

From the Desk of the Editor

The future is plastic. Dustin Hoffman looked incredulous and so did I. I was a teenager – a boomer no less – what did I know?

Speaking of plastic . . .

Many of you are using the EZ Reimburse® MasterCard® Card with your flex programs; others are interested in adopting. Card programs are very popular with employees and have resulted in increased participation and satisfaction with tax-favored account plans – this is good news for employers. However, as with all IRS regulations, there are mine fields to maneuver and a wrong step could blow up your plan. As our featured article this Quarter, I am including text excerpted from a “White Paper” recently prepared by FBMC in conjunction with our outside counsel, Alston & Bird, LLP titled “What every employer should know about electronic payment card claims processing.” We review some of the requirements and comment on certain industry practices that we do not recommend adopting.

What will 2006 bring in the way of revisions and new initiatives for health and welfare programs and defined contribution plans? As I finalize production of this newsletter, we are hours away from the President’s State of the Union Address; and two months away from the next ECFC Conference with invited guest Harry Beker. I heard on NPR this morning that Mr. Bush is expected to continue to promote an expansion of HSAs with high deductible health plans. How that plays out in practice will hopefully be at least a few of Mr. Beker’s talking points at the conference.

I am still awaiting those 125-2 final regs; maybe this is the year.

Trish

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A Perspective from the Hill

Robert McKnight, Senator; Senior VP

For the last several years the “benefits buzz” on the Hill has been about savings accounts, primarily dealing with health care. In 2006, the buzz may again be on savings accounts, but this time those dealing with retirement. During 2005, the Congress passed a pension reform bill, reducing some employer liability, and it is expected to prompt more congressional and administration oversight of the issue. The numbers tell the story with two words, “the boomers.” It is not just the aggregate number of people retiring, but the full time employees today who have no pension benefits or retirement savings programs. A recent Wall Street Journal article suggested that number may be as much as half the private sector work force. The problem is further compounded because the profile of the individual with no pension or savings protection is typically custodial, working in retail, construction or the agriculture sector, with little discretionary savings income available.

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The solutions being discussed on the Hill include:

1. Further enhancements to the Defined Contribution Retirement Plans.
2. Converting today's Health Savings Account to a tax free "Save For the Family" Account that could be used for anything.
3. Further enhancements to the new Roth (401K) in which distributions are tax free.
4. Making permanent the Savings Incentive Match Plan for Employees, "Simple Plan," which substantially reduces employer paperwork if a 2% employer match is made.
5. Broadening eligibility under the Simple Plan for middle income households or index the credit's adjusted gross income phase out limits for inflation.

With this being an election year and the number of voting boomers swelling, you can be sure the Congress will dive into this issue head on.

The drawbacks—the deficit, the war, and the staggering cost of the government subsidizing retirement. Stay tuned.

Featured Article

Thinking About Implementing an Electronic Payment Card?

Trish Neely, CFCI

Recently we collaborated with our outside counsel, Alston & Bird, LLP to prepare a White Paper entitled "What every employer should know about electronic payment card claims processing." Excerpts from the paper are reprinted below.

In June 2003, after much industry input (including input by FBMC's Chief Compliance Officer and our counsel), the IRS issued Revenue Ruling 2003-43 (the "Ruling"), which provides safe harbor parameters for the substantiation of health claims by means of an electronic payment card. In essence the Ruling provides that although the

traditional substantiation requirements continue to apply to electronic payment card payments, as long as the safe harbors are in place, an electronic process may serve **in place of** manual claims substantiation.

Despite the clear language of RR 2003-43, many in the benefits community have relied on a number of arguments to support the establishment of electronic payment card administrative policies that are **broader** than what the IRS guidance allows. Clearly this makes the program easier and less expensive to administer and tickles customers pink, but comes with risks as well.

IRS guidance is pretty clear within the Ruling that each and every electronic payment card payment **must be adjudicated and properly substantiated.**

The IRS is basically saying: **ok, we recognize there are very specific times where because of the type of transaction, an electronic system may serve as a proxy for manual substantiation of the expense.** We in the industry collectively refer to this as auto-adjudication. The types of transactions fall into three categories:

Co-Payment match. The claim for a particular service matches a co-payment imposed for that service.

Recurring previously approved claims. A claim that has been previously approved matches a subsequent electronic claim to a) amount, b) provider, and c) time period (e.g., for prescription drug refills that occur on a regular basis at the same provider for the same amount).

Real time verified claims. Electronic payment is accompanied at the time and point of sale with verifying information that the claim is for an eligible medical expense, which may be sent either electronically (e.g. internet, intranet, email, telephone) or by paper. (FBMC's RX program uses this technology.)

