THE ASSISTANT SECRETARY OF DEFENSE
1200 DEFENSE PENTAGON
WASHINGTON, DC 20301-1200

HEALTH AFFAIRS

MAY 15 2007

The Honorable Carl Levin
Chairman, Committee on Armed Services
United States Senate
Washington, DC 20510-6050

Dear Mr. Chairman:

This letter is in response to the National Defense Authorization Act for FY 2006 (Senate Report 109-69) that requests the Department to report on a plan to evaluate and implement the premium conversion/flexible spending account (PC/FSA) options for uniformed Service members.

No known statutory barriers to implementation would preclude the DoD from executing PC/FSA programs. If the Department were to implement PC/FSA programs, it may determine that future statutory changes might improve administration and facilitate increased participation among Service members. If implementation of PC/FSA programs were to proceed, such changes could be studied in greater detail in light of lessons learned from current enrollment history especially for active reservists. Therefore, it is recommended that no such changes be considered at this time.

Although administrative challenges exist to implementing PC/FSA programs for a military population, they differ according to the target audience (Active Duty or Selected Reserve). Such challenges may inhibit Service member participation.

Thank you for your continued support of the Military Health System.

Sincerely,

S. Ward Casscells, MD

PS: Sen Levin: One month on the job. Thanks for the opportunity
Respect + Gratitude

Enclosure:
PC/FSA for Uniformed Service Members: Report on Findings

cc:
The Honorable John McCain
Ranking Member

Premium Conversion/Flexible Spending Arrangements for Uniformed Service Members

EXECUTIVE SUMMARY

Introduction

The National Defense Authorization Act for FY 2006 Senate Report 109-69 directed the Secretary of Defense to provide a report to the congressional defense committees on a plan to evaluate and implement premium conversion (PC) and flexible spending arrangement (FSA) programs for uniformed service members. Such programs provide the advantage of lowering taxable salary in exchange for the PC/FSA benefit(s). Because salary is taxed *after* the salary reduction contribution to the PC/FSA, the amount of Federal Insurance Contributions Act (FICA) payroll taxes withheld is reduced, and disposable income is increased.

Findings

Potential Tax Savings

Although potential tax savings exist for many Active Duty and Selected Reserve service members for both PC and FSA programs, actual savings depend on many factors and differ according to the individual situation. In general:

- Service members at the higher end of the pay scale and/or in two-income family situations will likely find the tax advantages of PC/FSAs attractive.
- Service members at the lowest end of the pay scale may have a low enough salary that the tax benefits of a PC/FSA program are minimal, causing them to view participation as a non-critical expense burden. Moreover, participation in PC/FSA programs might adversely impact their total social security earnings status or level of earned income tax benefit.

Likely participation levels

Participation depends on such factors as the individual service member's income level; tax bracket; number, age, and health issues of dependents; and access to health and dental insurance and/or dependent care or health care FSAs through his or her spouse. In general:

- Most Active Duty and many Selected Reserve service members currently paying for TRICARE dental/medical premiums will likely participate in PC programs.
- Low initial participation rates are likely for both PC/FSA programs, but may rise over time.
- Only a small percentage of service members (Active Duty or Selected Reserve) would benefit from participating in a dependent care or health care FSA.

Barriers

No known statutory barriers to implementation would preclude the Department of Defense (DoD) from executing PC/FSA programs.

Although administrative challenges exist to implementing PC/FSA programs for a military population, they differ according to the type and intended purpose of the program and the target audience (Active Duty or Selected Reserve). The implementation plans for PC and

FSA programs reflected in the final report identify these administrative challenges and potential solutions to overcome them.

Program Implementation Decision

Prior to program execution, DoD must make an implementation decision for each PC/FSA program. Given the distinct characteristics of the uniformed population, the implementation decision is more complex for the military than it is for the federal civilian and private sectors. DoD should consider the utilization, sustainability, and administrative feasibility of each PC/FSA program when determining whether to implement.

Implementation Plans for PC/FSA Programs

The following sections represent the five phases of a PC/FSA implementation plan and include recommendations for each phase.

Assign Policy Office Responsible to Draft Written Plan

Within the Office of the Under Secretary of Defense for Personnel & Readiness, assign the specific policy office responsible for drafting the requisite written plan for the cafeteria plan under which the PC/FSA benefits will be offered.

Establish Plan Rules and Guidelines

A dental PC program for Active Duty personnel should use default elections (i.e., a service member automatically participates unless he or she specifically opts out). However, dental and medical PC programs for Selected Reservists should require the service member to enroll to participate. Renewal for either type of PC program should be automatic for both Active Duty and Selected Reservists. For FSA programs, DoD should not employ either default elections or automatic renewals, but should allow the full grace period for FSA programs and consider initially setting the maximum contribution below the $5,000 statutory cap.

Section 125 of the Internal Revenue Code requires that voluntary withholding of funds for PC/FSA programs (i.e., exchanging salary for the particular benefit) must be done as a payroll reduction. DoD needs to instruct service members wishing to participate in such programs that they must be able to use the payroll reduction mechanism.

DoD has a statutory requirement under 10 U.S.C. 1076d that receipt of medical/dental premium payments into the TRICARE system must be made on a monthly basis. Only Selected Reservists with sufficient funds available to allow for monthly salary reduction may participate in a PC program.

Conduct Program Administration Activities

DoD should administer PC programs in-house. Given the complexity of FSA program execution, the Department should strongly consider employing a third-party administrator for implementation.

DoD should apply the savings in its employer share of FICA payroll taxes from implementing PC/FSA programs to help offset the program administration costs. DoD should not charge service fees to the participating service members.

Decide Program Implementation Schedule

DoD should use a phased approach to implementation when introducing PC/FSA benefits, beginning with PC programs and followed a year later by FSA programs for Active Duty. DoD should then conduct an analysis of lessons learned from all PC/FSA programs before considering FSA programs for Selected Reservists.

DoD must determine the individual implementation schedule for each program. The schedule differs in length depending on the program type and intended audience (e.g., Active Duty, Selected Reserve). Reviewing and, as necessary, updating or drafting new regulatory guidelines and policy documentation may take 12 to 24 months.

Program management and administration efforts—including determination of funding requirements, any potential offsetting savings, and subsequent budget realignments—should be addressed concurrently. Resolving funding issues and reflecting PC/FSA programs in the budget process may take up to 12 additional months. Thus, the total timeframe required for implementation is approximately 18 to 30 months.

Establish Education Process

DoD will develop the requisite written plan and comprehensive education effort to assist service members in using PC/FSA programs. DoD will also develop informative materials that are simple, straightforward, accessible, and instructive; identify available tools and resources; and reflect how and where to seek additional assistance as needed.

Conclusions

Potential tax savings of PC/FSA programs are attractive. However, fairly significant differences exist among the employment circumstances of public and private sector civilians and uniformed service members, and between the Active Duty and Reserve components. These differences include the nature of service commitment, compensation and benefits, and how service members and their families participate in and are supported by the Military Health System. DoD must determine how PC/FSA benefit programs might work best for each component, and whether, when, and how to offer those programs. The implementation plans contained in this study offer a way to proceed.

Table of Contents

List of Appendixes

List of Exhibits

1 Introduction

This report details the study review of premium conversion and flexible spending arrangement (PC/FSA) programs for the Department of Defense (DoD). This review was conducted in response to congressional direction to report on a plan to evaluate and implement these programs for uniformed service members. **Section 2** presents an outline of the congressional request for such a review. **Section 3** and **Section 4**, respectively, contain a brief discussion of the background of these issues and the study design for the conduct of the review. **Section 5** presents the general process of implementing PC/FSA programs in any organization.

Section 6 presents key considerations affecting the potential decision to implement PC/FSA programs when dealing with the unique characteristics of a military population. **Section 7** outlines an implementation plan for executing PC programs for TRICARE dental/medical premiums for service members. **Section 8** outlines the implementation plan for dependent care and out-of-pocket health care expense FSAs for service members. Finally, **Section 9** provides the study's final conclusions regarding the implementation of PC/FSA programs for military personnel.

2 Congressional Interest in Premium Conversion and Flexible Spending Arrangement Programs

The National Defense Authorization Act for Fiscal Year 2006 (FY 2006 NDAA) Senate Report 109-69 directed the Secretary of Defense to provide a report to the congressional defense committees on a plan to evaluate and implement PC/FSA programs for uniformed service members. Specifically, Congress was interested in programs that would allow:

- Active Duty and Selected Reserve service members to use PC to pay for dental insurance premiums;
- Selected Reserve service members to use PC for TRICARE Reserve Select medical premiums authorized by the Ronald W. Reagan National Defense Authorization Act for FY 2005 (Public Law 108-375);
- Active Duty and Selected Reserve service members to use an FSA to pay for child care services; and
- Active Duty and Selected Reserve service members to use an FSA to pay for permissible out-of-pocket health care expenses not covered under TRICARE.

Appendix A provides the full text of the congressional language.

3 Background

For several years, many private sector companies have offered their employees the opportunity to exchange salary dollars, through salary reduction, on a pre-tax basis for a benefit called an FSA account. Those salary dollars go into an FSA account held by the employer from which, depending on the specific type of FSA benefit, the employee may seek reimbursement for certain expenses, including medical and dependent care services. Similarly, a PC account allows employees to exchange salary on a pre-tax basis for a benefit of qualifying group term life insurance or group medical, dental, vision, accident, or disability insurance. The salary dollars go into a PC account from which the employee's insurance premium is paid. These plans have been

called "cafeteria plans" because of the choice the employer has in deciding which PC/FSA benefits to offer (consistent with IRS regulations), and the choice the employee has in selecting which of these benefits he or she is willing to exchange salary. **Appendix B** provides an overview of cafeteria plans. The advantage to employees participating in these programs is the lowered amount of taxable salary, thereby reducing actual taxes withheld and increasing disposable income because salary is taxed *after* the contribution to the PC/FSA.

