

TRENDS

Human Resources, Compensation, & Benefit Administration

IN THIS ISSUE...

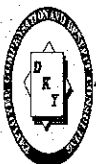
<i>When Must Salary Deductions Be Segregated?</i>	1
<i>Debit Cards Are Now Available Thru David K. Young, Consulting</i>	1
<i>401(k) vs. Defined Benefit Plans</i>	1
<i>Health Reimbursement Arrangements ("HRAs")</i>	3

TRENDS**DAVID K. YOUNG, CONSULTING**

If you are in need of answers to any of the issues raised in this newsletter, or other human resource questions, please feel free to call David K. Young, Consulting. The initial consultation is free. Call 210-558-0999.

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Sources used throughout this publication: CCH; SHRM HR News; and ISCEBS Newsbriefs



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When Must Salary Deductions Be Segregated?

The question often comes up as to when an employer must remove Section 401(k) or other retirement plan salary deferrals from his or her general assets. Following is straight from the "horse's mouth", i.e. the Department of Labor as to when those funds must be segregated and placed either within a trust for the retirement plan or sent to the investment company or insurance carrier.

Participant Contributions (29 CFR 2510.3-102) describes a general rule and a maximum time period for pension benefit plans. The general rule provides that the assets of a plan include amounts (other than union dues) that a participant or beneficiary pays to an employer, or amounts that a participant has withheld from his wages by an employer, for contribution to the plan as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets.

The maximum time period for pension benefit plans for transmitting participant contributions shall in no event be later than the 15th business day of the month following the month in which the participant contribution amounts are received by the employer (in the case of amounts that a participant or beneficiary pays to an employer) or the 15th business day of the month following the month in which such amounts would otherwise have been payable to the participant in cash (in the

case of amounts withheld by an employer from a participant's wages). The date when participant contributions reasonably can be segregated from the employer's general assets usually will be earlier than the maximum time period for pension plans in the regulation. Thus, when contributions reasonably can be segregated from the employer's general assets in a shorter time period, delay in forwarding the contributions, even a delay that does not exceed the maximum time period under the regulation, may cause a breach of fiduciary duty under title I of ERISA.

Debit Cards Are Now Available Thru David K. Young, Consulting

Debit cards are now an option for use with flexible spending accounts administered by our firm. Debit cards offer a no-paper claims opportunity for those employers who provide FSAs via their Section 125 Cafeteria Plan. Participants are able to purchase qualified medical items via a debit card provided by our firm via a large bank which pioneered the concept and specialized in the cards. Participants will also be able to check their account balances in real time 24/7 when using the cards. Large employers such as the State of Texas have been using the cards and now they are available to employers such as yourself. To find out more about how they were work, please call our offices at (210)558-0999.

401(k) vs. Defined Benefit Plans

There has begun to be a lot of

discussion in the news media about the failure of 401(k) Plans as a retirement plan. Last month we briefly discussed that 401(k)s are still strong and will be strong far into the future. Much of the news is just the hype of media types that do not have a firm understanding of how the plans have benefited numerous individuals and will continue to benefit employees and employers alike for years to come. Much of the discussion is knee jerk reaction to the Enron fiasco and other dishonest employers who were not good fiduciaries of the assets in their plans.

It is our opinion that defined benefit plans are excellent retirement plans for certain situations when an employer has excellent cash flow currently and is assured of it continuing into the future, wants to provide a good retirement benefit for their employees without the employees needing to contribute, and want to put away substantial sums of cash in a short period of time. There is probably no better retirement plan around for being able to tax shelter as much as \$300,000 or more per year for a high income individual, while at the same time providing an excellent benefit for his or her employees. However, many businesses can not always count on excellent cash flow year after year, nor do they have the ability to fund retirement benefits for their employees. That is where defined contribution plans like 401(k)s have given Americas workers an opportunity to put away money for retirement via payroll deduction, and many times having those deferrals matched by their employer.

