

**Special point of interest:**

- **"USE-IT OR LOSE-IT" GRACE PERIOD FOR FLEXIBLE SPENDING ACCOUNTS**
- **HEALTH CARE COST TRENDS – CHANGES IN THE INDUSTRY**

## **IRS Provides A "Use-It or Lose-It" Grace Period**

In an effort to ease the pain of the "use-it or lose it" rule, the IRS has provided a two and one-half (2½) month grace period for amounts remaining in flexible spending accounts (FSA) at the end of the plan year in IRS Notice 2005-42. This change means that a plan participant may use the money left in his account at the end of the plan year for expenses incurred within the first two and one-half (2½) months of the new plan year. If expenses incurred in the first two and one-half (2½) months of the new plan year are less than the amount remaining from the prior FSA plan year, these left over dollars would be subject to the "use-it or lose-it" rule. The key point would be for the plan participant to incur enough expenses during the first two and one-half (2½) months of the new FSA plan year to cover the amounts remaining from the prior FSA plan year.

For a plan year that ends on December 31, 2005, the maximum grace period permitted would be until March 15, 2006 (two and one-half (2½) months after the preceding plan year).

**Effective Date: An employer may adopt a grace period for the current cafeteria plan year (and subsequent cafeteria plan years) by amending the cafeteria plan document before the end of the current plan year. If your FSA plan year runs on a calendar year, the plan must be amended before December 31, 2005.**

According to IRS Notice 2005-42, Proposed Treasury Regulations §1.125-1 and §1.125-2 are modified as follows:

A cafeteria plan document may, at the employer's option, be amended to provide for a grace period immediately following the end of each plan year. The grace period must apply to all participants in the cafeteria plan. Expenses for qualified benefits incurred during the grace period may be paid or reimbursed

from benefits or contributions remaining unused at the end of the immediately preceding plan year. The grace period must not extend beyond the fifteenth day of the third calendar month after the end of the immediately preceding plan year to which it relates (i.e., "the 2 and 1/2 month rule"). If a cafeteria plan document is amended to include a grace period, a participant who has unused benefits or contributions relating to a particular qualified benefit from the preceding plan year, and who incurs expenses for that same qualified benefit during the grace period, may be paid or reimbursed for those expenses from the unused benefits or contributions as if the expenses has been incurred in the immediately preceding plan year. The effect of the grace period is that the participant may have as long as 14 months and 15 days (the 12 months in the current cafeteria plan year plus the grace period) to use the benefits or contributions for a plan year before those amounts are "forfeited" under the "use-it or lose-it" rule.

To the extent any unused benefits or contributions from the immediately preceding plan year exceed the expenses for the qualified benefit incurred during the grace period, those remaining unused benefits or contributions may not be carried forward to any subsequent period (including any subsequent plan year) and are "forfeited" under the "use-it or lose-it" rule. As under current practice, the employer may continue to provide a "run-out" period after the end of the grace period, during which expenses for qualified benefits incurred during the cafeteria plan year and the grace period may be paid or reimbursed.

**Examples:** The IRS provided two examples to illustrate how the grace period would work for a calendar year plan. In the first example, an individual has \$200 remaining in his health FSA at the end of 2005 and elects \$1500 for 2006. If the individual incurs \$300 in medical expenses during the grace period (January

1 – March 15, 2006), he may be reimbursed \$200 from the 2005 year end balance and \$100 from the 2006 plan year benefit.

In the second example, if the same individual incurs only \$150 in medical expenses during the grace period, he may be reimbursed \$150 from the \$200 account balance from 2005, but the remaining \$50 is subject to the “use-it or lose-it” rule and is forfeited. The 2006 FSA benefit election would remain untouched.

The new rule gives employees with FSAs more time to pay medical and dependent care expenses and will ease the year-end spending rush under the old rule. As under

current practices, the Plan may continue to provide a “run-out” period after the end of the grace period, during which expenses for qualified benefits incurred during the cafeteria plan year and the grace period may be reimbursed.

