

Quarterly Review

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From the Desk of the Editor

The big news this quarter was Treasury's response to Senator Grassley's call to do something about **Use it or Lose It**. On May 18th The Treasury Department and the IRS issued IRS Notice 2005-42 which modified (without Congressional action) the regulatory prohibition of permitting deferred compensation under a Code § 125 cafeteria plan.

On its face the ruling is simple to understand, as usual, the devil is in the details. In this issue we are including two articles to help you understand the ruling and chart a course of action.

The IRS also issued on April 18th Revenue Ruling 2005-24. This ruling permits Employers to contribute to an HRA plan an amount equal to the value of all or a portion of a retiring employee's accumulated unused vacation and sick leave. FBMC just made a decision to develop a product to administer this type of post-employment benefit. We will provide more details about the product in future newsletters.

Earlier this month I had the privilege of speaking before the Florida Education Risk Managers Association (FERMA) about Challenges and Opportunities facing employers. I am including a few of the highlights and the resource materials I shared with the group. No talk of challenges could be complete without commenting on WFTRA, the Great GASBs (43 & 45), or MMA-D.

And what about the rollover? I participated in a teleconference last week with former Treasury Secretary Bill Sweetnam who, like Senator Bob, sees the rollover as a revenue problem and not likely to pass anytime soon.

The ECFC Conference is next month. We are expecting Harry Beker and his team to come with further clarifications on HSAs and the new Grace period. We have heard that on the table is the possibility of extending the period to six months. This is not the answer; all an extended grace period buys is an additional 2 ½ or 6 months of procrastination. We are also looking for some additional clarifications to WFTRA and its impact upon DCAP plans. More to come.

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In this Issue of the *Quarterly Review*

- A Perspective from the Hill - 1
- New Grace Period - 2
- Grace Period Q&A - 3
- New HRA Design Approved - 4
- Florida's Voluntary Pre-K Program - 4
- Common 401(k) Mistakes - 5
- Question of Last Quarter – The Results - 6

A Perspective from the Hill

Robert McKnight, Senator; Senior VP

In our last report, we highlighted the record breaking budget deficit and how it makes it difficult for the Congress to change the "use it or lose it" rule, related to Flexible Spending Accounts ("FSA"). Perhaps of interest, is the recent announcement by the Treasury that the deficit is currently below the Administration's projections. As expect the Congressional Budget Office is skeptical of that announcement, but with the exception of fuel prices and a slight up tick in interest rates, most economists seem to suggest that the economy is strengthening.

Meanwhile, the powerful Chairman of the Senate Finance Committee, Sen. Charles Grassley (R., Iowa), continues to push for reform of the rule, suggesting the IRS allow a \$500 carry forward per year on FSA balances. He is gaining some support from the business community for an unexpected reason. In an attempt to appease FSA participants, the IRS recently announced the authorization of an extension of their annual grace period. With the promulgation of the back up to the new rule, most benefit professionals feel the IRS has only made the whole issue worse, which is why Sen. Grassley and his like minded law makers favoring reform of the FSA regulations are receiving unexpected support from large and small business across the country.

However the budget is taking second fiddle to the war, the Supreme Court confirmation hearings, and the source of the leak of the name of the CIA agent, so reform of this important employee benefit will probably not happen anytime soon.

Quarterly Review

Vol. XV; Number 2

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New Grace Period for Flexible Spending Accounts

*Barbara L. Gonzales, CEBS
Chief Operating Officer*

The IRS released revenue notice 2005-42 in May to answer pressure from participants, employers, administrators, and legislators to deal with the dreaded "use-it-or-lose-it" rule for flexible spending accounts. While employers and administrators were open to a "rollover" type arrangement preserving a participant's unspent funds for future plan years, this was not exactly the answer most people were looking for and it created a whole new set of business challenges for employers and administrators.

The revenue notice permits employer plan sponsors to adopt a grace period rule (not to be confused with the run-out period) for their dependent care and/or health care flexible spending accounts. The grace period can be extended for no more than 2 months and 15 days following the end of the plan year. During this grace period, the participant may incur expenses and file a claim for reimbursement using funds from the prior plan year.

This means, for example, if my health care spending account plan year ends on December 31, 2005, I may incur medical expenses during the timeframe January 1, 2006 through March 15, 2006 and file a claim for reimbursement out of my 2005 plan year account (if funds are remaining).

Upon release of the revenue notice and following several teleconferences with IRS officials and other industry experts, FBMC quickly assembled an internal team of subject matter experts to study the ruling and determine a proper course of business action.