To maintain parity with some of the attractive benefits many private sector companies offer their employees, the U.S. Government, through the Office of Personnel Management, also allows federal employees to voluntarily participate in PC programs for health, dental and vision insurance, and FSA programs referred to as the Health Care Flexible Spending Arrangement (HCFSA) and the Dependent Care Flexible Spending Arrangement (DCFSA).

The first program, HCFSA, offers tax savings by allowing an employee to seek reimbursement for qualified medical expenses not covered or reimbursed by his or her health benefits plan or other type of insurance. These expenses are paid with salary dollars, set aside specifically for this purpose, up to an allotted amount (i.e., part of the employee's salary contributed prior to deduction of federal, state, and local taxes). Expenses eligible for reimbursement may include medical treatment, equipment, deductibles, co-payments, vision care, dental care, orthodontia, and, in some circumstances, over-the-counter medicines. However, reimbursement for health care insurance premiums is specifically excluded.

The second program, DCFSA, allows an employee to contribute pre-tax income, up to a specific threshold, to reimburse child care or adult dependent care expenses for qualified dependents, including before- and after-school care. These expenses are considered necessary to allow employees or their spouses to perform activities such as working, looking for employment, or attending school full time.

At this time, neither PC nor FSA programs are offered to military personnel. However, service members receive other military benefits that differ from those received by federal civilian or private sector employees (e.g., special allowances that augment military pay, access to the Military Health System, etc.). In response to FY 2006 NDAA language, DoD has examined PC/FSA programs to determine how such benefits could be offered to uniformed service members. The office of the Assistant Secretary of Defense for Health Affairs provided an interim response to the defense committees in September 2006 indicating that it anticipated that a final report would be available to Congress in February 2007.

4 Study Design

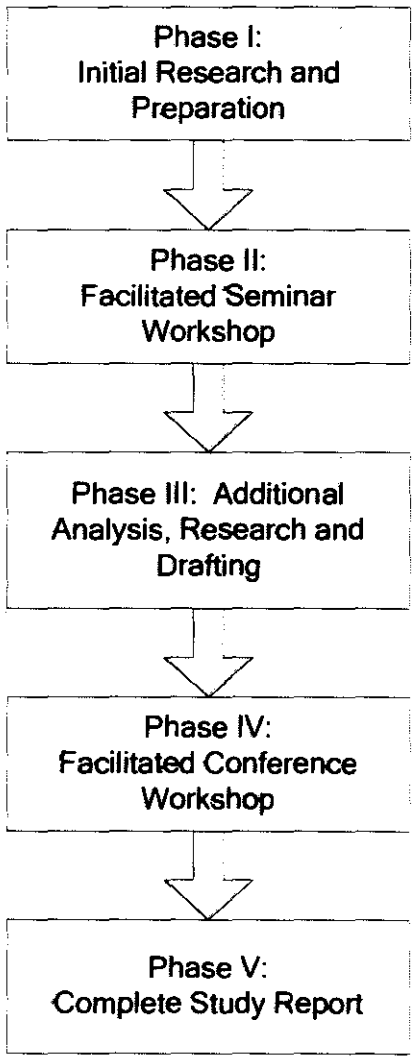
Based on the congressional direction in the FY 2006 NDAA Senate Report to perform this effort, the TRICARE Management Activity (TMA) evaluated the potential implementation of PC/FSAs for use by service members and their families for TRICARE medical and dental insurance premiums, child care services, and out-of-pocket health care expenses.

The goal of this study effort was to comply with the congressional direction by conducting a review of the requirements for PC/FSAs as governed by the Internal Revenue Code of the Internal Revenue Service (IRS) and administered by the Office of Personnel Management (OPM). The five-phase study design process included research and review of PC/FSA program requirements and examples offered by the public and private sectors, as well as two facilitated events conducted in the Washington, DC, metropolitan area. These facilitated events were

intended to obtain the advice and recommendations of individuals from IRS and OPM experienced with PC/FSA program implementation requirements and DoD staff knowledgeable of unique aspects in considering implementation for a military population. Participants explored relevant issues, barriers, and constraints to implementation, and developed recommendations that could help overcome these challenges to implementing PC/FSA programs.

Exhibit 1 illustrates the five phases of the study process. **Appendix C** contains a full description of the approach, methodology, and timelines of this process.

Exhibit 1. Study Design Plan's Five Phases

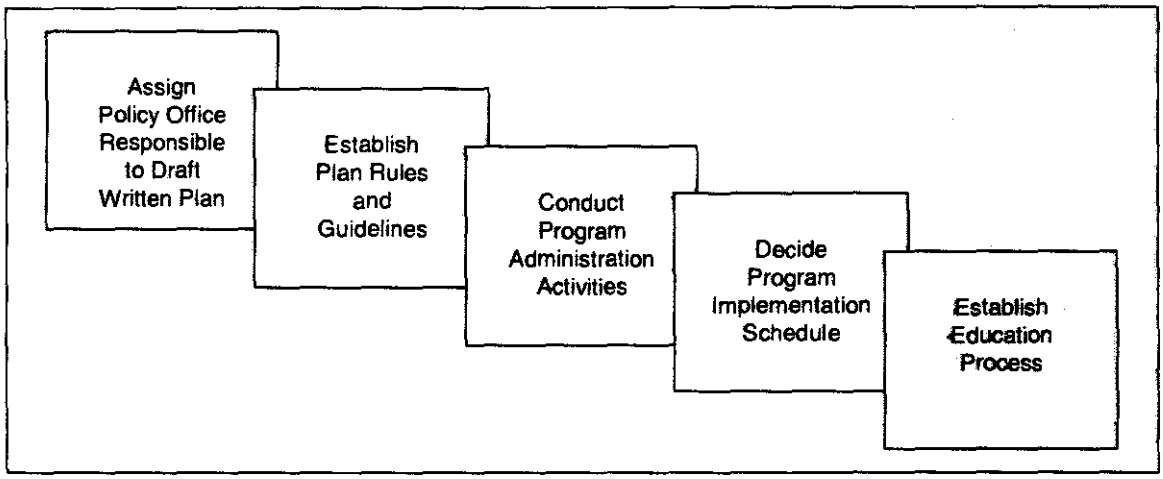


5 General Implementation Plan

To establish a basic understanding of the overall implementation process for PC/FSA programs, this section discusses the general steps necessary to implement such programs in any organization. **Sections 7** and **8** provide specific recommendations for DoD's implementation of PC and FSA programs, respectively. These recommendations address the differences not only in implementing the two types of programs overall, but in implementing these programs for Active

Duty and Selected Reservists. **Exhibit 2** illustrates the five major phases in the implementation plan process.

Exhibit 2. Phases of the Implementation Plan



5.1 Assign Policy Office Responsible to Draft Written Plan

In both the public and private sectors, each employer must develop a written plan regarding the elements of the cafeteria plan they set up; this plan must satisfy IRS regulations as reflected in Section 1.125-1 of the CFR. The employer designates the office within the organization responsible to develop the cafeteria plan. The responsible office then makes key decisions on plan design, program administration, and policy formulation and oversight. **Sections 5.2** and **5.3** will discuss issues regarding plan design and program administration in more detail.

The office responsible for policy formulation and oversight drafts the written plan, which includes information on the plan design, what benefits will be offered, who will pay for the benefits and in what manner, who will be eligible to participate, who will administer the plan and how administrative fees will be handled, allowance for a grace period, determination of "change-in-status" events (consistent with IRS regulations), maximum contributions, etc. Employees will have significant interest in the details of how they might avail themselves of PC/FSA benefits. Therefore, the employer should post the approved written plan on the organization's web site, as OPM and most private sector companies do.

In addition to drafting the written plan, the responsible policy office must review existing relevant statutory, regulatory, and policy documents; generate or update those documents accordingly; develop policy justification and guidance documents; and monitor program management and implementation to ensure consistency with policy goals and objectives.

5.2 Establish Plan Rules and Guidelines

Establishing the plan rules and guidelines requires the following five steps:

- Define/determine benefits to be offered
- Determine eligibility and establish level of participation
- Identify and document FSA-specific process
- Establish grace period for FSA
- Determine maximum contribution for FSA.

5.2.1 Define/Determine Benefits Offered

The employer determines which benefit(s) will be offered under the cafeteria plan. For example, an employer may choose to offer a PC program for employee medical insurance premiums only, or may decide to offer additional PC programs for dental and/or vision insurance. The employer may decide to offer one or more benefits, but is not required to provide any or all options. When considering each PC/FSA option, the employer would conduct a cost-benefit analysis to assess offering that option.

5.2.2 Determine Eligibility and Estimated Level of Participation

As part of the decision as to which benefit(s) to offer in a cafeteria plan, the employer determines which employees (and how many) are eligible to participate, and then estimates participation levels among those eligible. When determining who is eligible to participate, the employer must meet all relevant legal requirements; an employer cannot use the cafeteria plan to discriminate among employees. However, some factors will directly affect whether or not employees are eligible to participate. For example, an employer may offer a PC for medical insurance premiums, but if part-time employees are not eligible to participate in the company health care program, they may not use the medical insurance PC. Likely levels of participation may in turn directly affect plan decisions regarding which benefits may be offered.

5.2.3 Identify and Document FSA-Specific Process

Employers must clearly describe how FSA programs work and the process by which employees will participate in such programs. Employees need this information both to decide whether to participate in an FSA program and to manage that FSA during the plan year. The employer should include this information in the requisite written plan, other policy and program management documents, and the educational materials made available to employees. Key points include:

1. Employees must estimate their reimbursable expenses for health care or dependent care FSAs and arrange for salary reduction in exchange for that benefit.
2. To estimate accurately, participants must understand which specific expenses are reimbursable and which are not.
3. Employers need to state, consistent with statutory guidelines, what constitutes acceptable substantiation of expenses (e.g., receipts, etc.).
4. Employers detail the process by which employees seek reimbursement from their FSA for permissible expenses and the timeframe in which employees can expect this process to occur.