In spite of the effect this Revenue Ruling has on the type of expenses that can be reimbursed through an FSA, an employee cannot change the annual election without a valid change in status.

If BAS administers your Cafeteria Plan, additional information, a Plan Document Amendment, and an Employee Notification will be sent to you shortly.

## **Tracking Health Care Cost Trends Highlights Changes In Health Care Industry**

The following is an excerpt from Spencer Research Reports:

Getting information about the current and projected rates of increase in health care costs, and the reason for those increases is crucial for employers when setting future health care plan policy. Each year, dozens of surveys try to identify existing and future costs. Before making any decisions, benefit administrators should compare findings in surveys. This report analyzes key health care cost surveys to compile a single source of information about health care cost issues.

According to the *2004 Annual Employer Health Benefits Survey*, conducted jointly by the Kaiser Family Foundation and Health Research Educational Trust (HRET), premiums for employer-based insurance climbed by an average of 11.2% in 2004. Although still a double-digit increase, this was the first time in five years that the rate of increase declined. In 2003, premium increases averaged 13.9%, up from 12.7% in 2002, 11.9% in 2001, 8.3% in 2000 and 4.8% in 1999. Single premiums averaged \$3,695 for single coverage in 2004 and \$9,950 for family coverage, reports the Kaiser/HRET study. Employees have more cost-sharing responsibility and pay an average of \$558 per year of this premium for single coverage and the employee share of premiums for family coverage averaged \$2,661 per year. The percentage of premiums paid by workers is statistically unchanged over the last two years, at 16% for single coverage and 28% for family coverage. Although this percentage remains stable, employees are actually paying more out-of-pocket, because of the overwhelming cost increases.

The *National Survey of Employer-Sponsored Health Plans 2003*, conducted by Mercer Human Resource Consulting, found results that were marginally lower than those in the Kaiser/HRET study. The Mercer survey estimated that average health care costs rose 10% IN 2003. According to the Mercer survey, the average per-employee cost of health benefits in 2003 was \$6,215. Employers in the Mercer survey predict an average increase of 13% for 2004. Watson Wyatt believes that employers do not expect the rise in health care benefits costs to abate anytime before 2005. Double-digit cost increases (averaging 14%) are expected for both 2004 and 2005.

Hewitt's *Health Care Expectations: Future Strategy and Direction, 2005*, expects costs to increase 12% in 2005. Hewitt also found that employers believe that the maximum added cost they can absorb annually is 8%. Consultant Towers Perrin is predicting an 8% increase, and thus, the first significant break in the double-digit cost spiral in over half a decade, as indicated in its *2005 Health Care Cost Survey*. But, Towers Perrin warns that employers should not be fooled into thinking that total costs will be significantly lower this year than in years past. In terms of actual health care costs, employers are paying 63% more than they spent eight years ago.

### **Slowing Of Trend**

According to the Center for Studying Health System Change (HSC), growth in spending on hospital inpatient care slowed to 5.1% in the first half of 2004, while the trend for outpatient spending held steady at 11.4%. Hospital utilization continued to grow at a slow rate for the second year in a row and hospital price increased 7.7% in the first half of 2004,

which accounted for much of the hospital spending increase. Prescription drug spending increased 8.8%, similar to increases in 2003 and substantially below the peak increase of 19.5% in the second half of 1999.

Although the trend appears to be slowing, Deloitte & Touche reports that the rising cost of health care benefits remains the primary factor driving employers' health care strategy. In 2003, 85% of the survey respondents cited costs as the primary factor, while only 14% regarded employee recruitment and retention as the principal driver in their health care plan decision-making. When asked to identify what issue has the greatest impact on their health care plan costs, 23% of the respondents cited prescription drug costs (down from 31% in 2001), 22% cited increasing utilization, 21% cited rich plan design, 14% cited catastrophic claims and 11% cited an aging work force.

