



**INDEPENDENT REGULATORY REVIEW COMMISSION  
COMMONWEALTH OF PENNSYLVANIA  
333 MARKET STREET  
14TH FLOOR  
HARRISBURG, PA 17101**

**(717) 783-5417  
Fax (717) 783-2664**

June 25, 1998

Honorable Robert A. Judge, Secretary  
Department of Revenue  
Strawberry Square, 11th Floor  
Harrisburg, PA 17128

Re: IRRC Regulation #15-402 (#1942)  
Department of Revenue  
Payments for Employee Welfare Benefit Plans and Cafeteria Plans

Dear Secretary Judge:

Enclosed are our comments on your proposed regulation #15-402. These comments outline areas of concern raised by the Commission. The comments also offer suggestions for your consideration when you prepare the final version of this regulation. These comments should not, however, be viewed as a formal approval or disapproval of the proposed version of this regulation.

If you or your staff have any questions on these comments or desire to meet to discuss them in greater detail, please contact Chuck Tyrrell at 772-3455. He has been assigned to review this regulation.

Sincerely,

A handwritten signature in black ink that reads "Robert E. Nyce".

Robert E. Nyce  
Executive Director

REN:cae  
Enclosure  
cc: Anita Doucette  
Douglas A. Berguson  
Office of General Counsel  
Office of Attorney General  
Pete Tartline

**COMMENTS OF THE INDEPENDENT REGULATORY REVIEW COMMISSION**

**ON**

**DEPARTMENT OF REVENUE REGULATION NO. 15-402**

**PAYMENTS FOR EMPLOYEE WELFARE BENEFIT PLANS AND CAFETERIA PLANS**

**JUNE 25, 1998**

We have reviewed this proposed regulation from the Department of Revenue (Department) and submit for your consideration the following objections and recommendations. Subsections 5.1(h) and 5.1(i) of the Regulatory Review Act specify the criteria the Commission must employ to determine whether a regulation is in the public interest. In applying these criteria, our Comments address issues that relate to legislative intent, reasonableness, and clarity of the regulation. We recommend that these Comments be carefully considered as you prepare the final-form regulation.

**1. Structure of regulations governing employee benefit plans and cafeteria plans - Clarity**

The Department's stated purpose for the rulemaking is to provide employers and employees with a detailed explanation of how nondiscriminatory employee welfare benefit programs, such as self-insured medical reimbursement accounts or cafeteria plans, are taxed. As proposed, the regulation does not provide a clear picture of how these programs will be taxed. Instead, the Department attempts to indirectly describe the treatment of employer benefit programs and cafeteria plans through the definition of compensation in Section 101.6. We believe several formatting and language revisions are necessary to improve the understanding of the rulemaking.

First, the Department needs to revise the rulemaking to specifically address when benefits from employee benefit plans and cafeteria plans will be considered compensation. Some benefits in an employee benefit plan or cafeteria plan may be compensation and other benefits may not be compensation. Therefore, it is important for the regulation to focus on the benefits that will be treated as compensation. One distinct section of the rulemaking should describe when benefits in an employee benefit plan or cafeteria plan will be considered compensation and thus taxable.

Second, the Department should clarify its use of the term *cafeteria plan* throughout the regulation. Section 301(D) of the Tax Reform Code (Code) provides that compensation shall not mean or include "Payments made by employers or labor unions, including payments made pursuant to a cafeteria plan qualifying under Section 125 of the Internal Revenue Code of 1986, for employee benefit programs covering hospitalization, sickness, disability or death, supplemental unemployment benefits or strike benefits...." In certain provisions of the rulemaking, the Department simply uses the term cafeteria plan, without any indication if it is a Section 125 plan or provides benefits referenced in Section 301(D) of the Code. These qualifications are important because they determine if the benefits received will or will not be considered compensation.

We recommend the Department review its use of the term *cafeteria plan* to assure that it includes the statutory qualifications in Section 301(D) of the Code when discussing whether the benefits of a plan are considered compensation. In the sectional comments below, we have identified uses of the term cafeteria plan that need further clarification.

Finally, the rulemaking appears to use the terms *compensation* and *taxable* interchangeably. Although the terms may be used interchangeably, we recommend that the Department consistently refer to benefits as compensation when they qualify as such. The Department, for clarity purposes, may want to add a provision in the rulemaking explicitly stating that items classified as compensation are taxable for purposes of Pennsylvania Personal Income Tax. In addition, the Department uses the phrases “taxable as compensation” and “taxable compensation” in several provisions of the rulemaking (e.g. Section 101.6(h) and Section 101.6(k)). Since something that is compensation is taxable, these phrases are redundant and should be deleted.