There are some who call for the return of the old-fashioned pensions, i.e. defined benefit plans that, as opposed to 401(k)s, pay out a fixed percentage of salary once you retire, no matter where the stock market is

headed.

Research funded by the National Institute on Aging found that even when the stock market is troubled, 401(k)s remain better retirement-saving tools than defined benefit plans.

Using the Federal Reserve Surveys of Consumer Finances to examine hundreds of pension plans, it was found that 401(k)s yielded higher retirement income with less risk compared to older-style defined benefit plans. Indeed, the typical worker could expect an extra 38% of retirement income from 401(k) plans.

The results held even when simulated investors went through a long history of bull and bear markets, including the Great Depression. The researchers even "cooked the books" in favor of defined benefit plans by excluding the years after 1990, when the stock market reached unheard-of highs, and by reducing average after-inflation returns to just 5% across the board. No matter what rigors 401(k)s were put through, the plans still beat out the defined benefit plans available in the 1980s.

How can a research report like this reconcile this rosy picture with the media horror stories? One answer is that the researchers looked at retirement income over a full range of possible outcomes, not just at the bottom of a bear market. The more important reason is that while some 401(k) plans failed to provide much at retirement because people managed their plans unwisely -- for example, by making bad investments, failing to contribute or spending their balances between jobs -- the old-style defined benefit plans were even worse. This point has been ignored in most of the recent media coverage.

The main flaw in defined benefit plans is their reliance on the last few years of salary in determin-

ing benefits. Even a worker who remains with the same firm until retirement is exposed to enormous risk; a few bad years prior to retirement can devalue a retirement nest egg rapidly. For a more typical worker who has several employers during a career, the early- and mid-career earnings used to calculate benefits will be eroded by inflation, so the pension will pay little when the worker is eligible to collect it. In contrast, 401(k) plans can be rolled over when a worker changes jobs and continue to grow.

Many holders of 401(k) plans are hurting now, and those who are at retirement age may will be hurt by the sudden decline of the market. But to put things into perspective, during 1990, the Dow Jones never closed above 3,000. If the Dow drops to 6,000, it would have still doubled during the past 12 years, and even this calculation excludes all the dividends paid.

The real problem is not with 401(k)s, but with unsound investment decisions. Sensible financial advice is built on the twin pillars of diversification and a long-term horizon. The objective is to get rich, but not necessarily to get rich quickly. Therefore, when an employer uses a 401(k) or similar retirement plan for his or her employees, good enrollment and communication procedures should be implemented with the plan. Many employers will just say "here it is, enroll in the 401(k) and save for retirement." However, the more responsible approach would be to ask the pension plan administrator or product vendor to help explain the options available within the plan and how to go about making the wise investment choices that will produce long term planning goals. Many workers today have unrealistic expectations of what it takes to save for a retirement nest egg that will carry them and their spouse through

their retirement years. Good enrollment communication materials will explain this to the workers and open their eyes to what they should be trying to save for retirement.

To prevent the sort of individual financial disasters we've heard about recently, 401(k) plans at the least should offer a very safe option, such as inflation-indexed bonds, so those workers who want to live in a defined benefit or "cash balance" world can easily replicate it through their 401(k) investments.

The 401(k) may not be perfect, and much can be done to mitigate the potential losses by over-ambitious or neophyte investors. But even in their current form, 401(k) plans far surpass the old-style defined benefit plans that they replaced for the average worker. Again, it must be emphasized however that defined benefit plans are excellent pension and estate planning tools for wealthy individuals approaching retirement age within 10 to 15 years, and who also have excellent cash flows year after year....there is no better financial planning tool than a well designed defined benefit plan for those types of individuals.

So, what is the bottom line?

Obtain a good financial planner or pension expert to help you through the decision making process. There are many options out there to choose from when making retirement plan design decisions for you and your employees. The options go far beyond the media hype from those who have their own social and political agenda to promote.