5. Employers must clearly state the circumstances under which an employee may make changes, if any, to his or her FSA election.
6. Employers set the maximum salary reduction contribution cap on each FSA program (see **Section 5.2.5**).
7. Employers must provide an avenue for redress should employees believe the process is not working appropriately (e.g., challenge disapproved reimbursement of expenses, register complaints regarding the process or timeline, etc.).

5.2.4 Establish Grace Period for FSA

For each FSA offered under a cafeteria plan, the employer determines whether to offer a grace period beyond the calendar year for accessing the funds in an FSA for reimbursement of permissible expenses. If offering a grace period beyond December 31st, the employer establishes how long that grace period should be, up to the maximum two-and-a-half months (i.e., not beyond March 15th). The employer should include this information about the grace period in the written plan and communicate it to participating employees to assist in their accurate estimation of expenses and to avoid potential forfeiture of unused funds. When the plan year ends, the employee loses access to any remaining balance in each FSA. The unused balance remains with the employer and does not return to the employee.

5.2.5 Determine Maximum Contribution for FSA

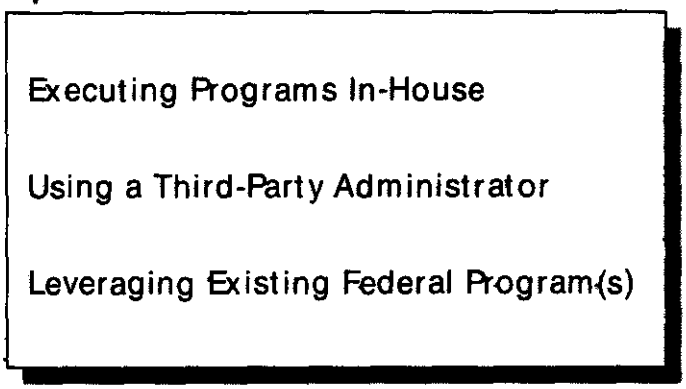
The employer clearly states, for each FSA offered, the maximum amount (up to the statutory cap of $5,000) an employee may contribute to that FSA. Setting the maximum contribution below the cap (at least in the early stages of offering FSAs) helps participants new to the FSA process avoid forfeiture of unused funds. It also reflects recognition that participants initially tend to be conservative in their estimates of relevant reimbursable expenses, in part to avoid agreeing to exchange too much salary than actual expenses warrant. For example, OPM chose to initially set the cap at $3,000 per FSA when introducing its dependent care and health care FSA programs to federal employees. As participants gained familiarity with the FSA process and participation levels increased, OPM raised the cap over successive years to the current $5,000 maximum allowed.

5.3 Conduct Program Administration Activities

5.3.1 Determine Who Administers Programs

The employer must determine which, among several existing models for implementing PC/FSA programs, is most appropriate for executing the particular benefits offered in its cafeteria plan. As illustrated in **Exhibit 3**, these include developing and executing programs in-house, utilizing a third-party administrator; and, as applicable, leveraging existing programs in the public or private sector. In the latter case, the employer must agree to abide by the established rules and guidelines of the host program, including paying service fees based on participation levels.

Exhibit 3. Potential Implementation Models



An employer may decide to use a combination of these models. For example, the organization may choose to execute various PC programs in-house primarily as a payroll function, but may decide that the complexity and workload associated with administering an FSA program (e.g., monitoring funds maintained in individual accounts, reviewing reimbursement requests, reimbursing approved expenses, etc.) warrants contracting with a third-party administrator.

The employer's determination of who administers an FSA program raises the related issue of where set-aside funds reside. This issue is particularly important in the case of a health care FSA. Sufficient funds must be available to the program administrator to be able to reimburse up to the full value of an employee's annual FSA expenses as of the very beginning of the plan year, even if the employee has not had the full annual value of funds withheld via salary reduction.

5.3.2 Determine Program Implementation Budget

The employer must assess the full range of costs associated with implementing a PC/FSA program, determine whether offsetting sources of savings and/or funding exist, and develop a program implementation budget. The costs associated with implementing PC/FSA programs will differ depending on the particular type of program, anticipated/actual levels of participation, and decisions regarding plan designs and education efforts.

Program management costs will differ depending on how the program is administered and by whom, and the size and complexity of the program execution. For example, PC programs essentially consist of payroll adjustments to reduce participants' salaries; those funds are then directly transferred to pay insurance premiums. Funds do not need to be held in individual participant accounts (as in the case of an FSA), and therefore require less oversight. PC programs tend to be more straightforward in their execution because they do not have the additional rules associated with FSAs (e.g., estimating permissible expenses, collecting and submitting substantiation of expenses for reimbursement, potential for forfeiture of unused funds, grace periods, contribution caps, etc.); thus, the education process associated with PC programs should be less complicated than for FSA programs. Consequently, PCs should be less expensive to implement than are FSAs.

Implementation of either a PC or FSA program should result in some savings internal to an organization in the form of reduced employer's share of Federal Insurance Contributions Act

(FICA) payroll tax withholding for participating employees. As participant levels grow for PC/FSA programs, so should the amount of employer's FICA savings.

For example, OPM was able to implement PC/FSA programs for its own employees without any appropriated funding by using its employer share of decreased FICA payroll tax withholding and by charging small administrative fees on a monthly basis for each participating employee. In addition, OPM is responsible for offering PC/FSA programs for federal employees in the agencies and departments under its purview in the federal employee health benefits program. OPM funded these programs in part through an administrative fee charged monthly to each participating employee and a similar administrative fee charged to each agency/department for each participant. The latter is referred to as a "risk fee," a fee that is required to ensure that the third-party administrator has sufficient funds to cover expense reimbursements, even in advance of each employee's full annual contribution of salary reductions. In turn, the agency/department fees paid to OPM were likely offset in part or in whole by each agency or department's own savings realized from decreased FICA taxes withheld for its employees participating in PC/FSAs.

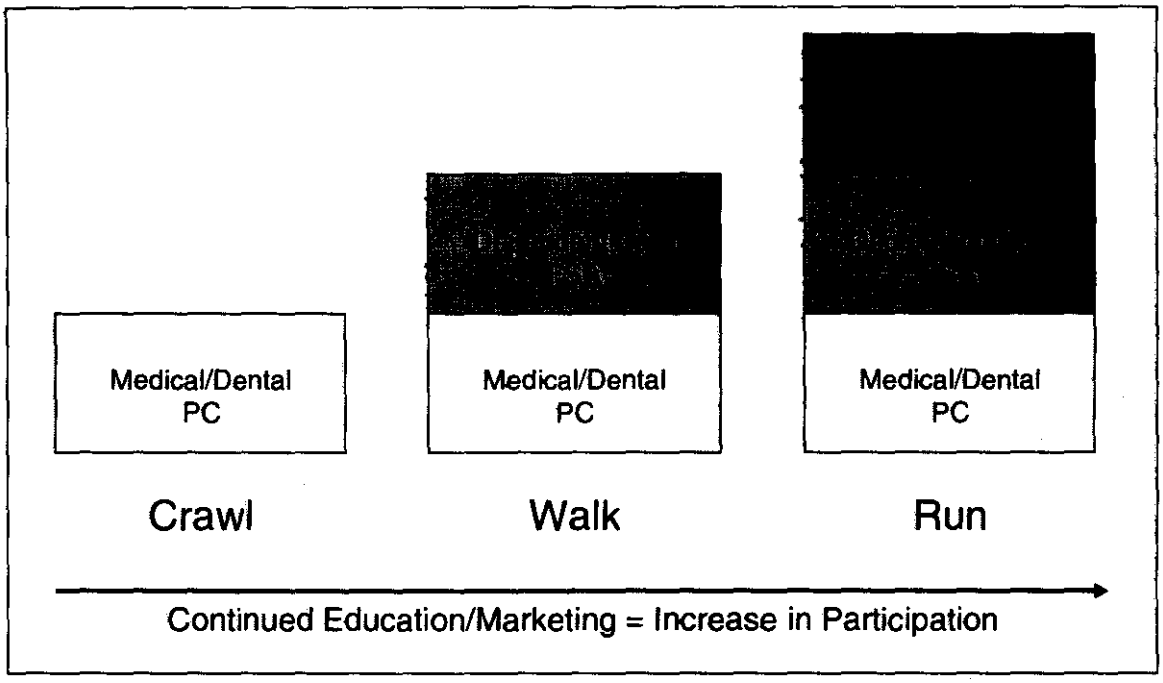
Additionally, OPM uses forfeited funds to help cover PC/FSA administrative costs. However, these funds are a fluctuating, unpredictable, and therefore destabilizing source of revenue, as well as highly problematic to those individual employees who lose unused FSA funds. OPM has seen instances of forfeiture balances decrease over time with ongoing education and increased participant experience with FSA programs. Because these funds are a source of concern for employees and a poor source of revenue for employers, every effort should be made to minimize the likelihood of forfeited funds in implementing any PC/FSA program.

5.4 Decide Program Implementation Schedule

The employer determines the schedule for implementing PC/FSA programs. How long the implementation process takes once a decision is taken to offer a PC/FSA program or programs differs greatly from one organization to another. As discussed, employers need to decide key program features, determine costs and appropriate funding, choose an implementation model, draft the requisite written plan and develop their education and marketing approach. Additionally, public sector organizations must also review existing statutes and federal regulations, and seek changes in them if necessary.

