DATE: January 25, 1991

TO: D. Cruz Gonzalez, Risk Management Director,
via Jack McGrory, Assistant City Manager
FROM: City Attorney
SUBJECT: Section 125 Regulations and Health Flexible Spending Arrangements

In a memorandum dated October 24, 1990, you stated that effective July 1, 1991, the City will begin to offer Flexible Spending Arrangements (FSAs) through payroll deduction in conjunction with the cafeteria plans. Referring specifically to paragraph (b)(2) of Q&A-7 of proposed regulations to 26 U.S.C. Section 125, you asked whether the City is entitled to seek recovery of premiums for health FSAs from employees who either enter a leave without pay status for a portion of the year which suspends premium contributions, or terminate their employment with the City prior to contributing sufficient premiums to cover the full amount of their claims. You asked further that if the City were able to recover such premiums what vehicles could be considered to accomplish the recovery. We have reviewed proposed regulations Sections 1.125-1 and 1.125-2 and conclude that the City is not entitled to seek recovery of the premiums described.

REGULATORY BACKGROUND

Currently, there are two sets of proposed regulations clarifying 26 U.S.C. Section 125. As of December 31, 1990, neither proposal has been adopted. The first proposal, dated May 7, 1984, consisted of twenty nine (29) questions and answers relating to the tax treatment of cafeteria plans. It is known as Section 1.125-1. Subsequently, on March 7, 1989, a new regulation further clarifying 26 U.S.C. Section 125 was proposed. It is known as Section 1.125-2. Section 1.125-2 contains seven (7) questions and answers relating to Section 125 cafeteria plans that supplement and, in part, update the questions and answers in the proposed regulations contained in Section 1.125-1 (49 FR 19321). 54 Fed. Reg. 9460, 9461 (1989).

HEALTH FSA REQUIREMENTS UNDER PROPOSED REGULATIONS SECTIONS 1.125-1 AND 1.125-2

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 and employee health insurance premium contributions. San Diego's Medical/Dental/Vision Reimbursement Plan is a Flexible Spending Account (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.

Q&A-7 of proposed regulation Section 1.125-2 contains special rules applicable to health plans that are FSAs. First, health FSAs must qualify as "accident or health plans" in conformity with Sections 105 and 106 of the Internal Revenue Code. Second, although health coverage under a FSA need not be provided through a commercial insurance contract, a health FSA must exhibit the risk-shifting and risk-distribution characteristics of insurance. Third, reimbursements under health FSAs must be paid specifically to reimburse the participant for medical expenses incurred previously during the period of coverage. Finally, a health FSA will not qualify for tax favored treatment under Sections 105 and 106 of the Internal Revenue Code if the effect of the reimbursement arrangement eliminates all, or substantially all, risk of loss to the employer maintaining the plan. These rules apply with respect to a health plan without regard to whether the plan is provided through a cafeteria plan. A-7 of proposed regulation Section 1.125-2 specifically directs further inquiry in this area to Q&A-17 of proposed regulation Section 1.125-1.

Q&A-17 of proposed regulation Section 1.125-1 discusses with greater specificity the application of the specific rules of Section 105 of the Internal Revenue Code which provides an income exclusion for amounts received as reimbursement for medical care expenses under an accident or health plan when coverage under the accident or health plan is offered as a benefit under a cafeteria plan. With respect to the requirement that the reimbursements must be provided under a benefit that exhibits the risk-shifting and risk-distribution characteristics of insurance, A-17 provides:

> A benefit will not exhibit the required risk-shifting and
>
> risk-distribution characteristics, even though the benefit is provided under a commercial insurance contract, if the ordinary actuarial risk of the insurer is negated under the terms of the benefit or by any related benefit or arrangement (including arrangements formally outside of the cafeteria plan).

A-7 of proposed regulation Section 1.125-2 contains additional requirements for health FSAs. According to paragraph (b)(2), "the maximum amount of reimbursement under a health FSA

must be available at all times during the period of coverage (properly reduced as of any particular time for prior reimbursements for the same period of coverage)." As such, "the maximum amount of reimbursement at any particular time during the period of coverage cannot relate to the extent to which the participant has paid the required premiums for coverage under the health FSA for the coverage period." In addition, the payment schedule for required premiums for coverage under a health FSA may not be based on the rate or amount of covered claims during the coverage period. Finally, "if the employee revokes existing elections, the employer must reimburse the employee for any amount previously paid for coverage or benefits relating to the period after the date of the employee's separation from service regardless of the employee's claims or reimbursements as of such date." Three examples illustrating the rules of paragraph (b)(2) are set forth in the proposed regulation Section 1.125-2. Significantly, none of the examples discuss whether the employer is entitled to seek recovery from employees who either enter a leave without pay status for a portion of the year which suspends premium contributions or terminate their employment with the City prior to contributing sufficient premiums to cover the full amount of their claims.

DISCUSSION

According to the Internal Revenue Service, the special rules contained in Q&A-7 applicable to FSAs are "intended to protect the integrity of the distinction between the taxable treatment of personal medical expenses (subject to the rules of section 213) and the more favorable tax treatment of employer-provided health plan coverage and benefits under section 105 or 106 . . . ." 54 Fed. Reg. 9466-9467 (1989).

Discussing this distinction in greater detail, the Internal Revenue Service has stated:

> In general, if a health plan has a low maximum limitation on benefits and the amount of the premium for coverage is the same or similar to this limitation on benefits, there is a significant concern that the plan operates primarily to exclude from income amounts paid for personal medical expenses that would otherwise only be deductible under section 213 to the extent that they exceed 7.5 percent of adjusted gross income.

> This concern is greater if, with respect to such plan, there is no person, such as an employer or insurance company, who bears a risk of experience loss with respect to the health plan and thus has an interest in regulating the arrangement to minimize adverse selection and substantiate claimed expenses. In order to limit the extent to which health FSAs effectively operate to exclude amounts paid for personal medical expenses, Q&A-7 applies requirements to health FSAs that are similar to the requirements that an independent health insurer with a meaningful risk of loss would apply to protect against adverse selection and the inappropriate reimbursement of expenses. Thus, the requirements in the proposed regulation are consistent with those features that are commonly associated with arrangements that exhibit the basic risk-shifting and risk-spreading characteristics of insurance.

54 Fed. Reg. 9467 (1989).

Finally, as articulated by the Internal Revenue Service:

> Q&A-7 clarifies that an employee's salary reduction contributions under a health FSA are payments of a premium by the employee for health coverage with respect to which the maximum reimbursement amount is the same or similar to the amount of the required premium. Therefore, health FSAs are bona fide plans and are not separate employee-by-employee, health expense reimbursement accounts that operate in a manner similar to employee-funded, defined contributions plans.

54 Fed. Reg. 9467 (1989).

CONCLUSION

Proposed regulations Sections 1.125-1 and 1.125-2 do not entitle the City either directly or indirectly to seek recovery from employees who enter a leave without pay status for a portion of the year which suspends premium contributions or terminate their employment with the City prior to contributing sufficient premiums to cover the full amount of their claims. A Health FSA such as San Diego's Medical/Dental/Vision Reimbursement Plan must qualify as an "accident or health plan" in conformity with Sections 105 and 106 of the Internal Revenue Code. It must also exhibit the risk-shifting and risk-distribution characteristics of insurance. If the City were allowed to recover premiums in the situations described, the health FSA would not qualify for tax favored treatment under Sections 105 and 106 of the Internal Revenue Code because the recovery of the premiums would effectively eliminate all or substantially all risk of loss to the City maintaining the plan.

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