## **2. Section 101.1 Definitions – Reasonableness and Clarity**

The regulation defines *cafeteria plan*, *employe benefit plan*, and *employe welfare benefit plan*. It appears that these definitions overlap. Furthermore, the definition of *employe benefit plan* and *employe welfare benefit plan* are each defined by using the other term. This is confusing and does not create a distinct definition. Overall, it is not clear why each term is needed, especially as they relate to the personal income tax. We recommend the Department explain the need for each term and avoid using the terms to define any other term.

### *Cafeteria Plan*

The definition of cafeteria plan includes *flexible benefit plans*. The rulemaking does not define what is considered a flexible benefit plan. Accordingly, we recommend the Department define *flexible benefit plan*.

### *Employe Welfare Benefit Plan*

The definition of *employe welfare benefit plan* includes numerous examples of this term. However, some of the benefits listed as examples will be taxable and some will not. To avoid confusion on the application of the personal income tax, we recommend that the examples provided in (A) – (M) of the definition be deleted. Instead, the Department should include the examples in the section of the rulemaking discussing when aspects of an employe welfare benefit plan will be considered compensation, and thus taxable.

### *Poverty Income*

The definition of *poverty income*, as well as Section 101.6(c)(10), uses the terms *working condition fringes*, *qualified transportation fringes*, and *de minimis fringes*. The rulemaking does not define these terms. Accordingly, we recommend they be defined in the final-form regulation.

### *Program Covering Hospitalization, Sickness, Disability, or Death*

The Department is using specific criteria to determine what will be considered a program covering hospitalization, sickness, disability, or death. The criteria are confusing and we

question the intent and need for the criteria. We recommend the Department explain why the criteria found in Subsection (i) and (ii) of the definition are necessary. Beyond the intent of the criteria, we find that several of the provisions also need further clarification.

First, in Subsection (A) it provides that “No program benefits are payable or *subject to anticipation*, assignment or pledge until the commencement of a covered sickness or disability or death, except...”(emphasis added). We question what is meant by *subject to anticipation* and recommend the Department clarify this phrase in the final-form regulation.

Second, Subsection (i)(B) provides, as one of the criteria, that the only means of obtaining entitlement to program benefits is “proof of hospitalization, disability or death.” We question what the Department considers “proof” and if it is consistent with what insurance companies require.

Finally, Subsection (ii) provides that this term does “not include programs under which benefits are payable either upon hospitalization, sickness, disability or death or separation from employment or some other contingency.” As we read this section, it would appear that any program that provides benefits upon hospitalization, sickness, or disability would not be considered an employee welfare benefit plan covering hospitalization, sickness, disability or death. This does not seem logical. We recommend the Department explain its intent and if necessary either clarify or delete this subsection. If there are specific criteria that disqualify a program, the criteria should be clearly stated.

#### *Wage or Salary Supplement*

The definition of *wage or salary supplement* provides that it may be employer-provided coverage under an employee benefit plan. Under Section 101.6(a), wage or salary supplement is considered compensation and thus taxable. Therefore, taking these two sections together, it can be concluded that employee benefit plans are taxable. Because benefits received under an employee benefit plan may not always be compensation, the Department needs to revise this definition.

### **3. Section 101.6 Compensation – Legislative Intent, Reasonableness, Clarity**

After the submission of this proposed regulation, the General Assembly amended the Tax Reform Code (Code). Specifically, the Code now provides that personal use of an employer’s owned or leased property or of employer provided services is not considered compensation, and thus is not taxable. The proposed regulation does not reflect this recent amendment.

The Department must include the recent amendments for what is excludable from compensation. In addition, the Department needs to delete those provisions in the proposed rulemaking that consider employer provided service or property to be compensation. For example, Subsections 101.6(c)(11) and (e)(1) should be deleted.

Subsection (c)(5) provides that compensation will not include “Payments made by employers to reimburse actual expenses allowable as an ordinary, reasonable and necessary expense.” How will this section will be applied for reimbursement for service or property that involved both personal and business use? For example, if the employee leased a car that was used

for both personal and business reasons, the regulation needs to provide that the tax only applies to the percent used for personal purposes. The regulation should also indicate how the employer should withhold taxes from the taxable income in this case.

Subsection (c)(9) provides that "Payments made by an employer or labor union *for a collectively bargained* or nondiscriminatory supplemental unemployment benefit or strike benefit plan" is not considered compensation. We question why the Department included the term *collectively bargained* and recommend that the Department either delete or explain the need for the term.

Subsection (e)(3) provides that "The amount of taxable compensation paid in the form of federally taxable noncash fringe benefits shall be determined in the same manner as is prescribed by the Internal Revenue Service under Federal statutes and regulations." This subsection needs to be amended to be consistent with the recent amendment to Section 301 of the Code. Because noncash fringe benefits may include the "personal use of an employer's owned or leased property or of employer provided services," they should not be considered compensation for Pennsylvania tax purposes. The Department must clarify this section accordingly.