Most public and private sector organizations have employed what DoD refers to as a "crawl, walk, run" approach (i.e., phased implementation) in implementing PC/FSA programs. **Exhibit 4** illustrates this phased implementation. Many of these organizations decided to introduce a PC program first, and then added additional PC program options for dental and/or vision insurance premiums later. Often these PC programs were implemented in-house as part of each organization's payroll function. More complex FSAs for dependent care and health care tended to be introduced after additional analysis and planning, usually with the help of third-party administrators.

Exhibit 4. Potential Phased-In Implementation Approach



Implementing PC/FSA programs in a phased manner allows employers to gather and review information on how employees responded to various PC/FSA offerings and to educate the participant population on the PC/FSA benefits process and special rules (e.g., salary reduction required to ensure potential FICA tax savings, annual elections, estimating expenses, etc.). Employers can study lessons learned in the roll-out and execution of earlier programs, gaining valuable insight to adjust both existing programs and those under consideration for implementation. Similarly, employees gain familiarity with key concepts underlying the potential tax benefits and risks, and participation levels increase as more employees choose to join those employees already participating in PC/FSA programs (i.e., the "early innovators"). Familiarity with PC/FSA program offerings tends to grow as employees hear about them in the workplace, which raises employees' comfort levels in joining current participants. Employers in turn can improve both the content of information provided and access to that information and enhance marketing efforts to increase participation.

Using this phased approach when introducing PC/FSA programs to federal employees, OPM began with the unveiling of a PC program in October 2002 to become effective December 31, 2002. OPM then introduced health care and dependent care FSAs in January 2003 to go into effect on that summer. OPM deliberately chose to start the health care and dependent care FSAs in this shortened, six-month plan year as part of its learning curve strategy. Lessons learned from the initiation of their FSA programs helped inform minor modifications to existing and new plans as participation levels continued to rise.

5.5 Establish Education Process

The employer develops an education process to provide key information to employees of the PC/FSA benefits available under the cafeteria plan. This education process should inform employees of the various benefit options available, instruct them in determining whether participation is warranted, and show them how to access and utilize such PC/FSA programs.

Because they recognize the need to assist employees in weighing the potential benefits and risks of participating in PC and FSA programs, most employers develop an extensive education process using web site information with links to relevant information and offer on-line and hard-copy documents outlining key program aspects (e.g., the written plan, fact sheets, guidelines and answers to frequently asked questions, etc.). Similarly, many employers offer calculator worksheets that allow employees to enter relevant information to help determine the monetary benefits of participating in the various benefit options. **Exhibit 5** shows the various materials and elements involved in a typical education plan.

Exhibit 5. Tools for Educating Users

◆ Written Plan ◆ Pamphlets ◆ CD-ROMs, DVDs ◆ Web site ◆ Training classes	◆ Eligibility ◆ Reduce salary in exchange for PC/FSA benefit ◆ Potential tax benefits ◆ Estimating FSA expenses ◆ Risk of overestimating FSA expenses (forfeit unused $) ◆ Reimbursement process ◆ How to sign up ◆ When allowed, how to make changes during plan year

In developing an education process for the cafeteria plan, the employer determines whether that process will be more of a "push" system—in which the employer makes an extensive effort to educate and encourage employee participation—or a "pull" system—in which the employer makes the benefits and corresponding information available for interested employees to seek out, but doesn't aggressively push participation. Both approaches have their advantages, and many employers use a mix of "push/pull" depending on the particular benefit or benefits offered.

During the initial offering of its cafeteria plan for federal employees, OPM chose to provide general information and access to additional material, but did not undertake a massive education and public affairs campaign. Just as lessons learned by OPM helped inform minor plan modifications (e.g., over time slowly raising the maximum contribution on FSAs to the $5,000 cap), early participants "blazed the trail" for others. Familiarity with the programs grew, spread by word of mouth, and participation levels have grown slowly but steadily. For example, OPM had 30,000 participants in the FSA programs initiated in 2002. By 2006 the number of participants had grown to 200,000, representing a participation rate of approximately 12% of their eligible population of 1.8 million federal employees. Participation levels were expected to rise further in calendar year 2007 based on initial feedback from the open season conducted in the latter part of 2006.

6 The Program Implementation Decision

Prior to implementation of a given PC/FSA program, the employer must decide whether or not implementation is warranted and should proceed. Given the distinct characteristics of the

uniformed population, the implementation decision is more complex for the military than it is for the federal civilian and private sectors. Individual implementation decisions should address the type of program (PC, FSA), intended purpose (e.g., medical or dental premiums, out-of-pocket health care expenses, dependent care expenses, etc.) and the targeted military population (i.e., Active Duty, Selected Reserve, or both).

Although the distinction between Active Duty and Selected Reservists may appear similar on the surface to the full-time/part-time dynamic evident in the private sector and the civilian side of the public sector, notable differences exist. These differences include duty requirements, compensation, benefits, and how the service members—and as applicable, their families—participate in and are supported by the Military Health System. DoD must determine how benefit programs under a cafeteria plan would work best for each component, and whether/when to offer those programs. Many factors affecting potential eligibility and participation must go into these plan decisions. As in the civilian sector, these factors (and the subsequent plan decisions) may well affect service members on a case-by-case basis. **Sections 7** and **8** address these factors in more detail.

In examining the statutory and administrative barriers for implementation of the various PC/FSA programs for the military population, three categories of considerations regarding the implementation decision become apparent:

- **Utilization** – What level of participation is anticipated? Participation is influenced by factors that include income, number and age of dependents, health issues, and access to other benefits (e.g., private sector plan or government benefits). In light of the anticipated levels of participation, is the benefit to the intended military population worth the cost of program implementation? [Note that the potential effects of such PC/FSA programs on recruitment, retention, and readiness have not been determined and are not addressed in this study.]
- **Sustainability** – Would administrative issues specific to military PC/FSA programs make financial stability more difficult to achieve than it is in the private sector (e.g., administrative complexity, limited participation, would cash flow be adequate to ensure sustainability, etc.)?
- **Administrative Feasibility** – Would complexities associated with implementing the program for certain sectors of the military population threaten the program's equitable access, fairness, or ability to project and control cost (e.g., change in status among Active Duty and Selected Reservists, inconsistent drilling affecting salary reduction for Reserves, etc.)?

For each type of PC/FSA under consideration, **Exhibit 6** provides an assessment of whether the preceding considerations represent significant potential constraints on program implementation and should be investigated and evaluated prior to the decision to implement the program. The individual implementation plans that follow discuss additional details of these considerations and their impacts on implementation.

Exhibit 6. Consideration of Significant Potential Program Implementation Constraints

	Utilization	Sustainability	Administrative Feasibility
PC for dental premiums for Active Duty	No	No	No
PC for dental premiums for Selected Reserve	No	No	Yes
PC for medical premiums for Selected Reserve	No	No	Yes
FSA for dependent care for Active Duty	Yes	No	No
FSA for dependent care for Selected Reserve	Yes	No	Yes
FSA for health care for Active Duty	Yes	Yes	Yes
FSA for health care for Selected Reserve	Yes	Yes	Yes

Consideration of potential utilization of PC/FSA programs for military personnel starts with the size of the uniformed force. Currently, that force consists of 1.3 million active duty service members and 1.1 million Guard and Reserve members. Many of those service members could benefit from voluntarily reducing their taxable salary in exchange for receiving their TRICARE medical and dental benefits via a PC program. Active duty service members do not pay TRICARE premiums for medical or dental coverage for themselves or medical coverage for their family members, but do pay premiums for their families' dental coverage. Selected Reserve members, when eligible, must pay a portion of their TRICARE medical and dental coverage premiums for themselves, a portion of medical coverage premiums for family members, and 100% of their families' dental coverage premiums.

Of the aforementioned 1.1 million Selected Reserve members, almost 800,000 are eligible for some level of TRICARE Reserve Select (TRS) medical coverage. Yet only 13,000 currently choose to participate. The recently passed John Warner National Defense Authorization Act for FY 2007 and accompanying conference report 109-702 contain language streamlining the three-tiered TRS, significantly expanding the potential number of Selected Reservists eligible for coverage. The language also reflects reductions in the percentage of total TRS premiums that the reservists would be responsible for covering. DoD would pick up a larger share of the TRS premiums, in many cases increasing from 15% or 50% (under the previous third and second tiers) to 72% of the total premium (the first tier). The current participation level of Selected Reservists in the TRICARE Dental Program is also relatively low, with 55,000 contracts for dental coverage for the service members alone or with their families.

Administrative feasibility is another important consideration when exploring the decision whether to execute PC/FSA programs for the military population. One of the most challenging issues Selected Reservists face should they wish to participate in a PC/FSA program to take advantage of the potential tax benefit is having sufficient pay available on a monthly basis to allow for salary reduction. The current percentage levels of participation of Selected Reservists in TRICARE Reserve Select for medical coverage and TRICARE Dental Program for dental coverage are relatively low compared to the number eligible. Selected Reservists participating have the flexibility of paying for their own medical/dental coverage premium, and for their families' medical coverage premiums, through salary allotment (i.e., after FICA payroll taxes have been taken out), or through other non-payroll means (e.g., electronic funds transfer, personal check, credit card, etc.).

Participation in PC/FSA programs requires the exchange of salary through salary reduction to gain the benefit of lowering taxable income. For PC programs, the issue is not just

when a service member has salary reduced (i.e., to exchange for the insurance benefit) but also when the TRICARE system must receive insurance premiums. TRICARE medical and dental premiums are required by statute (10 U.S.C. 1076d) to be received into the system on a monthly basis. Therefore, participation in PC programs requires salary reduction on a monthly basis for all service members, both Active Duty and Selected Reserve—a particular challenge for Selected Reservists. Of the more than 600,000 Selected Reservists who drill each year, only 28% conduct drilling each and every month; this average differs slightly by Guard and Reserve category.

