made on account of “significant cost increases” or a “significant curtailment” of coverage. Prop. Treas. Reg. §1.125-4(f).

b. Concerns

The Proposed 2000 Regulations do not contain a definition of “significant” (other than in Example 7 where a ten percent (10%) increase in dependent care cost was significant). Consequently, a plan administrator must use its discretion in interpreting such language.

The Service has informally stated that although the establishment of any bright-line dollar amount or a percentage may facilitate plan administration, it could not apply evenly to all participants. An increase in cost is more significant for lower-paid workers than for higher-paid workers. Further, any dollar amount would have to be continually updated for inflation. Although we agree with the Service, employers desire some guidance in order to apply the rules regarding significant cost or coverage changes.

c. Recommendation

We recommend that, when finalized, the Proposed 2000 Regulations define the word “significant” to require the use of uniform and objective standards taking into account each participant’s individual circumstances. Adding this guidance to the Proposed 2000 Regulations should not result in an abuse of the permitted election rules.

6. Safe Harbor Approach

a. Explanation of New Rule

Prop. Treas. Reg. §1.125-4(f) sets forth rules for permitted election changes during a period of coverage as a result of significant cost or coverage changes. Unlike Q & A 6(c) in Prop. Treas. Regs. §§1.125-2 and 1.125-4 which contains examples and not a definitive list of circumstances of when an employee may change his or her election during a period of coverage, the Proposed 2000 Regulations do not appear to provide employers and plan administrators with discretion to permit a change in election as a result of a significant cost or coverage change unless it is one of the permitted election changes listed in the Proposed 2000 Regulations.

b. Concerns

An important issue to resolve in the Proposed 2000 Regulations is whether the events that permit election changes during a period of coverage are the only events for which employers may allow employees to change their elections, or whether they constitute a “safe harbor” thereby permitting election changes for other similar events. Although the approach taken in the Proposed 2000 Regulations may be helpful in providing definitive answers in certain circumstances, there are many transactions and events not enumerated in the Proposed 2000 Regulations, which may reasonably permit changes in elections without violating the constructive receipt rule.

c. Recommendation

We recommend that when the Proposed 2000 Regulations are finalized, they clarify that the permitted election change rules constitute a “safe harbor” that would permit employers to allow other events to qualify as permitted election changes. In order for employers to reasonably permit changes to occur in such instances while avoiding abusive situations, the Proposed 2000 Regulations may provide that changes will only be permitted to the extent that they are not intended to result in any “subterfuge” to the general constructive receipt rules.

For example, a more appropriate approach would be one similar to that of the section 401(k) hardship distribution rules. Under the hardship distribution rules, events such as the purchase of a home, college education, medical expenses, etc. are enumerated events allowing hardship distributions. However, employers may also go beyond the safe harbor to grant hardship distributions in other circumstances. Although most employers do not take such action due to lack of guidance from the Service, employers nonetheless have the flexibility under the 401(k) hardship rules to take appropriate action to avoid unintended hardships to employees.

Adopting such an approach with respect to permitted election changes would be a practical solution that would balance an employer’s human resources needs and the Service’s desire to prevent abusive situations. A nonexclusive safe harbor approach recognizes the reality of the workplace, where employers often must respond quickly to the many varied factual situations that occur in the lives of their employees. For example, many employers are instituting (and employees are electing) flexible and telecommuting work arrangements that could change the nature of dependent care arrangements. Such workplace changes may not coincide with the beginning of a new tax year and may not result in a reduction in the hours of employment. A safe harbor approach would permit employers the flexibility to make reasonable decisions based on the facts at hand and thereby avoid employee hardship.

B. Medicare, Medicaid and other Government Programs

1. Explanation of New Rule

Under the Final 2000 Regulations at Treas. Reg. §1.125-4(e), if an employee, spouse or dependent becomes eligible for coverage under Medicare or Medicaid, the employee is entitled to make a prospective election during a period of coverage to cancel or reduce coverage under an accident or health plan for such individual. Similarly, an individual's loss of eligibility for Medicare or Medicaid (other than coverage consisting solely of the distribution of pediatric vaccines) qualifies as an event permitting an employee to make a prospective election during a period of coverage to commence or increase coverage under an accident or health plan for such individual. *Id.* The Final 2000 Regulations, however, do not address prospective election changes to reflect an individual's eligibility or ineligibility for accident or health coverage under other government programs that pay for or subsidize health coverage.

