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Plan Design

When Is Your ERISA Plan or Flexible Benefit Plan Not Good Enough to Be a Bona Fide Plan?

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Employee benefit plan drafters frequently complete plan documents for their client's use assuming that the document's status as an employee benefit plan under the Employee Retirement Income Security Act of 1974 (''ERISA'') or under the Internal Revenue Code of 1986, as amended (the ''Code''), is definitive. The Ninth Circuit decision in *Flores v. City of San Gabriel*, (824 F. 3d 890 (9th Cir. 2016), *cert. den'd* 137 S. Ct. 2117 (2017)), which the U.S. Supreme Court permitted to stand, calls into question that assumption. A plan may not be a plan for all purposes. Failure to consider the company as a whole, as an employer and the implications of other federal laws may raise risks for the company. The Ninth Circuit reviewed whether payments made to employees as opt-out payments for electing not to take health insurance under a flexible benefit plan (Code section 125 plan, a/k/a a cafeteria plan) were excludable from the employee's compensation and therefore not included as part of their regular rate of pay for purposes of calculating overtime pay under the Fair Labor Standards Act of 1938 (the ''FLSA'').

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FLSA Background With Respect to Opt-Out Payments and ERISA Plans

Under the FLSA, employees are required to be paid one and half times their regular rate for all overtime worked. The ''regular rate'' is defined in the FLSA as *all* remuneration for employment paid to, or on behalf of, an employee subject to certain statutory exclusions (29 C.F.R sec. 778.108; *Bay Ridge Operating Co. v. Aaron*, 334 U.S. 446 (1948) and *Walling v. Youngerman-Reynolds Hardwood Co.*, 325 U.S. 446 (1948)):

- Section 207(e)(2) exempts from the ''regular rate of pay'' items such as vacation pay, reimbursable travel expenses and ''other similar payments to an employee which are not made as compensation for his hours of employment.''

- Section 207(e)(4) excludes from the regular rate of pay ''contributions irrevocably made by an employer to a trustee or third person pursuant to a bona fide plan for providing old-age, retirement, life, accident, or health insurance or similar benefits for employees.''

The FLSA was enacted in 1938 many years before the enactment of ERISA and its concept of benefit plans. The FLSA's reference to a ''bona fide plan'' is not tied statutorily to ERISA's definition of an employee benefit plan. There has been no statutory amendment recognizing the ERISA or Code concepts of an employee benefit plan as a ''bona fide plan'' under the FLSA. The FLSA was also not amended to address any of the more recent employee benefit plan creations such as health reimbursement arrangements under IRS Notice 2002-45 or health savings accounts added to the Code as Sec. 223 in 2003 by the Medicare Prescription Drug Improvement and Modernization Act (''MPDIMA'') (P.L. 108-173) or the Qualified Small Employer Health Reimbursement Arrangements added late in 2016 by the 21st Century Cures Act (P.L. 114-255). Instead the FLSA continues to exempt from the regular rate of pay only what the FLSA considers to be ''bona fide plans.'' While the relevant provisions of the FLSA for this article's purpose have not been amended, Congress has demonstrated an ability to amend or add to other provisions in the FLSA during this same period (such as the amendments contained in the Patient Protection and Affordable Care Act).

Why Are We Talking About the FLSA and Opt-Out Payments Now?

The Ninth Circuit's decision in *Flores v. City of San Gabriel*, requiring inclusion of opt-out payments in the regular rate of pay for purpose of calculating overtime, was permitted to stand when the U.S. Supreme Court denied the *writ of certiorari* in May 2017.

The case concerned police officers (the ''Employees'') in the City of San Gabriel (''City'') who were covered by a flexible benefit/cafeteria plan providing each Employee with a designated pool of funds that each could use to purchase vision and dental insurance. The purchase of medical benefits was discretionary, assuming the Employee provided proof of alternative medical coverage. Some employees chose to not use the funds to buy the medical insurance and instead received an opt-out payment as an addition to their paycheck as a separate line-item listed as ''cash in lieu'' payments. Benefits provided under a flexible benefit plan or cafeteria plan are generally not held in, or paid from, a trust for ERISA purposes, but paid from the employer's general assets to avoid the independent CPA audit requirement under ERISA.