In light of issues regarding considerations of utilization, sustainability and administrative feasibility, determining how many service members would actually participate in PC/FSA programs if implemented in the DoD is difficult. Despite the difficulty, estimating as best as possible potential levels of participation in each type of program is important. **Exhibit 7** shows the estimated participation levels among the military population for the various types of PC/FSA programs.

Exhibit 7. Estimated Participation Levels Among Military Population

	PC Dental		PC Medical		FSA Dependent Care		FSA Health Care	
	AD	SR	AD	SR	AD	SR	AD	SR
w/o dependents	n/a	neg	n/a	neg	n/a	n/a	n/a	neg
w/ dependents and/or dual income	neg	neg	n/a	neg	neg	neg	neg	neg
w/o dependents	n/a	low	n/a	low	n/a	n/a	n/a	low
w/ dependents and/or dual income	low	low	n/a	low	low	low	low	low
w/o dependents	n/a	low	n/a	low	n/a	n/a	n/a	low
w/ dependents and/or dual income	mod	low	n/a	low	low	low	low	low
w/o dependents	n/a	low	n/a	low	n/a	n/a	n/a	low
w/ dependents and/or dual income	high	low	n/a	low	mod	low	mod	low
w/o dependents	n/a	low	n/a	low	n/a	n/a	n/a	low
w/ dependents and/or dual income	high	low	n/a	low	high	low	high	low

[Key: n/a=not applicable; neg=negligible; mod=moderate]

In general, participation levels are expected to be higher for PC programs than for FSA programs, and for Active Duty service members than for Selected Reservists. The number of service members (either Active Duty or Selected Reserve) at the E-4 level and below likely to participate in any PC or FSA is negligible. Service members at this low end of the pay scale may find participation in PC/FSA programs do not afford significant benefits, and may adversely impact their tax situation. Potential levels of participation in PC/FSA programs increase for NCO personnel at the E-5 level and above, but only slightly. Participation is not anticipated to rise to the moderate level or higher until service members are mid-level officers with dependents and/or

are members of a dual-income family. Participation by Selected Reservists in any of the PC/FSA programs is anticipated to remain relatively low.

Although estimated participation is an important factor in implementation decision-making, it is certainly not the only one. The next two sections discuss considerations that address aspects of the unique nature of the military population involved, outlining an implementation plan for PC (**Section 7**) and FSA (**Section 8**) programs for Active Duty and Selected Reserve personnel. Where applicable, these sections contain recommendations regarding many of the key decisions required under the typical implementation plan discussed in **Section 5**.

7 Implementation Plan for PC for TRICARE Dental/Medical Premiums for Active Duty and Select Reserve

No known statutory barriers to implementation preclude DoD from executing dental PC programs for Active Duty and dental or medical PC programs for Selected Reserve service members. If the Department were to implement PC programs, it may determine that future statutory changes might facilitate increased participation among service members.

For example, 10 U.S.C. 1076d requires that TRICARE premiums be paid monthly, which could preclude the almost two-thirds of Selected Reservists who do not drill each and every month—and therefore may not have the incoming pay from which to take salary reduction—from participating in PC programs. However, because the majority of Selected Reservists currently do not choose to participate in the TRICARE Reserve Select or the TRICARE Dental Program, the need for a statutory change is unclear. Such statutory changes could well have unintended, perhaps negative, consequences. If implementation of PC programs were to proceed, such changes could be studied in greater detail in light of lessons learned. Therefore, no such changes are recommended at this time.

Administrative challenges unique to the military population that need to be addressed when implementing PC programs for service members do exist. As identified in **Exhibit 6** in **Section 6**, these administrative challenges fall into the category of administrative feasibility, dealing with the issue of salary reduction in exchange for medical/dental premiums for Selected Reservists.

The following sections contain an implementation plan that discusses these challenges and presents potential solutions to overcoming them wherever possible.

7.1 Assign Policy Office Responsible to Draft Written Plan

Assigning the policy office responsible for drafting the requisite written plan for the overall cafeteria plan of benefits is an important step in implementing PC programs.

In DoD, policy formulation and oversight are the responsibility of the Office of the Secretary of Defense (OSD). Specifically, within OSD, consideration of potential PC/FSA programs for medical and dental insurance premiums, out-of-pocket health care expenses, and dependent care expenses for service members and their families is the responsibility of the Office of the Under Secretary of Defense for Personnel and Readiness.

7.2 Establish Plan Rules and Guidelines

During implementation, when considering participation by service members in PC programs for insurance premiums, most Active Duty personnel already paying such dental

premiums (i.e., on behalf of their families) will likely participate in such a PC program. Thus, a large number of Active Duty members with families could benefit from a dental insurance PC program. However, the percentage of Selected Reserve service members that could benefit from dental or medical insurance PC programs is considered to be relatively small. Only those Selected Reserve personnel already paying medical and/or dental premiums (i.e., on behalf of their families and/or themselves) and who are able to use payroll reduction will likely participate in such programs.

When implementing PC programs for Active Duty personnel only, the plan should use default elections—all Active Duty personnel are automatically participants unless they specifically opt out of the program. The plan should not use such default elections for Selected Reserve members—each Selected Reservist should not automatically be enrolled and must take steps to do so if he or she desires to participate. Automatic or "evergreen" annual renewal should be used for both Active Duty and Selected Reserve service members.

Potential tax savings exist for Active Duty and Selected Reserve service members for PC and FSA programs. However, actual savings and whether an individual service member might decide to participate in any of the programs depend on many factors, and may therefore differ according to the individual situation.

In general, service members at the higher end of pay scale and/or in two-income family situations will likely find the tax advantages of PC/FSAs more attractive. However, service members at the lowest end of the pay scale may find that participation in PC/FSA programs adversely impacts their tax situation. In some instances, such service members may find that receiving tax benefits from PC/FSAs adversely impacts their ability to receive a slightly more beneficial earned income tax benefit.

Section 125 of the Internal Revenue Code requires that voluntary withholding of funds for PC and FSA programs (i.e., exchanging salary for the particular benefit) must be done as a payroll reduction. To preserve the pre-tax advantage, service members cannot receive their salary and then pay into the PC or FSA by electronic funds transfer or check from their personal checking or savings accounts. Some service members currently choose to pay their insurance premiums electronically or via check; when participating in a PC program, they would be instructed that they must be able to use the payroll reduction mechanism to achieve the tax advantage of participation. This requirement holds true for Active Duty service members interested in dental premiums for their families and Selected Reserve service members interested in medical or dental premiums for themselves and/or their families. Active Duty service members do not pay medical or dental premiums for coverage for themselves, or medical premiums for coverage for their families.

Because payroll reduction is required to gain the pre-tax advantage, in certain instances some Reserve members may not have earned sufficient salary when regular reductions are made. Unlike Active Duty personnel who receive pay on a regular basis, Reservists receive pay when they drill. Not all Selected Reservists maintain regular drilling schedules of one weekend a month and two weeks a year. Many Reservists maintain an irregular drilling schedule, often referred to as "flexible drilling." For example, a Selected Reservist may save up drilling days, often at the behest of his or her unit Commander, in order to drill for a longer period of time to cover duties when other personnel are deployed, in training, or in exercises. Hence, an important challenge Selected Reserve members face when considering participation in PC/FSA programs is

the issue of monthly availability of pay for salary reduction. Only Selected Reservists with sufficient funds available to allow for monthly salary reduction could participate in a PC for medical or dental premiums.

7.3 Conduct Program Administration Activities

When implementing a PC program for medical or dental premiums for service members, DoD should administer that program in-house and not use a third-party administrator.

In a PC program, those service members agreeing to salary reduction in exchange for receiving the insurance premium benefit in question on a pre-tax basis would have that premium paid by DoD. DoD's employer share of FICA payroll taxes saved due to participation of service member personnel participating in a PC program should be applied to help offset the program administration costs.

If the amount of such savings does not fully offset all program administration costs, DoD should not charge service fees to the individual participating service members.

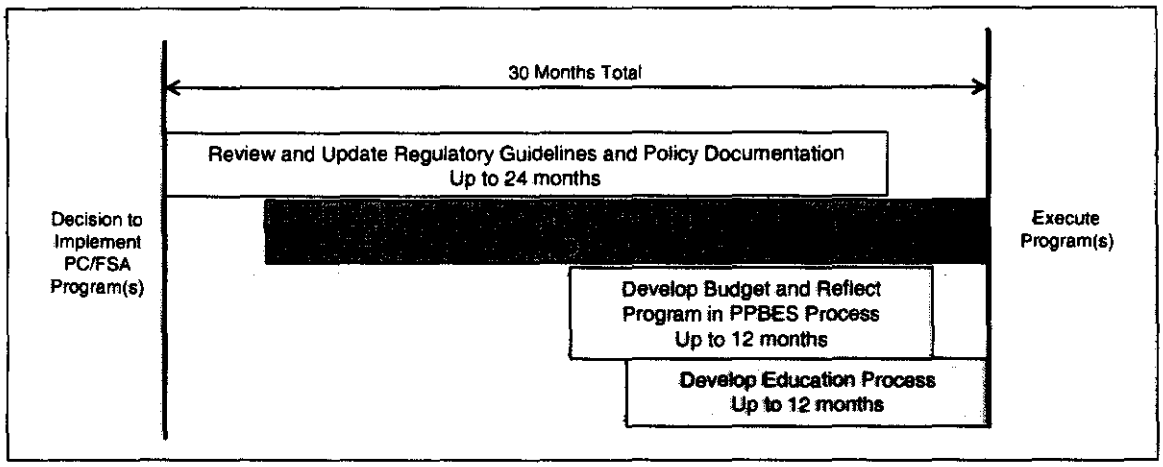
7.4 Decide Program Implementation Schedule

A phased approach to implementation of PC/FSA programs is recommended. DoD should offer a dental PC program for Active Duty and medical and dental PC programs for Selected Reservists. These programs could be followed by FSA programs for Active Duty; an analysis of lessons learned from all PC/FSA programs should be performed before considering implementation of FSA programs for Selected Reservists.