The Service specifically requested comments on whether eligibility or ineligibility for other government programs should be added as a permitted election change under a cafeteria plan. The Service also requested comments on any special administrative difficulties employers might have in identifying such an event and, if so, the types of government programs that should be taken into account. The preambles referenced the State Children's Health Insurance Program ("CHIP"), as an example of such a government program. CHIP was established by Congress in 1997 as a federal program designed to enable states to provide health insurance to the children of working parents with incomes too high to qualify for Medicaid but too low to afford private coverage through separate state programs, Medicaid expansions or a combination of both. 21 U.S.C. §4901.

2. Concerns

There are strong policy considerations for adding a dependent's loss or gain of eligibility for CHIP as events permitting an employee to make a prospective change to his or her election for group health coverage during a period of coverage. The states and the federal government have an interest in shifting children and families who have access to private employer-sponsored group health plans off of public assistance and into employer plans and ensuring that those families who do not have access to private health insurance coverage receive the public assistance that they need. Permitting an employee to make a prospective election based upon his or her dependent's eligibility for health coverage under a private employer's health plan would further the objective of moving those families who have access to employer-sponsored health coverage off of public assistance, thereby lessening the burden on public programs and enabling them to expand access for individuals with greater need.

While eligibility requirements for participation in CHIP vary from state to state, generally children who are covered under a group health plan or other health insurance, as defined by the Health Insurance Portability and Accountability Act of 1996

(“HIPAA”), are ineligible for assistance under CHIP. There may be, however, situations in which a child who is covered by a group health plan might be treated as uninsured. For example, an employee elects family coverage only under his employer’s dental plan (which is \$400 per year) because the cost of medical insurance offered by the employer for family coverage (which is \$5000 per year) is too expensive for the employee. The employee elects to participate in the employer’s Health FSA to pay for vision benefits for his family, in particular for a special needs child. During the year, the employee discovers that his child is eligible for health coverage under CHIP and that the CHIP coverage also provides vision benefits. In this case, the employee should be permitted to change his election under the employer’s Health FSA during the period of coverage so that he is not paying for coverage that his child receives under CHIP.

3. Recommendation

It is recommended that when finalized, the Regulations be expanded to permit an employee to make a prospective election upon a dependent becoming eligible or ineligible for CHIP.

C. Clarity of the Regulations

1. Service Request for Comments

In the preamble to the Proposed 2000 Regulations, the Service requested comments on the clarity of the Proposed 2000 Regulations and how they may be made easier to understand.

2. Concern

We respectfully submit that although the Proposed 2000 Regulations offer flexibility to both employees and employers, they are somewhat cumbersome because the reader must review several other sets of regulations to fully understand the importance of the Proposed 2000 Regulations.

In the past sixteen years, multiple sets of regulations have been issued under § 125 Code in proposed, temporary and final form. The most recent set of regulations, the Proposed and the Final 2000 Regulations, are contained in separate documents. The two sets of regulations, however, continually cross-reference one another and the previously issued regulations and consequently must be read together. For example, the Proposed 2000 Regulations use a term “benefits package option”, which is defined in the Final 2000 Regulations. The significant cost and coverage rules in the Proposed 2000 Regulations expand the Final 2000 Regulations, which were published on the same day as the Proposed 2000 Regulations.

3. Recommendation

Accordingly, it is recommended that the Proposed and Final 2000 Regulations be simplified and combined into one document. In the Proposed 2000 Regulations, the Service stated that the Proposed and Final 2000 Regulations are an integrated package. Furthermore, we respectfully request that the Service consider re-issuing the cafeteria plan regulations (both proposed and final) in one document. Combining the regulations into one document would dramatically improve the clarity of the regulations and ease employer compliance.

As currently issued, it is easy for employers to incorrectly administer cafeteria plans or shy away from such plans because of the administrative burden in understanding how all of the regulations work together. All of the cafeteria plan regulations form an integrated package of rules for administering cafeteria plans. Changes made to one set of the cafeteria plan regulations impact another set of cafeteria plan regulations, even if both sets are not formally changed. We welcome an opportunity to provide additional comments on the impact of integrating all of the cafeteria plan regulations into one document.