In 2012, Employees brought suit against the City, alleging the ''cash in lieu'' payments were compensation, not benefits, and must be included in their regular rate of pay for purposes of calculating overtime under the FLSA. The Employees alleged the City's conduct was willful, entitling them to three years of back pay, as well as liquidated damages (double damages, as provided under the FLSA). The City argued that the cash in lieu payments were excluded from the regular rate under Section 207(e)(2) of the FLSA because they were not compensation for an employee's hours of work and it also argued that they were part of a bona fide benefit plan, not compensation and excluded from the ''regular rate of pay'' calculation under FLSA Section 207(e)(4). Of the total monies the City paid on behalf of its employees pursuant to or through its Flexible Benefit Plan, 42% to 47% was paid through to the employees as cash in lieu of benefits payments in their paychecks. Between 2009 and 2012, the monthly cash in lieu of benefits payment for each employee who declined medical coverage was between approximately $1,000 and $1,300 per month. The District Court granted summary judgment to the Employees, finding that the cash in lieu payments must be included in the calculation of the regular rate of pay for purposes of overtime. The District Court, however, found that the City's violation of the FLSA was not willful and limited damages to a two-year period.

On appeal, the Ninth Circuit held that cash payments made to employees in lieu of health benefits must be included in the ''regular rate'' used to compensate employees for overtime hours worked. The Court rejected the City's argument under FLSA Section 207(e)(2) and held that the payments were not directly attributable to any particular hours worked, but generally understood to be compensation for services, and are not excluded from the ''regular rate.'' Furthermore, the cash in lieu payments could not be excluded as a payment made irrevocably to a third party pursuant to a bona fide benefit plan for health insurance, retirement, or similar benefits, pursuant to § 207(e)(4) of the FLSA, since those payments were paid directly to the employees. The Court went on to hold that the opt-out arrangement in question was not a ''bona fide'' benefit plan because the payments to employees were more than ''incidental'' so as to be considered a bona fide benefits plan under the FLSA regulations (29 C.F.R. Sec. 778.215). The Court did not rule on the DOL's position, expressed in prior Opinion Letters, that a 20% plan wide cap is appropriate. Perhaps most alarming, the Court held that even payments made to trustees or third parties under its flexible benefits plan were not properly excludable from the regular rate because the flexible benefit plan was not a bona fide benefit plan.

What Does This Mean for Employers?

■ Eligible Opt-Out payments (as well as ineligible opt-out payments as such are defined in the proposed regulations under the health care tax credit under Section 36B of the Internal Revenue Code) are treated as part of the regular rate of pay under the FLSA.

■ What does this mean for other defined contribution health plan designs, many of which pass funds through a cafeteria or flexible benefits plan such as Health Savings Account contributions? Similarly, what does this mean for other flexible benefit plans providing employees with credits the employee can elect to use to purchase benefits or cash out? Courts have not ruled on these arrangements yet, but employers should consider analyzing their benefits under the FLSA in addition to ERISA and the Code to determine if there are alternative structures that may help to minimize the FLSA risk considering the exclusions in the statute, the analysis in *Flores v. City of San Gabriel* and the analysis in later cases.

■ Health reimbursement arrangements and Qualified Small Employer Health Reimbursement Arrangements are generally notional accounts set up for employees to access to reimburse medical expenses and are generally paid out of the employer's general assets and not from a trust. At the time this was written, these arrangements have not been analyzed by a court under the FLSA.

■ Health savings accounts—created in 2003 in MPDIMA—have also not been addressed by any decision interpreting the application of the FLSA to amounts employers contribute to these accounts, which individuals own and control and which can be used for nonmedical expenses with payment of an additional tax.

While there are a variety of different benefits arrangements that could be impacted by the *Flores* decision, it is not clear if the same analysis would be applied if the payments at issue were significantly less. Health savings accounts have limits on the amount that can be contributed, and while individuals can use these accounts for non-medical purposes, that can only be done by incurring income tax and paying an additional penalty tax. Health savings accounts are owned by the individual and there is published guidance indicating these accounts are not an employer-sponsored plan (U.S. Department of Labor Field Assistance Bulletin 2006-02 (October 27, 2006)), which would seem to cut against treatment of such accounts as a bona fide benefit plan under the FLSA. However, the employer contributions to health savings accounts are frequently paid through a cafeteria plan to avoid the comparable contribution requirements of Code section 4980G. Accordingly, it is unclear if this plan feature along with the limitation on the contributions would result in a finding that such accounts fall within the FLSA's bona fide benefit plan exemption.