Determining the program implementation schedule is another important step in executing a PC program or programs in DoD for the military population.

The implementation timeline, illustrated in **Exhibit 8**, starts from the point at which a decision is taken to execute a PC program and differs in length depending on the particular type of program offered and its intended audience (e.g., Active Duty, Selected Reserve). Experience with similar programs suggests that reviewing and, where necessary, updating or drafting new regulatory guidelines (e.g., Code of Federal Regulations) and policy documentation (e.g., the written plan for a DoD cafeteria plan for service members, TRICARE Operations Manual, applicable DoD and Military Service directives and instructions, etc.) may take 12 to 24 months. Many program management and administration efforts can be concurrently addressed, including determination of funding requirements, any potential offsetting savings, and subsequent budget realignments. Depending on where in the programming and budgeting cycle the Department is and how long it might take to resolve any funding issues, reflecting the particular PC program in the budget process and eventually executing the program may take up to 12 additional months.

Exhibit 8. Implementation Timeline



7.5 Establish Education Process

During implementation, DoD will establish an education process to assist service members in using PC/FSA programs. DoD will develop the requisite written plan consistent with IRS regulations, containing extensive information about the benefits program or programs being undertaken. Similarly, DoD will develop a comprehensive education effort to supplement that information prior to implementation. This education and training is necessary to assist individual service members in understanding the potential benefits (e.g., tax savings) and possible risks (e.g., negative impact on their tax and social security earnings status, forfeiture of the unused funding in FSAs, etc.) inherent in PC/FSA programs to determine whether participation is appropriate. The education process will likely foster higher participation rates among those service members who might benefit from PC/FSA programs.

DoD does not have the expertise or resources to take on the role of tax advisor to its service members. However, educational materials will be developed, properly vetted, and made accessible to service members. These informative materials will assist potential participants in understanding the basic tenets of PC/FSA programs, how they operate, and when participation might be beneficial. This plan follows OPM's experience with introducing PC/FSA programs, including continually upgrading the information available to federal employees. Information will be simple, straightforward, accessible, and easily understood, and include clear, concise guidelines.

Military personnel have benefits available to them that may affect, overlap with, and/or cancel out potential benefits from the PC program(s) under consideration. The interplay of these benefits might complicate an individual service member's tax situation, so general guidelines alone may not be sufficient. In addition to stressing the voluntary nature of participation in such programs, educational materials will identify available tools and resources (e.g., benefits calculators or worksheets, web site links, etc.) to assist in their analysis of tax implications and decision-making. Finally, the educational effort will indicate when additional assistance might be warranted or recommended, including how and where to seek additional assistance from financial and tax experts.

The majority of service members already selecting medical or dental insurance for themselves and/or their families would likely benefit from participation in PC programs. Service

members at the lower pay grades might not receive a tax advantage from participating in a PC program but are not apt to be harmed by participation. In a very limited number of cases, some service members might find their tax status unfavorably impacted by participation in a PC program (e.g., adversely impacting their ability to receive a slightly more beneficial earned income tax credit, etc.).

8 FSA for Dependent Care or Out-of-Pocket Health Care Expenses for Active Duty and Select Reserve

No known statutory barriers to implementation preclude DoD from executing FSA programs for dependent care or out-of-pocket health care expenses for Active Duty and Selected Reserve service members. In the course of implementing FSA programs, DoD might find future statutory changes beneficial. Should this be the case, the Department would study such potential changes in greater detail, in light of lessons learned, to determine whether they are indeed necessary or warranted.

Administrative challenges unique to the military population that need to be addressed when implementing FSA programs for service members do exist. As identified in **Exhibit 6** in **Section 6**, these administrative challenges fall into the categories of utilization, sustainability, and administrative feasibility for health care and dependent care FSA programs, for both Active Duty and Selected Reserves.

The following sections contain an implementation plan that discusses these challenges and presents potential solutions to overcoming them wherever possible. Many of the considerations for FSA programs are similar to those of PC programs outlined in **Section 7**. For completeness, all of the considerations previously discussed for PC programs in **Section 7** that pertain to FSA programs are repeated in this implementation plan as well. Because the level of complexity inherent in executing FSA programs presents a significant difference requiring additional attention, this implementation plan also discusses the special considerations unique to the implementation of FSA programs.

8.1 Assign Policy Office Responsible to Draft Written Plan

Assigning the policy office responsible for drafting the requisite written plan for the overall cafeteria plan is an important step in implementing FSA programs.

In DoD, policy formulation and oversight is the responsibility of the OSD. Specifically, within OSD, consideration of potential PC/FSA programs concerning medical and dental insurance premiums, out-of-pocket health care expenses and dependent care expenses for service members and their families is the responsibility of the Office of the Under Secretary of Defense for Personnel and Readiness.

8.2 Establish Plan Rules and Guidelines

When implementing an FSA for dependent care or out-of-pocket health care expenses, the plan should not include default elections for any military service members; participants must take action to participate in any FSA program. Similarly, FSAs should not use automatic annual/evergreen renewals. DoD should allow the maximum grace period (i.e., extended from December 31st to March 15th) for any FSA program. The program manager responsible for

implementation should consider whether the maximum contribution for an FSA program should be set at the $5,000 statutory cap or lowered, at least initially.

Potential tax savings exist for Active Duty and Selected Reserve service members for both PC and FSA programs. However, actual savings and whether an individual service member might decide to participate in any of the programs depend on many factors, and may therefore differ according to the individual situation.

In general, service members at the higher end of pay scale and/or in two-income family situations will likely find the tax advantages of PC/FSAs attractive. However, service members at the lowest end of the pay scale may find that participation in PC/FSA programs negatively impacts their tax situation. In some instances, such service members may find that receiving tax benefits from PC/FSAs adversely impacts their ability to receive a slightly more beneficial earned income tax benefit.

Section 125 of the Internal Revenue Code requires that voluntary withholding of funds for PC and FSA programs (i.e., exchanging salary for the particular benefit) must be done as a payroll reduction. To preserve the pre-tax advantage, service members cannot receive their salary and then pay into the PC or FSA by electronic funds transfer or check from their personal checking or savings accounts.

Because payroll reduction is required to gain the pre-tax advantage, in certain instances some Reserve members may not have earned sufficient salary when regular reductions are made. Unlike Active Duty personnel who receive pay on a regular basis, Reservists receive pay when they drill. Not all Selected Reservists maintain regular drilling schedules of one weekend a month and two weeks a year. Many Reservists maintain an irregular drilling schedule, often referred to as "flexible drilling." For example, a Select Reservist may save up drilling days, often at the behest of his or her unit Commander, in order to drill for a longer period of time to cover duties when other personnel are deployed, in training, or in exercises. Hence, an important challenge Selected Reserve members face when considering participation in PC/FSA programs is the availability of pay for salary reduction. DoD has no FSA-type programs in place and therefore has no statutory requirement that payment into such a program would have to be on a monthly basis, as is the case of payment/receipt of medical/dental premiums into the TRICARE system. Only Selected Reservists with sufficient funds available to allow for some type of negotiated regularly scheduled salary reduction could participate in an FSA for either dependent care or out-of-pocket health care expenses. Wherever possible, plan administration should take the special requirements of Selected Reservists into consideration.

Participating in FSA programs is generally less attractive to service members than is participating in PC programs, mainly due to the greater level of complexity involved in FSA programs. In a PC program, service members know the amount of the insurance premiums involved, and once they are signed up for such a program they do not need to take further action for the balance of the plan year. In the case of FSA programs, service members must estimate expenses to determine how much to have reduced from their salary, collect and submit receipts and substantiating documentation for reimbursement of permissible expenses, verify receipt of requested reimbursements, and monitor the unused balance of funds. Therefore, participation in an FSA program requires that a service member possess an understanding of the potential tax benefits, and the likelihood that they would pertain to his or her situation; the ability to estimate expenses for the particular FSA; and sufficient disposable income to allow for salary reduction of

funds into the FSA and subsequent payment of actual expense, prior to seeking and receiving reimbursement from the FSA. The action itself of estimating FSA expenses could provide the additional benefit of building financial planning abilities in each service member.

Participation levels would be significantly lower for FSAs than they would be for PCs—consistent with the experience of private sector companies, which generally see PC participation levels at 90% and higher among employees eligible for and already accepting health care insurance as a benefit, and FSA participation levels in the 15% to 20% range. OPM found initial FSA participation levels closer to 10% but has since seen that percentage steadily rise in the past few years to levels on par with those in the private sector.

Only a small percentage of service members, either Active Duty or Selected Reserve, could benefit from participating in a dependent care or health care FSA. Participation depends on many factors, including the individual service member's income level, tax bracket, number and age of dependents, dependent care arrangements, health issues, and access to a health care or dependent care FSA through a spouse. Low initial participation rates are likely; these rates may rise over time, but to what extent is unclear. Participation rates could increase as the experiences of the earliest participants spreads and others seek out additional information, as happened several years ago when the federal government's Thrift Savings Plan (TSP) for civilian employees was extended to the military population. Over time, word of the positive aspects of the TSP (e.g., wide selection of stock, bond, and mutual fund options; good track record of return rates; government matching of up to a certain percentage of employee contributions; etc.) resulted in slowly increasing participation rates by service members.

Dependent care FSA expenses may have a greater level of predictability than do out-of-pocket expenses for a health care FSA. Also, based on public and private sector experience, many participants tend to estimate their FSA expenses more conservatively at the outset to develop familiarity with the participation and reimbursement process without risking forfeiture of unused funding.