D. Effective Date of the Proposed 2000 Regulations

1. Service Request for Comments

The Service requested comments on the lead-time necessary for employers to implement the Proposed 2000 Regulations after they are adopted as final regulations. The Proposed 2000 Regulations do not provide for an effective date. However, employers may rely on the Proposed 2000 Regulations as of March 23, 2000. The Final 2000 Regulations are applicable for cafeteria plan years beginning on or after January 1, 2001. However, employers may rely on the Final 2000 Regulations as of March 23, 2000.

2. Recommendation

We recommend that employers have at least a one-year period of lead-time once the Proposed 2000 Regulations are adopted as final regulations. This lead-time will afford employers an opportunity to make the necessary changes to their benefit programs, revise and/or restate plan documents, summary plan descriptions and/or prepare summaries of material modifications. In addition, such lead-time will allow human resources professionals sufficient time to familiarize themselves with the regulations.

In addition, because the Proposed 2000 Regulations offer flexibility to both employers and employees, the Service should consider offering transition relief that would permit employers to immediately adopt the changes contained in the final regulations without plan amendment provided that (a) such changes were communicated to employees prior to the employer implementing the changes contained in the final regulations, (b) the employer's cafeteria plan is operated in compliance with the final

regulations, and (c) the employer amends its cafeteria plan by the end of the plan year following the year in which the Proposed 2000 Regulations are finalized.

E. Comments on the Final 2000 Regulations and previously issued cafeteria plan regulations.

Although the Service is not formally seeking comments on the Final 2000 Regulations or any of the previously issued cafeteria plan regulations, the Service has informally suggested that it would consider comments on the Final 2000 Regulations and the previously issued cafeteria plan regulations since they form an integrated package and relate to each other. Consequently, this section briefly lists a few issues under the Final 2000 Regulations and previously issued cafeteria plan regulations that need clarification. This list is merely a brief statement of the most significant outstanding issues concerning cafeteria plans that require clarification. We would welcome an opportunity to prepare additional comments on these and other issues.

1. Is the list of changes in status events an exhaustive list or is it merely a safe harbor?

There are several practical issues that arise in administering cafeteria plans that are not addressed by the current change in status provisions:

a. Impact of Mergers, Acquisitions and Dispositions

i. Explanation of Rule

Although the employment status event in the change in status rules of the Final 2000 Regulations was broadened, it nonetheless does not cover all types of mergers, acquisitions and dispositions. Hence, the cafeteria plan regulations need to be broadened to include a merger, divestiture or acquisition as a change in status event as long as the change in election does not result in any “subterfuge” to circumvent the change in status rules.

ii. Recommendation

The Regulations should specifically provide that transactions for which a change in election should be permitted include the following:

- (A) Events under Code §401(k)(10);
- (B) Any purchase of a majority of the stock of a company or of a subsidiary or substantially all of the assets of a trade or business; and
- (C) An acquisition of a new division in a merger or a stock or asset purchase.

In addition, it is recommended that instead of identifying all permissible corporate events, a change in election generally be allowed for any corporate transaction resulting in a new employer under Code §§414(b), (c), (m) or (o), except where to do so would be a subterfuge to avoid the general intent or purpose of the rules. In any case where a change in employer occurs, a change in election would typically be warranted as long as such change did not result in any subterfuge. Permitting such a change would give employers the ability to make benefit-related decisions solely based on business and human resources considerations.

For example, in purchasing the assets of a division, buyer may assume seller's medical program and/or cafeteria plan for the division employees to avoid a disruption in benefits. At the same time, buyer may wish to encourage employees to enter the HMO or PPO that buyer maintains for its other employees. Thus, buyer would like to allow employees to elect to either continue to receive medical benefits under the plan previously maintained by seller or to participate in a new program sponsored by buyer for buyer's other employees. Allowing employees to change elections in this manner mid-year, due to the unanticipated corporate transaction, would not appear to violate the underlying objectives of the change in status rules (i.e., the limited exception from the constructive receipt rule).