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The IRS is pretty clear that **if the claim does not fall into one of the specified “auto adjudicating” categories, then the**

Administrator must manually adjudicate the claim. In the claims processing world that means a third-party receipt is needed.

Creative Interpretations

Some in the benefits community ignore (or try to argue away) the substantiation requirements. For example, many argue that since cards must typically be limited to merchants with medical merchant category codes, virtually all expenses will be for “medical care” as defined in Code Section 213(d) and so no substantiation is required. Not so. The Ruling clearly requires substantiation for claims outside the three auto-adjudication categories despite the fact that use of the card is typically limited to merchant medical category codes.

Others argue that the Ruling is a “safe harbor” and that other adjudication procedures are permissible. Even if 2003-43 is a safe harbor; the Ruling addresses and then **rejects** a fact pattern where “sampling” techniques were utilized. These techniques (found inadequate by the IRS) are frequently relied upon by those in the industry who seek to “flout” the clear guidance of the Ruling:

- Administrator reviews only 20% of unsubstantiated dental claims in excess of \$100 on the assumption that no cosmetic dental claims are available for less than \$100.
- Administrator only reviews 5% of physician office transactions below \$150 on the assumption that almost all such charges are for medical expenses.
- Administrator does not review any amounts below a low dollar threshold on the assumption that such amounts are for eligible medical care (or are nominal); or
- Amounts that are multiples of a whole dollar amount on the assumption that these are for co-payments.

The IRS’ rejection of these sampling techniques, which result in only some of the claims being adjudicated and substantiated, further supports

the conclusion that the Ruling does not eliminate the adjudication and substantiation requirements

set forth in Sections 105 and 129 (and the corresponding guidance). Thus, any adjudication procedure that requires no substantiation is, in our view, faulty. Although it reduces or even eliminates the inherent **pay and chase phenomenon**, in light of the potential tax consequences for both employee and employer/plan sponsor, implementing any procedures other than the auto-adjudication techniques set forth in the Ruling is risky.

Pay and Chase v. : the act of securing repayment from a customer for payment previously made through a card swipe from his/her reimbursement account to a vendor that 1) could not be substantiated or 2) was deemed an ineligible service aka “bad claim”.

If a claim does not fall into one of the three auto adjudication categories listed above, the claims must be adjudicated manually (generally by reviewing a receipt). If proper substantiation is not subsequently provided, the plan must follow the procedures below to recoup the money from the participant.

- The Plan must require the participant to repay the bad claim. The Ruling does not identify the specific steps that must be taken; however, a letter (or electronic communication) to the participant should be sent identifying the amount, the reasons for repayment and the time frame in which the repayment must be made.
- If the bad claim is still outstanding the plan should utilize a substitution or offset approach to offset subsequent valid claims against the amount of the bad claim.
- If the repayment request is unsuccessful, an amount equal to the bad claim must be withheld from the individual’s pay (to the extent consistent with applicable wage withholding laws). Employers should check with legal counsel to determine whether state law permits such a process. Also, appropriate authorization for withholding should be included as part of

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the plan and card enrollment materials.

If the three “pay and chase” methods identified above prove unsuccessful, the Ruling indicates that the participant remains indebted to the employer and the employer may treat the payment as it does any other business indebtedness. Comments from the IRS indicate that the employer may include the bad claim amount in the income of the employee (e.g., presumably an upward adjustment to the employee’s Form W-2), but only as a last resort. In addition to the above, other actions must be taken to ensure that no further violations occur, including denial of access to the card until the amount is repaid.

It is important to note that the IRS and Treasury have not formally recognized use of an electronic payment card for payment of Dependent Care FSA claims or Section 132 Commuter Benefits. That being said, employers who do choose to utilize an electronic payment card under the Dependent Care FSA should note that there would be no situations in which claims are “auto-adjudicated” under current guidance. Nonetheless, many administrators apply analogous “auto-adjudication” techniques to such payments.

Consequences of failing to comply

Code Section 105 makes it clear that failing to take steps to ensure that payments are made solely for medical care expenses can result in the taxation of all payments made under the arrangement, including those payments actually made for medical care expenses (see Treas. Reg. 1.105-2). This point is reiterated in Notice 2002-45, the HRA guidance. Thus, one likely possibility where the plan fails to require adequate substantiation is that the entire plan can be disqualified and all payments made to each participant are included in the participant’s gross income. There has historically been little audit activity in this area so the approach the IRS would take is not entirely clear. What is clear is that at least some amounts paid under the plan would be included in the participant’s gross income and wage withholding penalties could be asserted against the employer. Rev. Rul. 2002-80 clarifies

that amounts paid as medical reimbursements or loans to an employee without regard to the

employee's actual medical status are subject to employment taxes.