Subsection (e)(4) discusses the computation of compensation as it relates to IRC Section 125 cafeteria plans. The subsection makes no distinction as to what types of benefits may be provided under the cafeteria plan. As previously discussed, Section 301(D) of the Code provides that certain benefits of a federal cafeteria plan are not compensation. Accordingly, the Department needs to amend this subsection to be consistent with the statutory language of Section 301(D) of the Code.

One Commentator recommended Subsection 101.6(f) be amended to indicate incentive stock options, instead of stock options. This suggestion has merit because the Code includes incentive payments as compensation. Therefore, we recommend that this section solely refer to incentive stock options instead of all stock options.

Subsection (g) references cafeteria plan and Subsection (g)(2) references a federal qualifying cafeteria plan as they relate to the application of the personal income tax to vacation benefits. We question what relevancy a cafeteria plan has to do with the taxation of vacation benefits. That is, does it matter if the vacation benefits are part of a cafeteria plan in order to determine if they are compensation? We recommend the Department explain the intent of this subsection. In addition, the Department needs to clarify if the cafeteria plan in Subsection (g) is an IRC Section 125 cafeteria plan.

Subsection 101.6(i)(1) provides that "Payments made after December 31, 1996, for employe welfare benefit plans under a cafeteria plan qualifying under Section 125 of the IRC will be deemed to be an "employer contribution" for Pennsylvania personal income tax purposes if the following apply..." Again, we believe the section must be amended to be consistent with Section 301(D) by making the distinction of the type of benefits included in the cafeteria plan.

Furthermore, in describing the situations that apply in Subsection (i)(1)(i) and (ii), the Departments uses "they." It is not clear what "they" refers to. We recommend the Department clarify this in the final-form regulation.

We have several concerns with Subsection 101.6(i)(2). First, the Subsection begins “If these conditions are satisfied, cafeteria plan contributions are taxed under the rules as apply to employe welfare benefit plans.” It is not clear what conditions are being referred to in this subsection. The conditions must be either referenced or specifically listed. Second, it is not clear what “rules” the Department is referencing. A citation to these rules needs to be included. Third, this subsection refers to cafeteria plans as a whole, and does not include the distinction for cafeteria plans contained in Section 301(D) of the Code. Overall, Subsection 101.6(i)(2) lacks clarity, especially as to the full effect of its provisions and needs to be more clearly drafted.

In the first example under Subsection 101.6(i), the Department uses the term *gross pay requirements*. We believe the term *requirements* is unnecessary and the example should simply refer to gross pay.

In the fifth example under Subsection 101.6(i), the Department should separate the conclusion in a separate subsection as it has with the other examples. Furthermore, relevant facts to the example are contained in the conclusion. To improve understanding of the example, the facts should be listed before the conclusion.

We believe the sixth example under Subsection 101.6(i) is too detailed and should not be in the rulemaking. The example would be more appropriate for a Department guidance manual. If the Department deletes this example, it should also delete examples seven and eight since they reference example six.

#### **4. Section 101.7 Receipt of income – Clarity**

Subsection 101.7(f) begins with a sentence that is not understandable because of its length and structure. We recommend that the Department re-draft this subsection in clear, understandable language.

#### **5. September 27, 1997 Statement of Policy**

On September 27, 1997, the Department published a statement of policy in the *Pennsylvania Bulletin* concerning the application of the personal income tax on employe welfare benefit plans and cafeteria plans. The statement of policy is similar to this proposed rulemaking. To avoid duplication and inconsistent interpretations, the Department should rescind the statement of policy with the adoption of the final-form regulation.

#### **6. Need for advance notice of final rulemaking**

Because the Department will be adding new provisions resulting from the recent amendments to the Tax Reform Code, it would be beneficial to allow further public comment prior to the submission of the final-form regulation. This will allow affected parties to comment on the Department’s interpretation of the new statutory changes. Therefore, we suggest the Department publish a draft final-form regulation for public comment before it submits the final-form regulation to the Commission.

# INDEPENDENT REGULATORY REVIEW COMMISSION

**To:** Anita Doucette  
**Agency:** Department of Revenue  
**Phone:** 7-1382  
**Fax:** 2-1459

**From:** Kristine M. Shomper  
Deputy Director for Administration  
**Company:** Independent Regulatory Review  
Commission  
**Phone:** (717) 783-5419 or (717) 783-5417  
**Fax:** (717) 783-2664

**Date:** June 25, 1998  
**# of Pages:** 6

**Comments:** We are submitting the Independent Regulatory Review Commission's comments on the Revenue Department's regulation #15-385. Upon receipt, please sign below and return to me immediately at our fax number 783-2664. We have sent the original through interdepartmental mail. You should expect delivery in a few days. Thank you.

**Accepted by:** Anita M. Doucette **Date:** 25 June 1998