Also, the Service should provide guidance on whether an employee's account balance in the seller's FSA can be transferred to a new plan maintained by buyer. If not, how can employees use their account balances in the former employer's FSA after the sale of the subsidiary is effective? The Service has informally taken the position that if buyer's plan is identical to seller's plan and was assumed by seller as part of the transaction, then the employee's account balances can be transferred to buyer's FSA. Otherwise, employees must continue to participate in their former employer's FSA under COBRA in order to submit expenses that were incurred after the transaction became effective.

b. Impact of change in employment status where eligibility conditions of a cafeteria plan do not depend on an employee's employment status

i. Explanation of Rule

The Service indicated in the preamble of the Final 2000 Regulations that it broadened the employment status provision in the change in status rules of the Final 2000 Regulations. The Final 2000 Regulations permit an employee to make an election change during a period of coverage if there is a change in the employee's or dependent's employment status that affects the individual's eligibility under a cafeteria plan. Treas. Reg. §1.125-4(c)(2)(iii).

It appears, however, that the employment status provision in the Final 2000 Regulations is not broader than the change in employment status provision under Q & A 6(c) of Prop. Treas. Regs. §§1.125-2 and 1.125-4. Under Q & A 6(c), an employee could

elect to participate in the cafeteria plan during a period of coverage if the employee or his or her spouse switched from part-time to full-time employment (or vice versa), even if the employee was previously eligible to participate in the cafeteria plan.

For example, a part-time employee who previously declined coverage under his employer's health plan switches to full-time status in the middle of the year and wants to participate in his employer's health plan because he can now afford the coverage. Under the Final 2000 Regulations, it appears that the employee could not make such an election until the enrollment period of the following plan year.

ii. Recommendation

Expand the scope of the change in status rules to permit employee's to make changes in their elections as a result of an change in their employment status or the employment status of their dependents, regardless of whether such individual becomes or ceases to become eligible to participate in the employer's cafeteria plan as a result of the change in employment status.

2. Expanding the scope of the cafeteria plan regulations to apply to other types of programs that provide group insurance

The Service has informally requested comments on whether the cafeteria plan regulations should be expanded to apply to other types of programs, besides employer-sponsored benefit plans, that provide "group insurance." For example, should the regulations apply (*i.e.*, should the permitted election changes apply) if an employee becomes eligible and elects coverage under a foreign government health plan or a military health plan? Although in many instances US employees who work for their employers overseas (expatriates) remain in the employer's US health plan, there may be instances where the employee moves overseas indefinitely and would prefer coverage under the local foreign government health plan. We recommend that the cafeteria plan regulations be expanded to apply to other types of programs that provide "group insurance" and welcome an opportunity to discuss this issue further with the Service.

3. Use of electronic claims reimbursement

a. Explanation of Rule

The 1989 Regulations require Health and Dependent Care FSA claims to be substantiated before reimbursements are made to the participant. Specifically, the plan must receive (1) a written statement from an independent third party stating that the medical or dependent care expense has been incurred and the amount of the expense, and (2) a written statement from the participant that the medical or dependent care expense has not been reimbursed or is not reimbursable under any other applicable plan. Prop. Treas. Reg. §1.125-2 Q&A-7(b)(5).

Many employers have already adopted or are in the process of adopting electronic claims processing and reimbursement procedures in an effort to simplify FSA operations and reduce administrative costs. Some of the common processing and reimbursement procedures are annual participant statements of recurring medical and dependent care expenses, automatic reimbursement of deductibles and co-payments based on EOB statements, and in the extreme example, the use of debit cards for medical expenses. Employers have adopted these procedures despite any formal guidance from the Service. Guidance on the following issues would be useful:

- i. what type of documentation would substantiate an electronic claim; and
- ii. whether the employee must consent to the provider filing the claim electronically.

b. Recommendation

One of the ways to make the two-part substantiation requirement more flexible would be to only require that the participant statement (i.e., the statement that the expense has not been reimbursed or is not covered under any other plan) be provided to the plan once per year, such as during annual enrollment for example. As a matter of course, participants are not required to provide any such similar statement (e.g., the participant is not required to state that he or she will not commit fraud by filing the same claim with other health insurance carriers) when he or she files a claim with component health plans.

Further, another way to simplify the substantiation requirement that requires only medical expenses (as defined under Code §213) be reimbursed through a health FSA is to allow automatic reimbursement of deductibles, co-payments and other amounts to be automatically reimbursed based only on the submission of an EOB (or its electronic version) to the health FSA directly by the component health plan or its administrator. Since component health plans must only reimburse or pay for medical expenses in order to have such reimbursement or payment be tax-free to the participant, this should be a simple change to make.