Since the rule is not mandatory for flexible spending account plans, employers must decide if and when they want to adopt the rule for their plans. Different employers may approach this with different perspectives given what they are trying to achieve with their overall employee benefits program. Indeed, we have already discovered that employers are taking different approaches. For example, some plans use forfeitures to offset administrative expenses and are therefore, sensitive to adopting the new grace period rule without understanding the full impact of this rule upon expected plan forfeitures. Others anticipate that this new and enhanced benefit provision may be a valuable strategy to use during upcoming collective bargaining sessions. Other employers have readily adopted the new grace period rule and are in the stages of making decisions about when to implement.

We expect to have our proprietary Common Remitter system ready to handle the new grace period rule for plan years ending on December 31, 2005. We are encouraging employers not to adopt the new grace period rule for dependent care plans due to possible adverse tax consequences for employees and additional tax reporting for employers. There are annual statutory maximums for dependent care plans that could be exceeded if a dependent care plan is amended to allow for the grace period rule.

Most of our clients have expressed a desire to amend their health care flexible spending account plans to permit the grace period rule and a majority will allow the full 2 months and 15 days. Many clients are rethinking the run-out period given their decision to adopt the grace period rule. A few clients believe that additional legislation may be forthcoming regarding flexible spending accounts and possible rollover modifications – so they are taking a wait-and-see approach.

Some questions that you will need to consider as you deliberate on this new revenue notice and its impact on your employee benefit plans –

Do I want to adopt the revenue notice for my flexible spending account plan(s)?

If yes, do I want to adopt it for the current plan year or future plan years?

Do I want to allow the full 2 months and 15 days or some period less than 2 months and 15 days?

How will this affect my run-out period? Do I maintain the same run-out period or extend it to accommodate the new grace period rule?

How will I communicate this change to participants and what is the timing of that communication?

Once these decisions are made, our compliance department can work with you to complete the necessary plan document amendments that must be executed before the end of the plan year for which the change applies. Yes, this means if your plan year ends on December 31, 2005 and you want to adopt the grace period rule for the current plan year, you must execute the formal amendment to your plan document by December 31, 2005.

Whichever way you decide to go, we are here to help you implement any changes to your plans and answer any questions you may have regarding the impact of these decisions on your flexible spending account program.

Quarterly Review

Vol. XV, Number 2

July 2005

IRS Notice 2005-42: Q&A

Tina Bischoff, CFC
Compliance Officer

Some frequently asked questions and answers we thought might be of assistance in understanding the new notice:

- Q-1. *Does this Notice change or replace the uniform coverage rule for a health FSA plan?*
A-1. No, but it may ease participants' end of the plan year spending rush and stockpiling to avoid forfeitures.
- Q-2. *If an employer amends its plan document(s) mid-plan year to allow the grace period, is that an event that would permit a plan participant to change his or her cafeteria plan election or salary reduction amount?*
Q-2. No.
- Q-3. *Does this new grace period affect eligibility requirements under COBRA for health FSA plan participants?*
A-3. No. Medical expenses incurred during a grace period will be treated as having been incurred in the prior plan year for purposes of COBRA.
- Q-4. *Does the new grace period affect a plan's nondiscrimination testing?*
A-4. No. Expenses incurred during a plan year (regardless of whether a grace period is involved) will be applied only to that plan year's nondiscrimination testing.
- Q-5. *Does the new grace period change a plan participant's protection under HIPAA's portability rules?*
A-5. No.
- Q-6. *Can FBMC's EZ Reimburse® Card accommodate the grace period?*
Q-6. Yes, as part of multi-purse functionality. The card will include an ordering rule. At point of sale, if the date of the expense is within the grace period, the expense will be applied first to the previous year's balance if any, and then to the current year's balance.
- Q-7. *Can an employer design a run out period to extend beyond the maximum IRS grace period?*
A-7. Yes.
- Q-8. *Is the grace period available to employees who terminate employment mid-plan year?*
A-8. Yes, as long as the employees elect COBRA. The notice requires that an active or former employee must participate in a group health plan benefit on the last day of the plan year preceding the benefit's grace period.
- Q-9. *Does an employer have to adopt the new grace period?*
A-9. No, the grace period is not mandatory but rather an employer option.
- Q-10. *Does the grace period apply to all participants in the cafeteria plan?*
A-10. Yes, it applies to all participants in the qualified benefit making it available.
- Q-11. *Does the grace period apply to tax-favored arrangements outside of a cafeteria plan?*
Q-11. No.
- Q-12. *Does this mean that a plan year can now last up to 14 ½ months?*
A-12. No, a plan year can still be no longer than 12 months.
- Q-13. *Can the employer still determine whether or not to have a run-out period for post-plan year claims submissions?*
A-13. Yes. There are many options available. For example, the employer could apply a single run-out period to both plan year and grace period expenses. FBMC's recommendation for all clients is to apply the same grace period duration to all qualified benefits and to allow for only one run-out period for all café plan benefits at the end of a grace period that does not go beyond the last day of the month in which the grace period ends.
- Q-14. *Can amounts spent for a single medical service be reimbursed out of two plan years? For example, if a health FSA participant elects \$1,000 coverage in 2005 and again in 2006, can the health FSA accounts in both plan years be used to pay for a \$2,000 expense incurred within the 2 ½ month grace period following the 2005 plan year?*
A-14. Yes, if the health FSA plan adopts the grace period and the participant incurs no other expenses that are chargeable against the 2005 expenses, then \$1,000 would be reimbursed out of the 2005 health FSA and the balance of \$1,000 would be reimbursed out of the 2006 plan year.

