United States
Office of Personnel Management
The Federal Government's Human Resources Agency

Retirement and Insurance Service
Benefits Administration Letter

Number: 03-301 Date: January 9, 2003

Subject: Preliminary Information about Flexible Spending Accounts

The Federal Flexible Benefits Plan ("FedFlex") enables eligible employees to pay for benefits with pre-tax dollars. The initial FedFlex benefit, Premium Conversion, was implemented in October 2000. In calendar year 2003, we plan to enhance FedFlex to include a second pre-tax benefit called Flexible Spending Accounts (FSAs). We are currently in the process of procuring an FSA administrator. This letter provides agency payroll officials with *preliminary* information about FSAs, so that they may begin to plan for implementation. After we select an administrator and make some final policy decisions, we will issue additional guidelines on issues that are not addressed in this letter such as; the order of precedence, a possible lapse in coverage, periods of LWOP, insufficient funds, and transfers between agencies.

FedFlex will offer two FSAs:

- *A Health Care FSA [HCFSA]*, through which employees can use pre-tax allotments to pay for certain health care expenses that are not reimbursed by any other source and not claimed on the participant's income tax return. The actual amount an employee may set aside will not be known until the procurement is finalized, but will likely be in the range of $2-$3000 annual maximum amount.
- *A Dependent Care FSA [DCFSA]*, through which employees may use pre-tax allotments to pay for eligible dependent care expenses up to a maximum annual reimbursement of $5,000 ($2,500 if the employee is married and filing a separate income tax return).

Section 125 of the Internal Revenue Code, allows employees to pay for certain health and dependent care expenses with pre-tax dollars. As with Premium Conversion, employees may choose to make a voluntary allotment from salary to their FSA account; participants do not pay employment taxes on these allotments . Employees who elect to participate set-aside an annual amount of salary to be contributed to their FSA. The employer will deduct these contributions from the employees' pay throughout the plan year and remit them to the FSA administrator for deposit into the employees' FSA accounts. Employees can draw upon their FSA accounts for reimbursement as they incur eligible expenses.

ELIGIBILITY

Employees eligible for FEHB (even if not currently enrolled) will be able to elect a healthcare FSA to cover expenses not covered under their FEHB plan –deductibles, coinsurance and copayments, as well as services not generally covered such as dental care, orthodonture, etc. All Federal employees (including employees with temporary, seasonal and intermittent appointments) will be able to elect to participate in the dependent care FSA for eligible dependents. Employees will elect to contribute an amount, up to a maximum, to their FSA(s).

As with premium conversion, non-Executive branch agencies may elect to adopt the amended FedFlex for their employees. Agencies that have already implemented their own FSAs may choose to adopt FedFlex FSAs for the plan year beginning January 1, 2004, or retain their own program. At the present time, annuitants (except for reemployed annuitants) are not eligible for coverage in either FedFlex FSA.

USEFUL INFORMATION

FSA Plan Year. The initial FSA plan year will be a "short plan year" that begins on July 1, 2003 and ends on December 31, 2003. All subsequent plan years will encompass January 1 through December 31.

Open Season. After the initial (short) plan year, employees will make elections to participate in one or both FSAs at the same time as the FEHB open season.

Benefit Elections. Unlike Premium Conversion, participation in an FSA is not automatic; employees must make an election each and every year. Employees will make two "benefit elections" -- whether they wish coverage in one or both of the FedFlex FSAs and the annual amount they agree to have deducted from their pay during the plan year for deposit into their FSA accounts. The benefit elections are irrevocable once the plan year has begun, unless the employee experiences a qualifying "change in status" event.

Use or Lose. Because of the tax advantages of FSAs, the IRS has strict guidelines for its use. One of these guidelines is commonly known as the "*use it or lose it*" rule. Put simply, if employees have not incurred enough eligible expenses during the plan year to equal the annual amount they have contributed to their FSA(s), they will lose the balance remaining in their account(s) when the plan year ends.