### **Prescription Drug Spending**

Drug benefits still present the largest cost increases in the medical pie. According to Deloitte & Touché, prescription drug costs averaged \$847 per employee annually in 2002 or 16% of total medical plan expenses. According to the *National Survey of Employer-Sponsored Health Plans*, conducted by Mercer, the increases have eased in the past three years from 17.8% in 2001, 19.9% in 2002, to 16.1% in 2003. Mercer reports that employers are trying different approaches to contain drug costs, including encouraging the use of generic drugs for formulary brand-name drugs and applying three-tier copayments (50% of employers currently apply three-tier, up from 42% in 2002).

However, the rate of prescription drug costs is expected to rise 15% in 2005, reports the *2005 Health Plan Cost Trend Survey*, conducted by the Segal Company. For active employees and retirees younger than age 65, retail prescription drug costs will average 15.4%. Segal does note that this projected trend is lower than the 2004 projection of 18%. Forecasts vary widely by survey participants, ranging from less than 10% to more than 20%, noted Segal.

Although the trend rate is slowing, this consistent growth can be attributed to increased prescription drug utilization as a result of the following factors: an aging population; consumer demand fueled by direct-to-consumer advertising; greater reliance on drug therapy by physicians; improved technology – both to detect and diagnose disease correctly and to manufacture new, “improved” drugs and inflation.

### **What Does The Future Hold?**

The surveys suggest that with the slowing economy aggravating the impact of double-digit health care costs, employers have no clear course to follow. The current trends are similar to those of the late 1980s and early 1990s, but managed care organizations and other traditional delivery and cost cutting strategies can no longer provide relief. Employers will be forced to devise new options and strategies and they may need to completely redefine their role in providing health care to their employees.

In a tight labor market, employers would simply absorb the increased health care costs to retain their employees. In today's lagging economy such prospects seem daunting. According to Watson Wyatt, 84% of the employers report that they will have to increase employee premium contributions to stay competitive. Watson Wyatt also notes that more than half (58%) of employers say they will absorb at least a portion of the expected increases, while 42% state they will not absorb any.

According to the Kaiser/HRET study, 52% of large firms (200 or more workers) are very likely to raise employee costs for coverage in 2005, compared with 15% of all small firms (three to 199 employees). According to Towers Perrin, in 2005, employees will contribute 18% of their health care costs for single coverage (averaging \$720 annually) and 22% for family coverage (averaging \$2,532 annually).

Watson Wyatt reports that most employers are responding to increases in health care benefits costs by increasing employee costs or changing plan design. Employers plan to: increase employee copayments or coinsurance (67%); shift a larger percentage of cost to employees (48%); change out-of-pocket maximums (41%); and add or reconfigure coverage for certain services (35%). Only 15% of employers plan to reduce or eliminate coverage and only 3% plan to narrow their eligibility criteria.

### **Survey Information**

The following list identifies each survey mentioned in this report.

The HSC study is based on information from the Milliman Health Cost Index, The Bureau of Labor Statistics Producer Price Index and Consumer Price Index, and the BLS's National Compensation Survey. For more information, visit <http://www.hschange.org>

The Deloitte & Touche survey includes responses from human resource and benefit executives from more than 1,000 organizations. For more information, visit <http://www.deloitte.com>

The Hewitt study is based on responses from 524 organizations, representing more than 6 million participants. For more information, visit <http://www.hewitt.com>

Kaiser/HRET surveyed 3,017 randomly selected public and private employers. For more information, visit <http://www.kff.org>

The Mercer survey includes responses from 3,000 employers. For more information, visit <http://www.mercerhr.com>

Segal's survey includes responses from 60 insurance carriers, managed care organizations, third party administrators and pharmacy benefit managers. For more information, visit <http://www.segalco.com>

The Towers Perrin survey has data from 385 employers, covering more than 5.4 million U.S. employees, retirees and dependents. For more information, visit <http://www.towersperrin.com/hrservices>

Watson Wyatt's survey includes data from 90 employers, representing 800,000 lives. For more information, visit <http://www.watsonwyatt.com>