MEMORANDUM OF LAW

DATE: September 29, 1994

TO: Mary Rea, Assistant Risk Management Director

FROM: City Attorney

SUBJECT: Changes in Flexible Benefits Elections

Question Presented

You have asked whether an employee whose union affiliation changes, either through a change in employment status or resignation from the union, may in the middle of a plan year change his or her flexible benefits election.

Short Answer

An employee whose union affiliation changes because he or she promotes or transfers may make a new benefit election in the middle of the plan year. However, should an employee voluntarily resign from his or her union, the Internal Revenue Code does not allow changes to be made.

Background

Cafeteria plans such as the City's flexible benefits plan are governed by 26 U.S.C. Section 125. The specific guidelines for cafeteria plans are found in 26 C.F.R. Sections 1.125.1 and 1.125.2. A cafeteria plan must require that participants make an election of the benefits they want for the plan year and once made, the election may not be revoked. Under the City's plan, elections are made during open enrollment, prior to the start of the new fiscal year.

As part of the City's flexible benefits plan, employees in certain classifications have benefits available to them through their labor organizations. These benefits are in addition to City sponsored benefits available to other City employees. Each union sponsors a health plan and some unions also sponsor dental and/or vision plans. To obtain union sponsored health benefits, an employee need only be a member of a classification represented by the union. Dental and/or vision care sometimes requires that an employee be a dues paying member of the union to avail himself or herself of the union sponsored plan.

Pursuant to the dictates of Section 1.125.1, Risk Management has refused to allow benefit changes in mid-year due to a change in union status. Employees who become ineligible for their chosen benefits then forfeit the premiums for the remainder of the year.

Analysis

26 C.F.R. Section 1.125.1, question and answer (q&a) 8 provides:

> An election will not be deemed to have been made if, after a participant has elected and begun to receive a benefit under the plan, the participant is permitted to revoke the election, even if the revocation relates only to that portion of the benefit that has not yet been provided to the participant. . . . However, a cafeteria plan may permit a participant to revoke a benefit election after the period of coverage has commenced and to make a new election with respect to the remainder of the period of coverage if both the revocation and new election are on account of and consistent with a change in family status (e.g., marriage, divorce, death of spouse or child, birth or adoption of child, and termination of employment of spouse).

However, subsequent regulations outline additional instances in which benefit elections may change in mid-year. Specifically Section 1.125.2 q&a 6 states changes may be made under the following circumstances:

1. When there are significant cost changes
2. When there are significant coverage changes
3. If there is a change in family status
4. If there is a separation from service
5. When there is a cessation of required contributions

In reviewing the circumstances that would permit a benefit change, the exception that would apply to a change in union status is found at Section 1.125.2 q&a 6(b)(2). It provides:

> (2) Coverage changes. If the coverage under a health plan provided by an independent, third-party provider is significantly curtailed or ceases during a period of coverage, a cafeteria plan may permit all affected participants to revoke their elections of the health plan, and, in lieu thereof, to receive on a prospective basis coverage under another health plan with similar coverage.

From the facts as presented, it would appear that (b)(2) would apply. Clearly ineligible union status would result in a loss of coverage triggering the provision of the regulation that allows a benefit change. However, implicit in the language of the regulation is the understanding that the changes occur without any action by the

employee. Thus, because the loss of coverage occurs in one instance voluntarily and in the other instance involuntarily, the outcome in the two scenarios is different.

In the first instance, when a transfer or promotion results in a change in union status, new elections may be made because the coverage "is significantly curtailed or ceases" through no voluntary act by the employee. An employee should not be expected to refuse a transfer or promotion to maintain his or her health benefits. However, when union affiliation ceases because an employee resigns from the union there has been no forced loss of coverage. The employee may not make election changes under these circumstances. The remaining premium payments are forfeited because to allow the employee to receive the remaining premiums in cash would be the same as allowing a change in the benefit election. Such action could jeopardize the plan's tax qualified status.

Conclusion

26 CFR Section 1.125.2 q&a 6 provides for benefit changes when there is a loss of coverage. Therefore, employees who lose coverage through promotion or transfer may make election changes. Employees who voluntarily choose to discontinue converge may not make benefit changes and must forfeit their remaining premiums.

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