OPM Web Site. We have developed a new section for information on FSAs on our web site. The address is www.opm.gov/insure/pretax. We encourage agencies to visit this site regularly, as we expect to update it frequently.

PRELIMINARY PAYROLL REQUIREMENTS INFORMATION

As with the FLTCIP, OPM intends to place most of the responsibility for implementing and managing FSAs on the selected FSA administrator, rather than on agency payroll offices (APOs). Thus, we will require the FSA administrator to develop linkages with all APOs, and adapt its processing systems to those of the APOs, paying special attention to those agencies with extra security requirements. We believe that much of the work involved in developing the linkages with agency payroll systems has already been accomplished by LTC Partners, and will share that information with the successful FSA administrator.

Those agencies migrating to a consolidated payroll provider under the e-Payroll initiative must carefully consider their migration schedule in determining whether to make payroll system modifications to support FedFlex FSAs. Those agencies migrating before or shortly after July 2003 may not make the investments necessary to modify their systems without prior OPM approval.

Initial Opportunity To Participate. There will be an open enrollment period beginning in mid-May 2003 for the initial plan year that will run from July 1 through December 31, 2003. During the open enrollment period, eligible employees will be able to elect to participate in one or both FSAs along with the amount of their annual contributions. The benefit elections will be effective on the first day of the first payroll period that begins on or after July 1, 2003 and that follows a pay period during any part of which the employee was in pay status. The benefit elections will terminate with the first pay period ending in January 2004.

Subsequent Opportunity To Participate. After the initial plan year, employees will have an opportunity to make new FSA benefit elections during the FEHB Open Season. FSA benefit elections made during an FEHB Open Season will be effective with the first payroll period beginning after the following December 31.

Eligible employees who did not have an opportunity to elect coverage during an open enrollment period may elect to participate immediately upon entry-on-duty. The FSA administrator will notify the APO of an employee's election by means of its billing file (discussed below).

Allotments. In order to participate in an FSA, contributions must come from an employee's salary via an allotment. FSA allotments will be allotments to the employing agency that are then directed to a fund managed by the FSA administrator. As with premium conversion, the amount of employee contributions to FSAs will be allotted back to the employing agency. **By July 2003, payroll systems must have the capacity to process two new allotments from pay –** one for the healthcare FSA, and the second for the dependent care FSA. If an agency payroll system has allotment limitations, now is the time to expand it's capability.

Enrollment. As with the FLTCIP, individuals will enroll *directly* with the FSA administrator to participate in one or both FSAs.

Communication of Payroll Office Identifier. Since enrollment will be handled directly by the FSA administrator, employees' will need to know and input a payroll office identifier on their FSA enrollment applications, similar to the process used by LTC Partners. When an employee transfers between agencies, he/she must provide the FSA administrator the new payroll office identifier. We intend to leverage the payroll office identifier process established by LTC Partners; see http://www.ltcfeds.com/NASApp/ltc/do/payroll/payrollmain.

Communication of FSA participation between agencies. Agencies use various methods to communicate information upon the transfer of an employee -- we are aware of the use of the SF 75, the SF 1150, and a variety of internally developed forms and checklists. Regardless of the mechanism used, it is critical that the process provide the "gaining" office with the FSA status of the transferring employee; that is, whether the employee participated or did not participate in a HCFSA and / or DCFSA at the "losing" office.

Billing for Contributions ["Billing File"]. Once an employee has applied for an FSA and has been determined to be eligible, the administrator will submit to the identified payroll provider, a billing file. The billing file will contain all information necessary for the APO to deduct FSA contributions. The administrator will calculate the amount of deductions based on the payroll cycle of the enrollees' agency and provide it to the APO on the billing file; the APO will deduct the exact amount specified by the administrator.

