WISCONSIN DEPARTMENT OF EMPLOYEE TRUST FUNDS

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CORRESPONDENCE MEMORANDUM

DATE: May 26, 2005

TO: Employee Trust Funds Board

FROM: Marcia Blumer, Program Manager
ERA/Commuter Benefits Program

SUBJECT: Revision of Employee Reimbursement Accounts (ERA) program provisions subject to Treasury Notice 2005-42

On May 18, 2005, the Treasury issued Notice 2005-42 that modifies the rule prohibiting the receipt of deferred compensation under tax code Section 125 cafeteria plans. The new rule permits expenses incurred within 2 ½ months after the close of the plan year to be reimbursed with funds carried over from the prior plan year. Any unused amounts from the prior plan year that are not used to reimburse expenses by the end of the grace period remain subject to the "use it or lose it" rule and must be forfeited.

Recommendation

Staff recommends that the Employee Trust Funds (ETF) Board approve amendment of the ERA program to adopt the provisions of Treasury Notice 2005-42 allowing extension of the ERA program plan year by 2 ½ months, effective with the 2005 plan year. Staff will work with the plan administrator to implement the new provisions according to the Notice and communicate the change to plan participants.

Rule Provisions

Adoption of the new rule is elective. To implement the rule:

▪ An employer must amend their plan document prior to the intended effective date of the rule. Employers may implement the rule for the current plan year so long as they amend the plan document prior to the end of the current plan year.

▪ The grace period must apply to all cafeteria plan participants.

▪ The grace period may not extend beyond the 15th day of the third month following the end of the plan year; however, it may be shorter.

▪ Temporary Carry Over amounts may not be cashed out or used for any other benefits. Unused funds from the health FSA may only be used to reimburse eligible health FSA expenses incurred during the grace period and likewise for unused dependent care amounts.

Reviewed and approved by Tom Korpady, Division of Insurance Services.

Signature ____________ Date ____________

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Analysis

The rule is a plan enhancement for participants, particularly those with Medical Expense Accounts. Typically at the end of each plan year there is a rush by participants to spend all the money left their accounts so that none will be forfeited. Employers and health plans frequently encourage employees to be thoughtful consumers of health care, yet many employees are forced to spend medical expense dollars on items that may not be needed at the time simply to avoid losing money. The new rule will be particularly welcome for expenses such as end-of-the-year dental procedures that require several visits across plan years. The rule would also allow parents whose child care expenses were unexpectedly less than anticipated to use the balance early in the next year, thus saving money.

The new rule may have a negative effect on plan funding because the amount of money forfeited to the plan at the end of each year may be reduced. The plan is funded from three sources: administrative fees paid by the agencies (currently $.60/health insurance contract/month), forfeitures, and interest on the money held by ETF. It's unclear how much forfeitures may decrease. In the past, forfeitures have averaged less than 1% of dependent care contributions and about 1.5-2.0% of medical expense contributions. For the plan year 2004, the amount forfeited to the plan was approximately $55,070 for dependent care accounts and $231,434 for medical expense accounts.

According to Bob Willett, ETF Controller, the ERA program's estimated reserve balance is approximately $321,000. Of this amount, $195,000 is used for a cash advance to FBMC and the remaining $126,000 is surplus, slightly over our target balance of $100,000. Although allowing claims up to March 15th will likely reduce forfeitures, they will not be eliminated altogether. The reserve should be sufficient to absorb a loss and we do not recommend an increase in the fees paid by employers until we have better information about the fiscal effect of the plan year extension.

Many forfeitures are probably due to procrastination by the participants. Extending the plan year an extra 2 ½ months may simply result in a buying rush in mid-March, rather than December. On the other hand, it will allow for participants to schedule a needed dental appointment or other medical procedure for early in the year to use an unexpected account balance on a service that's needed.

It may also have the effect of increasing participation in the plan because the fear of the "use it or lose it" provision will be somewhat mitigated. Participation not only saves tax money for the employees, but employers also benefit by not paying FICA tax on employee contributions.

Compliance and Administrative Issues

FBMC is in the process of analyzing the Notice and the effect that it may have on plan administration. Administrative systems must be reviewed and revised to properly track account balances from the prior plan year and segregate them from the current year so that prior year funds are not used to reimburse expenses incurred after the end of the grace period. Likewise, procedures must be put in place to charge claims against any carry over first and safeguards must be established to ensure that claims incurred at the beginning of a year are not resubmitted under the current year. Administrative systems must also ensure that the statutory reimbursement maximum for dependent care accounts is not exceeded during the year when including any carry over amounts. Other issues to be addressed include how the grace period will be administered for terminated employees and how long the "run-out" period should be following the end of the grace period.

Additional guidance from the IRS would be helpful regarding the effect of the new rules on HIPAA and COBRA rules as they relate to medical expense accounts. Although medical accounts are generally not subject to HIPAA's portability rules if certain conditions are satisfied, the new grace period rule may result in situations where participant reimbursements will exceed the amount that is permitted for the medical account to be exempt. Medical expense accounts are also exempt from full COBRA rules if certain conditions are met. The temporary carry over amounts could cause medical expense accounts to fail to meet these conditions and be subject to full COBRA rules. Hopefully, these issues will be addressed by the IRS soon.