Most employers place limits on the amounts available to employees under health reimbursement arrangements and such amounts can only be taken as reimbursements of medical expenses and not as cash. However, these are generally structured as payable from the employer's general assets and not from a trust, so their status as a bona fide benefit plan under the FLSA may be in question. The employee benefit design square pegs do not fit neatly within the FLSA's round hole exemptions. The *Flores* decision leaves employers with many questions and only limited answers.

At this time, we know that the U.S. Supreme Court decided to pass on the opportunity to review the *Flores* decision. A few District Courts have issued rulings since the *Flores* decision. In *Slezak v. City of Palo Alto* (N.D. Cal. 2017), the Northern District in California also found that cash in lieu of health insurance payments must be used to calculate the regular rate of pay and overtime due following the Ninth Circuit's decision in *Flores*.

In *Sharp v. CGG Land (U.S. Inc.)*, (840 F.3d 1211 (10th Cir. 2016)), a case decided by the Tenth Circuit shortly after *Flores*, Plaintiff-employees brought a collective action against their employer alleging violations of FLSA arising out of the employer's failure to include in their regular rate reimbursements of daily meal expenses while working away from home. The Tenth Circuit ruled that the cost of food away from an employee's home is an additional expense that the employee incurs while traveling for the employer's benefit and is thus exempt as a living expense from being included in the employee's regular rate of pay.

In *Amador v. City of Ceres*, (E.D. Cal. 2017), employees brought a collective action against their employer, alleging, in part, they had received compensation from the city in the form of ''cash-in-lieu'' benefits for city-sponsored medical benefits and lump-sum payments for unused holidays. The employer moved to strike these portions of the employees' complaint. The court refused to strike, or alternatively dismiss, these portions of the complaint, largely ''in light of defendant's ultimate burden to establish that its. . .compensation policy must be exempted from plaintiffs' regular rate of pay.'' Much of this case hinged on the Court's interpretation of a similar 2009 case, *Hart v. City of Alameda*, (N.D. Cal. 2009), where that District Court ruled that payments made under a holiday compensation scheme were not made ''due to'' a holiday. The ultimate decision has not been rendered.

It is not clear what position the federal courts might take on a health reimbursement arrangements, other defined contribution health benefit alternatives or seed funds contributed by an employer to a Health Savings Account as those issues have not been adjudicated to date. Perhaps the fact that the monies at issue in these cases are generally far more limited in amount than the opt-out payments in *Flores* will mitigate the risk.

It is also not clear what position the federal courts might take on Qualified Small Employer Health Reimbursement Arrangements (″QSEHRAs″) under Code section 9831 and IRS Notice 2017-67. QSEHRAs may be used by employers who qualify (employers who are not part of an applicable large employer under Code section 4980H) to reimburse health insurance premiums and other medical expenses (including some over-the-counter expenses). QSEHRAs by statute are defined to not be group health plans under Code section 9831(d)(1) and ERISA section 731(a)(1). The payments under a QSEHRA are not required to be paid from a trust and can be paid from an employer's general assets to simplify ERISA compliance, but simplifying ERISA compliance may carry other costs. (Traditional health reimbursement arrangements are frequently structured in a similar manner without any trust or funding under IRS Notice 2002-45, but are not exempted from group health plan status under the Code or ERISA.) While the Code and ERISA were amended to facilitate QSEHRAs, no related amendment was made to the FLSA to exempt QSEHRAs from the ''regular rate of pay.'' If the federal courts review the implications of QSEHRAs under the FLSA, small employers who use QSEHRAs may face an FLSA litigation risk.

Employers may want to review their plans and policies to determine whether their Code or ERISA plan design may present an issue in calculating the regular rate of pay for overtime calculation for non-exempt employees. Employers need to understand that what they may consider to be a benefit plan for purposes of the Internal Revenue Code or ERISA may not be treated as a bona fide benefit plan under the FLSA and should carefully analyze their benefits plans to ensure that their plan offerings do not put them at risk under the FLSA. Proposed expansion of health reimbursement arrangements will need to consider whether there is an FLSA litigation risk related to such an alternative benefit structure.

Just being a well-drafted ERISA plan or plan under the Code may not be sufficient to protect an employer from all risks, because such status does not provide a free pass under the FLSA as a bona fide benefit plan.