

MEMORANDUM OF LAW

DATE: June 18, 1992

TO: Larry Gardner, Labor Relations Manager

FROM: City Attorney

SUBJECT: Dental/Medical/Vision Reimbursements

You have requested a response to Joel Klevens' letter dated June 2, 1992, concerning the legality of the City's retaining the unused Dental/Medical/Vision ("DMV") monies of City employees.

BACKGROUND

Through the City's flexible benefit cafeteria plan, employees may set aside certain monies as DMV reimbursement. Each employee selects the amount he/she anticipates using during the plan year. Unused monies are retained, pursuant to the plan, by the City.

Mr. Klevens, attorney for Fire Fighters Local 145, contends that the City, by retaining unused DMV funds, is confiscating, without notice, funds that rightfully belong to the employees. Mr. Klevens further indicates that he is aware of no legal or equitable basis for the City's decision to retain unused DMV reimbursement monies. Finally, Mr. Klevens states the City must either carry the funds over to the next plan year or refund the money to the employees.

DISCUSSION

Neither of the alternatives suggested by Mr. Klevens is legally permissible. The City's flexible benefit plan is a cafeteria plan structured and regulated pursuant to the dictates of Internal Revenue Code ("IRC") section 125 and the explanatory regulations found in Internal Revenue Service ("IRS") regulations 1.125-1 and 1.125-2.

A cafeteria plan may not offer a benefit that allows a participant to defer receipt of compensation. IRS regulation 1.125-1 specifically provides: "A cafeteria plan does not include any plan that offers a benefit that defers the receipt of compensation, with the exception of the opportunity for participants to make elective contributions under a qualified cash or deferred arrangement defined in section 401(k)."

In explaining the meaning of deferred compensation, the regulation goes on to say:

Generally, a plan that permits participants to carry over unused benefits or contributions from one plan year to a subsequent plan year operates to enable participants to defer the receipt of compensation. This is the case regardless of whether the plan permits participants to convert the unused contributions or benefits into another benefit in the subsequent plan year.

The regulation also indicates that: "A plan that allows participants to use employer contributions for one plan year to purchase a benefit that will be provided in a subsequent plan year operates to enable participants to defer the receipt of compensation."

Therefore, under the IRS regulations governing cafeteria plans, the City may not carry over unused DMV monies to the following year. To do so would jeopardize the plan's qualified tax status under IRC section 125.

Similarly, Mr. Klevens' suggestion that the unused monies be returned to employees is prohibited by the IRC. DMV reimbursement benefits are strictly a "use it or lose it" benefit. IRS regulation 1.125-1 provides:

A cafeteria plan benefit under which a participant will receive reimbursements of medical expenses is a benefit within sections 106 and 105(b) only if, under the benefit, reimbursements are paid specifically to reimburse the participant for medical expenses incurred during the period of coverage. Amounts paid to a participant as reimbursement are not treated as paid specifically to reimburse the participant for medical expenses if, under the benefit, the participant is entitled to the amounts, in the form of cash (e.g., routine payment of salary) or any other taxable or nontaxable benefit, irrespective of whether or not he incurs medical expenses during the period of coverage, even if the participant will not receive the amounts not used for expense

reimbursement until the end of the period. A benefit under which participants will receive reimbursement for medical expenses up to a specified amount and, if they incur no expenses, will receive cash or any other benefit in lieu of the reimbursements is not a benefit that qualifies for the exclusions under sections 106 and 105(b). See Section 1.105-2. This is the case without regard to whether the benefit was purchased with contributions made at the employer's discretion, at the participant's discretion (such as pursuant to a salary reduction agreement), or pursuant to a collective bargaining agreement. (Emphasis added.)

Again, under the IRS regulations governing cafeteria plans, the City is prohibited from returning unused DMV monies to employees.

Mr. Klevens is correct in his assertion that the Memorandum of Understanding ("MOU") with Local 145 does not specify that unused DMV funds will be forfeited. However, Article 22, note 2 reads: "It is the intent of the City that this Plan comply with the IRS regulations." Further, employees are given notice in the plan summary that unused DMV monies will be forfeited if they are not used. The specific language of the plan summary is:

If you do not use all the money in your Dependent Care or Dental/Medical/Vision Reimbursement Accounts, you will lose it at the end of the Plan Year. IRS regulations state that you must forfeit any money left in your Reimbursement Accounts when the Plan Year ends. These forfeitures cannot be deducted on your income tax return. Plan carefully before deciding how much to contribute to your Reimbursement Accounts. Set aside only the dollar amount you are certain you will use. (Emphasis in original.)

It is incumbent upon the individual employee to read the plan summary and to make wise choices in his/her selection of benefits. In those instances when employees designate too much

money for DMV reimbursements, unused money can not be returned to the employee without jeopardizing the qualified tax status of the City's plan. Based upon the IRC regulations and the plan summary, there is no illegal nor inequitable taking of employees' benefits through the City's retention of unused monies.

If I can be of further assistance in this matter, please feel free to contact me.

JOHN W. WITT, City Attorney

By

Sharon A. Marshall

Deputy City Attorney

SAM:mrh:352.3(x043.2)

cc D. Cruz Gonzalez

Joel N. Klevens

Fogel, Feldman, Ostrov, Ringler & Klevens

Attorneys at Law

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