Let me explain why it would be easy enough as an administrator and card vendor to tell you what you and your customers want to hear – implement the card and eliminate paper:

The tax liability associated with non-compliance is assessed against the employer and employee participants; the administrator has no liability to the IRS for improper substantiation procedures.

We are the conservative guys on your behalf, you won’t see us teetering on the edge of the cliff with creative interpretations of the regs to make our life easy. We recommend adopting an approach where 100% of all claims are adjudicated, either electronically in accordance with Revenue Ruling 2003-43, or manually in accordance with other IRS regulations. Nevertheless, it’s your plan. If you would like to discuss further, please contact the undersigned or your Account Manager.

The contents of this article and the paper from which it is excerpted represent our view of the applicable requirements and should not be construed or relied upon as legal advice. Employers should contact qualified tax and/or legal counsel to discuss these issues as they impact tax liability.

Form 2441 & Instructions

Tina Bischoff, CFCI

In our FBMC Benefits Alert 2005-6, we advised that the IRS issued on 09/07/05 IRS Notice 2005-61 to clarify for employers their Form W-2 reporting requirements if an employer amended its cafeteria plan document to provide the new Grace Period (see FBMC Benefits Alert 2005-3) under its DFSA Plan.

As you know, the amount that has been required to be reported in Box 10 of Form W-2 was the total amount of cash reimbursement provided to

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an employee under a qualified DFSA Plan. In IRS Notice 2005-61, the IRS provided that “[a]n employer that amends its cafeteria plan to provide

a grace period for dependent care assistance may continue to...[report] in Box 10 of Form W-2 the salary reduction amount elected by the employee for the year for dependent care assistance (plus any employer matching contributions attributable thereto).”

Unfortunately, the Notice stopped short by being silent on how DFSA participants were to report Grace Period carryover amounts on their Forms 2441 without being taxed on those amounts in the subsequent tax year.

In its revised 2005 Form 2441 and Instructions, the IRS resolved this reporting issue for employees. For a copy of the 2005 Form 2441, visit <http://www.irs.gov/pub/irs-pdf/f2441.pdf>. For a copy of the Instructions, visit <http://www.irs.gov/pub/irs-pdf/i2441.pdf>.

The welcomed news is that participants may treat their DFSA carryover amounts as forfeitures so that their carryover amounts are not taxable to them in the subsequent plan year.

Let’s look at an example.

An employee elects to salary reduce \$5,000 annually (based upon his maximum tax filing status) in calendar Plan Year 1. The employee and his spouse have a combined earned income of \$75,000 and plan to file a joint return.

Prior to the new Grace Period ruling, if the employee only used \$4,800 of his \$5,000 for eligible dependent care expenses incurred by the end of PY1, he would have reported the unused \$200 as a forfeiture on his Form 2441. Reporting the unused DFSA funds as a forfeiture meant that he did not exceed his \$5,000 annual amount in PY2 so there was no taxable amount for him to report on his Form 2441.

The new Grace Period ruling, however, permits the same employee to carryover his unused DFSA \$200 from PY1 into PY2 to pay for eligible, dependent care expenses incurred in PY2. Unless the IRS issued similar relief to DFSA

participants as it did to employers for their W-2 reporting requirements, that \$200 carryover

amount would cause the employee to exceed his PY2 annual amount resulting in him having to pay taxes on that \$200.

The IRS recognized this problem and revised its 2005 Form 2441 to address it by treating carryover amounts as forfeitures, too. Using the same employee in our example, this means that he will be able to carry over the \$200 he didn’t use in PY1 to pay for eligible dependent care expenses incurred in Plan Year 2. He can again elect to salary reduce \$5,000 annually in PY2. Adding his \$200 carryover amount from PY1 to his \$5,000 annual amount in PY2 will not cause him to exceed his PY2 maximum annual amount because the \$200 will be treated as a forfeiture on the revised 2005 Form 2441. When applying this example to a 2005 Form 2441, it is easier to see the relief provided by the IRS to DFSA participants.

Changes to the Definition of “Qualifying Person” in Form 2441 & Instructions (2005)

In FBMC’s Benefits Alert 2004-01, we shared that The Working Families Tax Relief Act of 2004 (WFTRA) had revised the definition of a Code § 152 dependent as well as that of a “qualifying individual” under Internal Revenue Code § 21.

Under WFTRA, this meant that dependent care expenses could no longer be reimbursed under a DFSA Plan for a disabled adult who was incapable of self-care if such person also:

- received gross income in excess of the exemption amount (\$3,200 in 2005), or
- was married and filed a joint return with their spouse, or
- was a dependent of persons who were themselves tax dependents.

There’s been Congressional legislation proposing a technical correction to relax these WFTRA requirements for DFSA Plans (as was subsequently done for group health plans) but it hasn’t been passed.