Health Reimbursement Arrangements ("HRAs")

There has been great excit-

ment in the employee benefit community about a new health plan design that is being compared to what 401(k)s did for the retirement plan arena in the 80s and 90s. Late in June 2002, Treasury and IRS gave a green light to health plan designs that use employer-funded, defined contribution accounts to pay employee and dependent health care expenses. Termed a Health Reimbursement Arrangement ("HRA") by the Treasury/IRS guidance, an HRA account may be used to pay both out-of-pocket health care expenses and health coverage premium costs. Any unused HRA balances may be carried forward from year to year. The guidance, issued as a combination revenue ruling and notice (Rev. Rul. 2002-41 and Notice 2002-45), dispels the low expectations for defined contribution health plans based on early comments by the government and restrictive existing guidance for health flexible spending accounts ("FSA").

Indeed, the new guidance should make the future for HRAs exciting for those who have creativity in health care plan design.

What Benefits Can an HRA Provide?

An HRA is an arrangement that is financed solely by the employer (no salary reductions are allowed), and that reimburses only:

- * Code section 213 medical expenses (including health insurance premiums and long-term care premiums),
- * Expenses incurred after the HRA is adopted and after an individual's coverage begins,
- * Expenses that are substantiated, and
- * Expenses that are NOT deducted by the employee under Code section 213 and NOT

reimbursed by another plan.

Who May be Eligible for HRA Coverage?

An HRA may reimburse medical expenses of current or former employees and the employees' spouse and dependents. An HRA may be specifically offered only to retirees, and the HRA coverage amount may be limited to the retiree's cost of post-retirement health insurance premiums.

How is an HRA Financed?

Amounts credited to an HRA must be provided solely by the employer, i.e. no salary reduction is allowed. There are no dollar limits on the amount that the employer can credit under an HRA, and amounts may be contributed in a lump sum (such as on a one time or annual basis) or periodically based on the employee's payroll period. In contrast to health FSAs, an employer may establish an HRA that only allows employees access to HRA amounts as they are credited to the account (i.e., uniform coverage is not required) and the HRA also may provide for the carryover of unused amounts at the end of the year (use-it -or-lose-it is not required). In addition, the unfunded HRA balances may also accrue interest, and that earnings may be allocated to an HRA surplus that is carried over to a subsequent year.

How Does an HRA Relate to a Cafeteria Plan?

Although HRA credits must be financed solely by the employer and may not be attributable to employee salary reduction or so-called "cashable credits" under a flex plan, the guidance allows an HRA to be provided in conjunction with a cafeteria plan as well as another health plan that is financed through employee salary reduction.

Fall 2002

However, in order to ensure that no salary reduction for the other health plan is being used to finance the HRA, the salary reduction for the other health plan may not exceed the plan's cost. Solely for this purpose, the guidance indicates that cost may be determined under the COBRA rules for determining the COBRA applicable premium, which is the cost to the health plan for such coverage (both employee and employer contributions), but without the 2% add-on for administration. In addition, the HRA also must not be indirectly financed through employee salary reduction. Indirect financing through salary reduction is deemed to occur if the HRA may pay for premiums under another plan that alternatively could be paid for by employee salary reduction, or if

FSA forfeitures are credited to the HRA. Indirect financing also occurs if the HRA maximum reimbursement amount increases in correlation with an increase in the salary reduction for the companion health plan.

How Does an Employer Establish an HRA?

Although the guidance does not include a requirement for a written plan document, if the HRA is self-insured, Code section 105(h) requires the adoption of a written plan document. Similarly, because an HRA should be an employee welfare benefit plan under ERISA, a written plan document, as well as the distribution of SPDs to participants, will be required by ERISA. Therefore, as with other group health plan documents,

the HRA plan document should establish rules regarding eligibility, participation and reimbursements of claims in addition to the establishment of the HRA account and employer credits.

What Questions Remain?

Not many, but there is one major question not addressed by the guidance that the IRS appears unwilling to officially address at this time. The question involves how HIPAA regulations apply to HRAs and whether health insurance products such as individual health insurance policies can be placed within a HRA if HIPAA applies. Some commentary would suggest "no", but others feel that it would be permissible to offer individual health insurance policies.

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