8.3 Conduct Program Administration Activities

When implementing an FSA program for dependent care or for of out-of-pocket health care expenses for service members, DoD should strongly consider employing a third-party administrator to execute the program(s), given the complexity of the FSA execution process.

This issue of who administers an FSA program is particularly important in the case of a health care FSA. Sufficient funds must be available to the program administrator to be able to reimburse expenses up to the full value of an employee's annual FSA amount as of the very beginning of the plan year, even if the employee has not had the full annual value of funds withheld via salary reduction. For example, an employee electing salary reduction for a $3,000 health care FSA could incur health care expenses of $2,500 in January. If the employee submits appropriate documentation and the expenses are permissible for reimbursement, he or she may be reimbursed for the full $2,500, even if salary reduction taken to date in January is only $250, or one-twelfth of the total $3,000.

DoD's share of FICA payroll taxes saved due to participation of service member personnel participating in a dependent care and/or health care expense FSA program should be applied to help offset the program administration costs of implementing that program.

If the amount of such savings does not fully offset all program administration costs, DoD should not charge service fees to the individual participating service members.

In an FSA program, those service members agreeing to salary reduction in exchange for receiving the benefit in question on a pre-tax basis would have their funding go into an FSA account. Administration of an FSA program requires the monitoring of service member accounts, reviewing receipts and substantiation of expenses, making determinations as to permissibility of expenses, dispensing reimbursements for approved expenses, resolving complaints and disputes, and other considerations.

The option of leveraging an existing executive branch program for federal employees, such as that offered by OPM, may also merit consideration. However, the complexity of supporting Active Duty and/or Selected Reserve service member participation in an FSA program such as OPM's, executed in turn by the third-party administrator SHPS, would require an extremely high degree of coordination and interface. Many of the unique aspects of supporting a military population may make this particular option unfeasible.

8.4 Decide Program Implementation Schedule

A phased approach to implementation of PC/FSA programs is recommended. DoD should offer a dental PC program for Active Duty and medical and dental PC programs for Selected Reservists. These programs could be followed by FSA programs for Active Duty; an analysis of lessons learned from all PC/FSA programs should be performed before considering implementation of FSA programs for Selected Reservists.

Determining the program implementation schedule is another important step in executing an FSA program or programs in DoD for the military population.

The implementation timeline (see **Exhibit 8** in **Section 7.4**) starts from the point at which a decision is taken to execute an FSA program, and differs in length depending on the particular type of program offered and its intended audience (e.g., Active Duty, Selected Reserve). Experience with similar programs suggests that reviewing and, where necessary, updating or drafting new regulatory guidelines (e.g., Code of Federal Regulations) and policy documentation (e.g., the written plan for a DoD cafeteria plan for service members, TRICARE Operations Manual, applicable DoD and Military Service directives and instructions, etc.) may take 12 to 24 months. Many program management and administration efforts can be concurrently addressed, including determination of funding requirements, any potential offsetting savings, and subsequent budget realignments. Depending on where in the programming and budgeting cycle the Department is and how long it might take to resolve any funding issues, reflecting the particular FSA program in the budget process and eventually executing the program may take up to 12 additional months.

8.5 Establish Education Process

During implementation, DoD will establish an education process to assist service members in using PC/FSA programs. DoD will develop the requisite written plan consistent with IRS regulations, containing extensive information about the benefits program or programs being undertaken. Similarly, DoD will develop a comprehensive education effort to supplement that information prior to implementation. This education and training is necessary to assist individual service members in understanding the potential benefits (e.g., tax savings) and possible risks

(e.g., negative impact on their tax and social security earnings status, forfeiture of the unused funding in FSAs, etc.) inherent in PC/FSA programs to determine whether participation is appropriate. The education process will likely foster higher participation rates among those service members who might benefit from PC/FSA programs.

DoD does not have the expertise or resources to take on the role of tax advisor to its service members. However, educational materials will be developed, properly vetted and made accessible to service members. These informative materials will assist potential participants in understanding the basic tenets of PC/FSA programs, how they operate, and when participation might be beneficial. This plan follows OPM's experience with introducing PC/FSA programs, including continually upgrading the information available to federal employees. Information will be simple, straightforward, accessible, and easily understood, and include clear, concise guidelines.

Military personnel have benefits available to them that may affect, overlap with, and/or cancel out potential benefits from the FSA program(s) under consideration. The interplay of these benefits might complicate an individual service member's tax situation, so general guidelines alone may not be sufficient. In addition to stressing the voluntary nature of participation in such programs, educational materials will identify available tools and resources (e.g., benefits calculators or worksheets, web site links, etc.) to assist in their analysis of tax implications and decision-making. Finally, the educational effort will indicate when additional assistance might be warranted or recommended, including how and where to seek additional assistance from financial and tax experts.

Service members at the lowest pay grades who are single and/or without dependents may have very little to gain from participation in health care or dependent care FSAs. In a very limited number of cases, some service members might find their tax status unfavorably impacted by participation in FSA programs (e.g., when participating in a dependent care FSA adversely impacts their ability to receive a slightly more beneficial earned income tax credit, etc.).

9 Conclusions

The potential tax savings of PC/FSA programs offered under a cafeteria plan are attractive to many employees. However, fairly significant differences exist among the employment circumstances of public and private sector civilians and uniformed service members, and between the Active Duty and Reserve components. These differences include the nature of service commitment, compensation and benefits for service members, and how the service members and their families participate in and are supported by the Military Health System. DoD must determine how PC/FSA benefit programs under a cafeteria plan might work best for each component, and whether, when and how to offer those programs. The implementation plans contained in this study offer a way to proceed.

APPENDIX A: Report to Accompany the National Defense Authorization Act for Fiscal Year 2006 (Senate Report 109-69)

Premium Conversion/Flexible Spending Account Options for Service Members

The Committee is concerned that uniformed service members do not have access to premium conversion and flexible spending account options that allow pre-tax payment of health and dental insurance premiums and out-of-pocket health care expenses for family member health care needs. The committee is also concerned that uniformed service members do not have access to flexible spending account options that can be used to purchase child care services. The committee directs the Secretary of Defense to provide a report to the congressional defense committees by March 1, 2006, on a plan to evaluate and implement these programs for uniformed service members, including identification of any administrative or statutory barriers to achieving their implementation.

The committee believes that Active Duty members and Selected Reserve members should be able to use premium conversion to pay dental insurance premiums, and Selected Reserve personnel should be able to use it to pay TRICARE Reserve Select premiums authorized by the Ronald W. Reagan National Defense Authorization Act for Fiscal Year 2005 (Public Law 108-375). The committee believes that members should also have access to flexible spending accounts for the purpose of paying for child care services. The committee recognizes that Active-Duty and Reserve family members can incur out-of-pocket expenses related to dependent care, pharmacy copays, TRICARE Standard deductibles and copays, dental care deductibles and copays, expenses for eyeglasses and contact lenses, premium payments for dental and medical care, and child care.

APPENDIX B: Basic Aspects of a Cafeteria Plan

This section outlines what a cafeteria plan is, the requirements of such a plan, and the various benefits that may be offered, including premium conversion and flexible spending arrangement (PC/FSA) programs.

What is a Cafeteria Plan

The IRS views all sources of income, including benefits, as gross income (i.e., taxable) unless there is a specific statutory exception. Section 125 of the Internal Revenue Code (26 U.S.C. 125) provides an exception for benefits such as PC/FSAs offered under a cafeteria plan, and specifically prohibits the IRS from taxing those benefits. A cafeteria plan itself is not a benefit. Consistent with 26 U.S.C. 125, a cafeteria plan is the written plan an employer uses to assist their employees in allowing them to choose certain benefits (on a pre-tax basis) in exchange for a reduction in salary. The key point is that the employee is not agreeing to "pay" for the benefit per se with some of their salary—that would be a deduction from base pay and hence taxable. Rather, the employee is agreeing to *reduce* their salary by *exchanging* the amount reduced for benefits of commensurate value. In addition to explaining the benefits offered by the employer's cafeteria plan, the written plan must meet certain legal requirements, consistent with Section 1.125-1 of the Code of Federal Regulations.

Thus, a cafeteria plan is essentially a basket of benefits for which an employee may choose to exchange cash (i.e., salary) without incurring the usual Federal Insurance Contributions Act (FICA) payroll tax. The FICA tax supports Social Security and Medicare and is imposed in an equal amount on both the employer and the employee. In 2006, each employer and employee paid 6.2% on up to $94,200 in compensation toward Social Security and 1.45% with no compensation limit toward Medicare. Not only do employees save their share of FICA taxes on the amount they exchange for a PC or FSA program benefit, but the employers offering the cafeteria plan also stand to save their share of the FICA tax on those benefits selected by employees in exchange for an equivalent reduction of their salary.

What Benefits May be Offered in a Cafeteria Plan

Employers may decide to include several types of benefits in their cafeteria plan, which employees may choose to accept via salary reduction in exchange for the benefits on a tax-free basis. The two most common types of benefits are a premium-only plan and a flexible spending arrangement (FSA). The premium-only plan, also known as a premium conversion (PC) program, allows an employee to agree to exchange "cash" on a pre-tax basis, through voluntarily reducing his or her salary prior to any taxes being withheld, for the value of the medical insurance premium.

In an FSA, the employee agrees to exchange a portion of his or her salary for a benefit that consists of allowing the use of the set-aside funding for a specific purpose. Many employers choose to offer two popular FSA programs in their cafeteria plan: a health care FSA and a dependent care FSA. The former allows employees to use their set-aside funding to reimburse qualified medical expenses not covered or reimbursed by their health benefits plan or other type of insurance. These expenses may include medical treatment, equipment, deductibles, co-payments, vision care, dental care, orthodontia, and some over-the-counter medicines. The

dependent care FSA allows funds to be set aside for reimbursement of child or adult dependent care-related expenses.