The FSA administrator will work with each APO to determine the most effective and efficient method and time frames to communicate this information. At a minimum, the billing file will contain the following information:

- Name of employee (last, first, middle initial)
- Social security number of employee
- Payroll office number (PON)
- Amount of deduction(s)
- Allotment amount
- Type of account
- Pay period date
- Codes, indicating whether it is an initial deduction, a change, or a cancellation .

Remittance of Deductions and Associated Information ["Remittance File"]. As with the FLTCIP, allotments will be remitted directly to the FSA administrator, not to OPM. The APO will deduct the allotments specified in the billing file and remit them to the FSA administrator on the payroll paid date via electronics funds transfer, along with supporting information. The FSA administrator will work with each APO to determine the most effective method to remit deductions. At a minimum, the remittance file will contain the following information:

- Name of employee (last, first, middle initial)
- Social security number of employee
- Payroll office number (PON)
- Total amount remitted

- Code, indicating reason for deductions not taken and date of event

Terminating Deductions. Unless instructed otherwise by means of the billing file, APOs will make deductions for FSA contributions at the specified amount until the last day of the last pay period that begins in the calendar year. If the employee terminates employment with an entity that the APO payrolls or in the Federal service in general or is no longer occupying an eligible position, the APO will inform the FSA administrator by means of the remittance file. If the FSA administrator determines that employees have experienced a qualifying "change in status" that allows them to terminate coverage in an FSA, it will notify the APO by means of the billing file.

Reemployed Annuitants. As with premium conversion, annuitants may not elect coverage in a FedFlex FSA at the present time. As a consequence, reemployed annuitants must have their FSA deductions taken from their pay as employees, not from their annuities.

Resolving Remittance Discrepancies. The FSA administrator will be primarily responsible to resolve variances between the remittances from an APO and the amount billed. In so doing, the FSA administrator will be expected to contact employees directly to resolve discrepancies. If the FSA administrator is unable to gain the necessary information from the employee, the billed APO will be expected to provide limited assistance in this regard.

Pre-tax Indicator. Payroll systems must incorporate a coding structure to indicate that HCFSA and DCFSA allotments are on a pre-tax basis.

Effect on Employment Taxes. FSAs affect employment taxes identical to premium conversion.

Federal Income Taxes. FSA deductions are excluded from wages before Federal income taxes are applied.

State and Local Income Taxes. FSA deductions are excluded from wages before most state and local income taxes are applied. Each state and local government, however, makes individual determinations as to whether to allow the pre-tax treatment for deductions under FSAs. At the present time, here are the exceptions that we know about:

- *New Jersey* and *Puerto Rico* do not allow for the reduction of taxable income for either HCFSA or DCFSA deductions.

- *Pennsylvania* does not allow for the reduction of taxable income for DCFSA deductions.

It is important that payroll systems are coded accordingly. We will research and advise agencies on local jurisdictions policies regarding the treatment of FSA deductions.

FICA Taxes. FSA deductions are excluded from wages before FICA taxes are applied. An employee's pre-tax contributions to an FSA also reduces the employing agency's FICA contributions.

Note: FSA calculations for CSRS Offset Employees will be identical to Premium Conversion.

Form W-2 Requirements. An employee's FSA deductions will not be included in Boxes 1 [Wages, Tips, Other Compensation], 3 [Social Security Wages], and 5 [Medicare Wages and Tips] of the Form W-2. The total amount deducted for the DCFSA during the plan year should be reported in Box 10 [Dependent Care Benefits]. The total amount deducted for the DCFSA, HCFSA and pre-tax FEHB deductions under Premium Conversion can be reported in Box 14 [Other].

Earnings and Leave Statements. To help employees understand the changes to their take-home pay, agencies should consider including some explanatory language on the initial earnings and leave statements.

If you have any questions regarding this information, we would prefer that you email us at finance@opm.gov, so that we have a record of our communication. You may also contact Laurie Bodenheimer on (202) 606-0004 or Cyndy Gilbert on (202) 606-0606.

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