Since most dependent care fees are paid on a weekly, bi-weekly or monthly basis and are the same amount each time, allowing reimbursements of recurring expenses without substantiation for each payment would simplify administration. This could be accomplished by allowing annual statements and substantiation for the first payment at the beginning of the year and requiring participants to notify the plan in the situation where payments were not made or were stopped. As an alternative, quarterly or bi-annual “audits” could be required of a certain percentage of the aggregate recurring claims reimbursed for all participants during a year. In addition, the dependent care provider can directly submit claims directly to the plan administrator. Payments to providers could be included on monthly statements to employees and if employees question the claims submitted by the provider, the employee could review the claim with the plan administrator.

4. Kindergarten Expenses under a Dependent Care FSA

Cafeteria plans which cover dependent care expenses have historically covered the tuition paid for kindergarten care. The basis for this position has been Treas. Reg. §1.44A-1 (c) (3) (i), which provides the definition of “care of qualifying individual” for purposes of Section 21 (the child care credit). That regulation does not clearly address the tuition cost associated with kindergarten. It clearly includes (as a qualifying expense) the tuition for nursery school, and it clearly excludes the tuition for first grade and above. However, the manner in which the regulation is worded suggests that tuition for kindergarten is included. As a result, that is the manner in which cafeteria plans have been administered. However, earlier this year the Service informally announced that kindergarten expenses would not be considered as permissible for purposes of the child care credit. This occurred through an example contained in Publication 503 (the example has since been withdrawn in the subsequent version of Pub. 503), and an information letter (INFO 2000-0246 dated 9/7/2000). If administrators must now begin administering cafeteria plans differently, and employers must amend their cafeteria plan documents, and participants should anticipate a change in the costs reimbursed through their cafeteria plan, such a change should be enacted through the rulemaking process (a proposed amendment to Treas. Reg. §1.44A-1 (c) (3) (i)) rather than informally.

5. Can coverage under a QMCSO be retroactive?

a. Explanation of Rule

The Final 2000 Regulations provide that an employee may change his/her elections to provide accident or health coverage for a dependent child if a judgment, decree or order (including a QMCSO under ERISA §609) requires such coverage for the child under the employer’s plan. Treas. Reg. §1.125-4(d)(1).

b. Concerns

In certain instances, it takes a considerable amount of time to have a QMCSO certified by the court and then approved by the plan administrator. In some cases, QMCSOs or divorce decrees provide specific dates from which an employee is required to cover a dependent child under the employee’s health insurance plan. In other cases, a QMCSO or divorce decree does not provide an effective date for coverage to begin under an employer’s group health plan or FSA. In each of these cases, the plan administrator must determine when coverage should begin once the order is approved as a QMCSO.

For example, an employee who elected employee-only coverage under the employer’s plan enters into a QMCSO with his former spouse several years after their divorce (the divorce decree did not address health coverage for the child). The QMCSO requires the group health plan of the employee’s employer to provide coverage for the child. However, although the QMCSO does not contain an effective date as to when

coverage under the employer's plan must begin, the date the QMCSO was certified by a court precedes the date the employee submitted it to the plan administrator.

In this instance, when should coverage become effective? Do the Final 2000 Regulations permit the Plan to honor a retroactive effective date? Even if no date is specified by the decree or order, due to the processing time, 30-60 days may have passed from the date that the order or decree was granted. During such time, a dependent child may not have accident or health plan coverage. Further, in the case of HIPPA special enrollment rights for dependents, retroactive coverage is allowed by reason of IRC 9801(f). If coverage is retroactive, can the employee "make-up" contributions to his or her FSA for the current plan year from future paychecks?

c. Recommendation

We recommend that the Final Regulations adopt a provision allowing for retroactive coverage under Treas. Reg. §1.125-4(d).

6. Guidance on non-discrimination testing

Code §125(b) sets forth 3 nondiscrimination standards:

- Discrimination is prohibited in favor of highly compensated individuals with respect to eligibility to participate. Code §125(b)(1)(A).
- Discrimination is prohibited in favor of highly compensated participants with respect to both contributions and benefits. Code §125(b)(1)(B).
- The statutory nontaxable benefits provided to key employees cannot exceed 25 percent of the total nontaxable benefits provided for all employees under the plan. Code §125(b)(2).

However, these tests are somewhat confusing and there is very little guidance published by the Service on the discrimination tests. We would appreciate an opportunity to provide comments on issues with respect to the nondiscrimination tests.