However, in its Instructions to the 2005 Form 2441, the IRS has nevertheless made some unexpected changes of its own to the definition of

a “qualifying person” that are less restrictive than the definition of a qualifying individual under Internal Revenue Code § 21 when it was revised by WFTRA.

For purposes of completing a 2005 Form 2441, the IRS provides that a qualifying person includes a disabled person not able to care for himself or herself whom a taxpayer can or could claim as a dependent *except* that the person (i) had gross income of \$3,200 or more, or (ii) filed a joint return, or (iii) could be claimed as a dependent on someone else’s 2005 return.

Because employers amended their DFSA plan documents to match the revised WFTRA definition of a qualifying individual, neither FBMC nor other industry experts are comfortable at this point with replacing WFTRA’s definition of a qualifying individual with the broader definition of a qualifying person that has quietly appeared in the 2005 Form 2441 Instructions. The IRS needs to provide clearer guidance and identify the authority that supports its publishing a less restrictive definition of a qualifying person in its 2005 Form 2441 Instructions than that provided by The Working Families Tax Relief Act of 2004.

Dependent Care Tax Credit

Industry experts caution that the revised 2005 Form 2441 has the potential of allowing a taxpayer-employee to receive tax credit on DFSA carryover amounts *even though* the employee *also* benefited by being able to use those same carryover funds to receive tax-free reimbursements under a DFSA Plan.

To claim the child and dependent care credit, lines 28-32 must be completed on the 2005 Form 2441. As drafted, line 31 does not currently exclude carryover funds that were also used to reimburse expenses under a DFSA Plan during the 2005 tax year.

News Briefs

USERRA Final Regulations Effective January 2006

Trish Neely CFCI

The Final Regulations and the Final Notice Regulations, both issued by the Department of Labor (DOL) this past December went into effect January 18th.

The Final Regs incorporate minor differences from the proposed regs issued in 2004. Although

extremely lengthy, they are straight forward and follow the outline of the law itself.

Of particular note to welfare plans:

- Employees on paid military leave may continue to make pre-tax contributions to their Cafeteria Plan;
- Employers may adopt more liberal rules for making premium contributions to continue health care coverage;
- Employers may adopt rules for enrollment that are more liberal than COBRA;
- The Employer cannot deny coverage where it is impossible to make a timely election;
- Upon return from duty, the Employee is to be reinstated in health coverages without any waiting period criteria or exclusions.

The Final Notice replaces the interim notice required by the Veterans Benefits Improvement Act of 2004. All Employers, both private and public, regardless of the number of employees must either post the notice in its workplace or mail to each employee – email is ok. The DOL has created both a private sector and a state government/public sector Notice.

For further information and a complete copy of the final regs and the Notices, visit the Department of Labor Web Site: www.dol.gov.

HIPAA Security & Small Health Plans Compliance Date Approaches

Kedra Baumgardner, Security Officer

Small health plans – those with annual gross receipts of less than \$5 million, have until 4/20/2006 to comply with HIPAA's security requirements. Employers and benefits administrators are not normally defined as covered entities for purposes of the Security Rule; however, group health plans **are** covered entities. As a result, plan sponsors and administrators must comply with the rules to protect and secure PHI.

It is important to incorporate the security provisions within your Business Associate Agreements prior to the final 4/20 deadline if you have not already done so.

401(k) New Kid on the Block

Patrick Peters
President, VMC (Subsidiary of FBMC)

Although in its infancy, the Roth 401(k) appears to have significant potential.

Beginning January 1st 2006, §401(k) plans may permit participants to contribute to a Roth IRA within the §401(k) environment – a Roth 401(k) plan. The Roth 401(k) is subject to the annual §402(g) deferral limit – \$15,000 + \$5,000 (catch-up provision); substantially higher than the Roth IRA – currently at \$4,000 + \$1,000 (catch-up provision).

Unlike elective pre-tax 401(k) plans where income taxes are deferred and distributions are taxed, Roth 401(k) contributions are elective, post-tax and distributions are tax-free if it is a qualified distribution. Roth 401(k) contributions are made in lieu of pre-tax 401(k) plans. Caution: Employers **cannot** sponsor a 401(k) plan that **only** offers the Roth option. Plans permitting Roth must establish a separate trust account for the post-tax contributions, earnings and distributions. Roth

accounts may only include Roth contributions and rollovers from other Roth 401(k) or Roth 403(b) plans.

In general, Roth 401(k) plans function like regular 401(k) plans, subject to the same elective deferral frequency and required minimum distributions. As the Roth 401(k) is an option under EGTRRA, Plan documents would have to be amended prior to end of the calendar year in which this option is implemented.

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