Examples of other benefits that an employer may choose to include in a cafeteria plan are term life insurance above $50,000 (because up to that amount is already tax free), adoption assistance, dental and vision insurance, etc. However, cafeteria plans do not cover long-term care or benefits that defer compensation (e.g., a pension).

Who Can Sponsor and Participate in a Cafeteria Plan

Consistent with Section 125 of the Internal Revenue Code, any employer can sponsor a cafeteria plan, but no employer is required to do so. Employees, their spouses and dependents, and former employees may participate in the cafeteria plan; however, self-employed workers may not.

How Do Employees Elect and Change Benefits

Employees must elect the benefits for which they will exchange a portion of their salary before the beginning of the plan year. The employer decides whether the employee must take action to participate, or they can choose to make elections "default" in nature (i.e., employees automatically participate for a given benefit unless they specifically choose not to). Similarly, the employer can decide whether the employee must take action to renew their participation on an annual basis before each new plan year, or to present renewal on an "evergreen" basis (i.e., participation automatically continues annually, unless an employee takes steps to opt out of participation).

Once an employee makes his or her election(s) for the year, they are generally irrevocable for the duration of the plan year. However, it is recognized that there are specific situations in which an employee's circumstances may change that warrant election changes for PC/FSAs. US Treasury Regulation 1.125-4 outlines those events that permit an election change during a cafeteria plan year. Also referred to as "life events," these include change in status for accident or health coverage such as marital status, number of dependents, employment status, work schedule, residence or worksite; judgment, decree or court order; special enrollment rights; entitlement to Medicare or Medicaid; and so on. When setting up a cafeteria plan, employers may chose to include all possible change-of-status events allowed by the IRS; in some instances they may define such events more narrowly, but they may not go beyond the scope of the IRS regulations. For example, when OPM set up its cafeteria plan (reflected in its "FedFlex" Plan), it chose to reflect most but not all of the IRS events in their own "qualifying life events" list. Federal agencies or departments participating in OPM's cafeteria plan for federal employees must agree to adhere to this slightly narrower set of qualifying life events.

Special Rules for FSA Programs

There are a number of special rules regarding reimbursable expenses that pertain solely to FSA programs.

Determining Salary Reduction for FSA Expenses

There is a significant difference in the level of complexity between PC and FSA programs, in large part due to the need to estimate child care or out-of-pocket health care expenses in the latter. In the case of a PC program, the agency determines the amount a

participant would need to agree to allocate for exchange for insurance premiums through voluntary salary reduction. Once the employee agrees to the salary reduction in exchange for payment of their insurance premium(s), they do not need to take any further action; the agency then takes that amount of reduced salary and applies it directly to cover the medical or dental insurance premiums.

FSAs are more complicated than PCs in that the employee must estimate the amount (up to the program's stated dollar limit) to be withheld through voluntary salary reduction for the intended purpose. For instance, in the case of an FSA to cover the cost of dependent care, the employee would seek to have reduced from their monthly paycheck the amount he or she pays for one month's dependent care (up to the maximum amount allowed under the cap). For a health care FSA, the employee has to determine what out-of-pocket costs he or she may incur that are not covered by an employer-provided plan (e.g., deductibles, co-pays, prescriptions, eligible over-the-counter drugs, etc.), and then have funds withheld from their salary on a pre-tax basis accordingly.

Reimbursement for Expenses

When determining the plan year period in which reimbursement of health care and dependent care expenses are incurred and may be reimbursed, the key date is when the services were provided, not when the services were billed or when they were paid. In order to seek reimbursement from one's health care or dependent care FSA, the employee will be required to provide substantiation of the expenses he or she incurred to assist in determining that the expenses are valid and reimbursement appropriate. Expenses that may be reimbursed are also limited to the participating employee, his or her spouse, and dependents.

Maximum Contributions

FSAs have a statutory cap for the value of salary reduction of $5,000 per plan year. Although an employer may not exceed that cap, he or she may choose to set the limit at a lower amount. Moreover, the employer is not required to set the same limit for different FSAs (e.g., $3,500 for a health care FSA and the full $5,000 for a dependent care FSA, etc.). It is up to the employee to determine the amount of salary reduction for each FSA he or she participates in, depending on the specific details of the employee's health care or dependent care situation.

[Note: There are no statutory limits to the amount of funding that may be withheld for PC programs. Although an employer may set his/her own cap, most do not. Generally, the implied cap for a PC program is the value of the insurance premium benefit offered. There is no benefit to an employee directing the reduction from his or her salary of an amount greater than the insurance premium (which the employee cannot do regardless), and so employers limit the reduction to that amount.]

Grace Period

A cafeteria plan year generally runs for twelve months, beginning January 1st and ending December 31st of that year. Because the employee has voluntarily reduced his or her salary in exchange for an FSA benefit in that amount, unused funds in the FSA cannot be "returned" to the employee as salary. *When the plan year ends, the employee loses any unused balance.* In an effort to help avoid having unused FSA funding "expire" and no longer be available for reimbursement to employees, per section 125 of the Internal Revenue Code, the IRS allows

employers to offer a grace period for an FSA up to two and a half months after the end of the calendar year (i.e., no later than March 15th). Employers are not required to offer a grace period beyond the end of the calendar year, but if they do so, they must determine what that grace period will be (up to the full two and a half months) for each type of FSA it includes in the cafeteria plan.

Not Employee Money

When an employee agrees to exchange a portion of his or her salary (i.e., salary reduction) for an FSA, they are forgoing that amount of salary permanently (for that plan year). As indicated above, any remaining funds in an FSA at the end of the plan year (defined as including any grace period offered by the employer) not used for reimbursing appropriate expenses belong to the employer. They are considered "forfeited" and may not be returned to the employee. Every effort must be made to educate participants on the rules regarding FSAs, including carefully estimating likely reimbursable expenses, to help minimize the likelihood of forfeiture of any unused funds.

APPENDIX C: Study Design Plan

Based on the Congressional direction in the FY 2006 NDAA Senate Report to perform this effort, the TRICARE Management Activity (TMA) evaluated the potential implementation of premium conversion/flexible spending arrangements (PC/FSAs) for use by service members (and their families) for dental insurance and TRICARE premiums, child care services, and out-of-pocket health care expenses.

The goal of this study effort was to meet the Congressional direction by conducting a review of the requirements of PC and FSAs as governed by the Internal Revenue Code of the Internal Revenue Service (IRS) and administered by the Office of Personnel Management (OPM). We explored relevant issues, barriers and constraints to such implementation; developed a common understanding of these issues among DoD, the IRS and OPM that would facilitate any formal coordination; and developed recommendations to overcome identified barriers and constraints and inform the generation of implementation plans with milestones and timelines.

The study design process included two facilitated events conducted in the Washington, DC, metropolitan area to obtain the advice and recommendations of individuals from the public sector experienced with PC/FSA programs. The input gathered from these two events directly supports creation of this final report, including required recommendations and implementation plans that integrate key findings and best practices.

A more detailed discussion of the approach, methodology and timelines that were implemented to satisfy the study contract requirements follows.

Phase I: Initial Research and Preparation

From the outset, TMA envisioned a five-stage approach to this project to ensure success of the study design and execution. The first stage consisted of a kickoff meeting and subsequent preparatory efforts in advance of the first facilitated event, the seminar workshop. Preliminary efforts included meetings to discuss the overall study design plan approach and schedule, as well as such as key issues for the facilitated seminar workshop such as identification of subject matter experts (SMEs) and other likely participants, an initial list of issues (including questions, potential administrative and/or legal barriers, etc.), draft seminar agenda items and initial assignments for logistical requirements. Preparations for the first event included identification of the seminar workshop (and subsequent conference workshop) venue, additional research of issues, refinement of the aforementioned agenda and participant list, and drafting the invitation letter, read-ahead materials and seminar materials. TMA contacted potential participants in a timely manner to ensure the most comprehensive representation of subject matter experts. These experts included persons knowledgeable of the Military Health System and PC/FSA program implementation from DoD, the IRS and OPM, and experienced with Congressional and legislative issues, statutory and regulatory issues, budgeting, and program marketing to targeted audiences for new programs.

Phase II: Facilitated Seminar Workshop

The second stage was the conduct of the facilitated seminar workshop on October 20, 2006. Outcomes included documentation of PC/FSA program implementation issues, challenges and potential barriers, as well as a draft participants list and agenda for the follow-on second

facilitated event, the conference workshop. TMA also reviewed the conduct, outcomes and preliminary findings of the facilitated seminar workshop.

Phase III: Additional Analysis, Research and Drafting

The third stage consisted of focused additional research, analysis of seminar workshop information, and drafting of preliminary recommendations drawing from best practices and "straw man" implementation plans with timelines for the use of PC/FSAs for dental and TRICARE premiums, child care services and out-of-pocket health care expenses. TMA developed the materials for review and evaluation during the December 7, 2006 conference workshop, refining the conference workshop agenda, participants list and materials, and monitoring participant invitation and planned attendance. TMA also initiated work on developing recommendations, including implementation plans where required, for this Final Report on Findings.

Phase IV: Facilitated Conference Workshop

The fourth stage was the conduct of the facilitated conference workshop on December 7, 2006 in which participants evaluated a range of issue statements representing preliminary findings and draft recommendations for straw man implementation plans for the four different PC/FSA programs. Conference participants also identified outstanding issues, and clarified discrepancies.

Phase V: Complete Deliverable Documents

In the fifth and final stage, TMA analyzed the information from the December 7, 2006 facilitated conference workshop to further refine the draft recommendations and implementation plans. TMA also developed a set of briefing slides on the conduct and findings of the entire study, and completed this Final Report on Findings, and a set of briefing slides on the conduct and findings of the entire study.