Quarterly Review

Vol XV; Number 2

July 2005

Q-15. *If an employee has low-deductible health coverage and participates in a complete health FSA during a calendar plan year, does the grace period affect his or her HSA eligibility for the upcoming plan year?*

A-15. No. The employee may enroll in a HSA if s/he has HDHP (and even a limited-purpose health FSA). But, under current IRS guidance, the employee will lose any unused funds from his/her prior plan year's complete health FSA.

Q-16. *Does it matter how unused funds from the prior plan year are used?*

A-16. Yes. For example, unused funds from a health FSA may only be used to reimburse eligible medical expenses incurred during the grace period.

New HRA Design Approved

Trish Neely, CFC
Chief Compliance Officer

On April 18, 2005 the IRS issued Revenue Ruling 2005-24. The ruling favorably addresses the income tax treatment of accumulated and unused vacation and sick leave whose "value" is contributed by an Employer automatically (and on a mandatory basis) into an HRA.

This type of HRA design provides an excellent post-employment benefit and the ruling was written with retirees in mind. However, the ruling indicates that it is also applicable to active employees.

The key is to assure the participant receives no part of the contribution in cash or other benefits – this is the basis for the favorable ruling. It is also important to assure the plan meets non-discrimination rules (this might be trickier with actives if either vacation or sick leave are based upon compensation or years of service).

For additional information, please contact the author or Patrick Peters, Manager of new product development.

In addition, the principal author of this Ruling is Barbara Pie. Her number is (202)622-6080.

Florida's Voluntary Pre-Kindergarten Program

Tina Bischoff, CFC

A new State-funded Voluntary Pre-Kindergarten Program (VPK) will begin in Florida for the upcoming 2005-2006 school year. Eligible children must be 4-years-old on or before September 1, 2005, and reside in Florida to participate in the VPK program. The program is free to parents and voluntary for eligible children and providers. It is designed to prepare young children for kindergarten and future school demands so that they can achieve educational success regardless of their financial resources. Public, private, and faith-based providers will be able to deliver the program if they meet the minimum standards required by law for literacy, curriculum and performance standards.

In order to be able to work, parents traditionally arrange for dependent care that provides for the well-being and protection of their children. The good care provided by some of these programs may even resemble a Pre-K class especially if they employ experienced, well-educated teachers who promote children's cognitive and social development.

State-funded VPK programs like Florida's, however, provide more than dependent care by setting specific state educational standards and providing the necessary resources to ensure that every Pre-K class they fund in a public or private setting (part-day or full-day) will offer a high-quality learning environment to ready these children for future schooling. At a very early age, children will be taught the skills they need to learn to read, do math, make progress in science and other areas as well as begin to understand the world and how it works. While custodial care is also provided, it is not the primary consideration for those providers who are eligible to offer this program to young children.

Some of VPK Program highlights described at <http://www.vpkflorida.org> include:

- the eligibility requirements that public and private providers must meet to offer the program.
- the State's position on providers' registration fees (only permitted for *non*-VPK programs or care) .
- whether the State will pay for transportation to and from the VPK provider (it won't).

How does this new VPK Program interface with an employer' DCAP Plan?

If a dependent care FSA participant enrolls an eligible child mid-plan year in this new program, the participant may elect to reduce (or drop, if applicable) the dependent care FSA election to account for the dependent care expenses that he/she had anticipated incurring when enrolling during open enrollment.

Parents may pre-apply for the VPK program at <http://www.vpkflorida.org> and are encouraged to check this Florida WebSite periodically for updates. Interested parents can also click on the link "Where do I go for VPK information in my area?" and select the county in which he or she lives to learn more information about their local early learning coalitions and completing the application process.

Common 401(k) Mistakes

Errol Arzola, Registered Representative

When I was younger, I recall my driver's education instructor making a cogent point, that I have since never forgotten. He asked, "Tell me how you can prevent an accident from happening?" The class responded, "Don't be distracted by the radio or don't speed!" Although correct, my instructor said the first thing you must do is so basic, that nobody ever thinks of it! He paused and said, "**Leave on time** for your destination."

