MEMORANDUM OF LAW

DATE: January 29, 1990

TO: D. Cruz Gonzalez, Risk Management Director,
via Jack McGrory, Assistant City Manager

FROM: City Attorney

SUBJECT: Section 125 Regulations

Recently you asked this office for an opinion regarding the interpretation of a new proposed regulation clarifying 26 U.S.C. section 125. Specifically, you are concerned that certain language of Question & Answer seven of proposed regulation Section 1.125-2 precludes the City from allowing employees to use medical reimbursement money to pay dependent or spousal health plan premiums that are offered as part of the City's flexible benefit plan. The language in question reads as follows:

> A health FSA may not treat participants' premium payments for other health coverage as reimbursable expenses. Thus, for example, a health FSA may not reimburse participants for premiums paid for other health plan coverage, including premiums paid for health coverage under a plan maintained by the employer of the employee's spouse or dependent (emphasis added).

You have asked if you have correctly interpreted this language and if your concerns are legitimate.

REGULATORY BACKGROUND

In 1984 a proposal was made to amend the Federal Income Tax Regulations by adding Section 1.125-1. This regulation, consisting of twenty-five (25) questions and answers, explained and clarified the benefits available under cafeteria benefit packages. Subsequently, on March 7, 1989, a new regulation further clarifying 26 U.S.C. section 125 was proposed. This proposed amendment is known as Section 1.125-2. As of December 27, 1989, neither of the proposed regulations had been adopted.

Nevertheless, the Internal Revenue Service has indicated that proposed regulations may be relied on as guidelines pending the issuance and adoption of final regulations.

FLEXIBLE SPENDING ACCOUNTS

The following information regarding flexible spending arrangements is taken from CCH Pension Plan Guide and Explanation Forms II Sections 4200-10399 (1989).

> Flexible spending accounts. - A flexible

> spending account is an arrangement providing for a dollar-denominated account in an employee's name available for the reimbursement of certain of the employee's personal expenses. Qualifying expenses include out-of-pocket health spending, dependent care, employee health insurance premium contributions, and certain other expenses.
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> A forfeitable flexible spending account is a form of benefit under which an employee (1) may receive, subject to a dollar limit, cash reimbursements of covered expenses and (2) does not have the right to receive the benefit of any amounts remaining unused at the end of the year. This type of flexible spending account qualifies for tax-preferred treatment; the reimbursements made through the account, whether financed by the employer or by the employee through salary reduction, are excluded from income for purposes of income and payroll taxes.

San Diego's Medical/Dental/Vision Reimbursement Plan is a forfeitable Flexible Spending Arrangement (FSA). The FSA qualifies for tax preferred treatment because the amount of reimbursement the employee will receive is selected at the beginning of the plan year and is subject to forfeiture if unused. Reimbursement is only one of the benefits available in the City's flexible benefit cafeteria plan. As noted in the paragraph defining FSA's, employee health insurance premiums are qualified expenses.

The meaning of the term "other insurance" found in the answer to question seven of the proposed regulations cannot be interpreted in a vacuum. The answer must be considered in conjunction with other Internal Revenue Code sections which define the tax benefits available in a cafeteria plan. Cafeteria plans are defined in 26 U.S.C section 125 and are said to be a plan under which:

> The participant may choose among two or more benefits consisting of cash and qualified benefits. The term "qualified benefit" means any benefit which, with the application of subsection (a) and without regard to section

89(a), is not includible in the gross income of the employee by reason of an express provision of this chapter (other than section 117, 124, 127, or 132).

Answer seven (4) of proposed regulation 1.125-2 specifies that a flexible spending account can only reimburse medical expenses as defined in 26 U.S.C. section 213. Section 213 indicates the term "medical care" includes amounts paid for insurance. Additionally, 26 U.S.C. section 105 provides that gross income does not include amounts paid to a taxpayer to reimburse the taxpayer "for expenses incurred by him for medical care (as defined in Section 213(d) above) of the taxpayer, his spouse, and his dependents." Note that section 105 specifically includes amounts paid for a spouse or a dependent. Additionally, the Mercer Meidinger Hanson Information Release of March 1989, issued at the time the regulation was proposed specifically stated: "A flexible spending arrangement may not reimburse employees for outside health coverage, such as that offered by a spouse's employer or purchased by a dependent" (emphasis added).

CONCLUSION

Proposed regulation 1.125-2 does not indicate that premiums for spousal or dependent insurance that are found within a single cafeteria plan are to be considered "other insurance." Dependent and spousal insurance are health benefits provided to an employee at his or her option as part of the cafeteria plan offered by the City. Each of the benefits available in the City's cafeteria plan is a part of a single benefit plan. Even the wording of the proposed regulation indicates that other insurance would be insurance maintained by the employer of a spouse or dependent.

To interpret "other insurance" as you have suggested would effectively deny an employee the benefits the IRS sought to allow participants by creating the cafeteria plan.

JOHN W. WITT, City Attorney
By
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Deputy City Attorney

SAM:mrh:352.3(x043.2)
cc Valerie VanDeweghe
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