The most common blunder I find in retirement planning is the mistake of not signing up.

Not signing up

I've seen a few awful 401(k) or 403(b) plans in my time. For example, one sponsored by a dentist forced his employees to help him buy raw land (That was the only employee investment option.) Another offered only high-cost, poorly performing variable annuities with surrender charges that lasted for 16 years -- leaving workers to forfeit a good portion of their earnings if they left their jobs and rolled over their accounts. Both of these plans are examples of truly heinous plans, but they are very uncommon.

Most participants get decent investment options with reasonable fees. There's simply no reason not to participate in a plan that's even halfway decent, yet research indicates one out of four eligible workers fails to sign up.

Taking too little risk

Most 401(k) investors understand that stock and stock mutual funds are deliver the best returns in the long run. In fact, according to the Employee Benefit Research Institute, which surveyed 46,310 plans in 2002, about 62 percent of 401(k) assets are invested in equities. Another 16 percent of the participants preferred money market accounts and didn't invest in stocks at all.

Some people avoid stock investments because they are approaching retirement or they aren't risk-tolerant. In reality, few investors will be able to reach their retirement goals without exposure to equities. Stocks are the only asset class that possess historically outpaced inflation. Leading financial planners believe the average investor regardless of age, needs to keep half of his portfolios invested in stocks if he wants an adequate income for retirement.

Taking too much risk

In comparison, there are investors who overload on stocks. Nearly 30 percent put all or nearly all of their money either into their 401(k)'s equity funds or into their company's stock, with no exposure at all to fixed-income investments.

There was a popular belief in the past that only older folks needed bonds. As time passed, the stock market swooned and proved that most investors could benefit from the cushioning effect of bonds and cash. Folks who panicked and cashed out at the bottom of the market may have weathered the bear market if they invested in bonds to add value to their portfolios.

The classic balanced portfolio of 60 percent stocks, 30 percent bonds and ten percent cash (money market) is a good starting point for most investors. You can rack up on stock exposure if you're young or aggressive.

Employer Stock – good or bad?

Many participants ask if what happened at Enron can happen to them. Although risk is an inherent part of any investment and all investments involve some level of risk, the Enron debacle is a different story. Basically, the 2001 blowout of this energy trading company decimated the 401(k) balances of its workers. It's because Enron employees put most of their retirement into the company's stock. The Enron story should have, once and for all, pounded home the point that you do not want your retirement account riding on the same company that provides your job. Yet, one in seven who had access to company stock had all, or nearly all, their money in company shares.

Mutual funds provide investment choices across a broad range of companies, such as Microsoft, Wal-Mart and Exxon – with, obviously, no employer stock. Simply stated, mutual funds provide automatic diversification.

Taking out loans

Borrowing your own money to pay yourself interest may seem like a good idea, but beware. Taking out a 401(k) loan has plenty of pitfalls, including:

1. The biggest pitfall is the risk you take should you leave your job. Your loan would become due, and, if you can't pay it back at once, you will owe income taxes and penalties on the unpaid balance.
2. The interest rate you pay yourself may be lower than what you would pay most other creditors, but paying yourself interest is no substitute for the real return you would be earning if you had invested those payments instead.
3. Borrowing from your retirement funds is often a sign that you're overspending -- particularly if you're using the proceeds to pay off credit card debt. People who use "easy outs" like 401(k) and home equity loans to pay off their cards often don't change the underlying behavior that originally put them in the negative.

Cashing out

Cashing out your 401(k) when you leave your job is the worst move you can make. Yet many of our participants do just that. Typically, cash-outs occur during the summer or when participants leave the school system.

They doubtlessly think they have years to save for retirement, so why not enjoy the cash now? Unfortunately, the mere fact is, the younger you are, the bigger the price you pay for a 401(k) cash out. Why? Had your money been left alone, you would have earned tax-deferred returns for decades.

Remember folks, your 401(k) money isn't a windfall, to be blown on vacations or cars or anything else that will be long forgotten by the time you're age 65. Consider this money to be a sacred nest egg to be used for what it was intended -- **your golden years**.

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Last Quarter's Question & Your Feedback

Q - Do you have or are you considering offering an HRA or HSA in 2006 as part of a consumer driven health care strategy?

Of the responses we received in answer to this question, 32% of respondents stated they were considering an HSA and would like additional information; 16% were interested in learning more about HRAs.

These numbers are consistent with trends nationwide. HSAs tend to be more popular with employees and employers. It's hard to know if the popularity is creating the buzz on Capital Hill or the result of it.

According to an article in Insurance Newsnet, 5/9/05 (www.insurancenewsnet.com), over 1,000,000 million people are enrolled in HSAs in 2005 – a 125% increase over 2004.

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