

Compliance Corner: Dependent Care Regulations Update

CONEXIS Compliance

On August 14, 2007, the Internal Revenue Service issued final regulations regarding the dependent care credit under Code §21 (typically referred to as the "Dependent Care Credit"). Dependent care assistance programs (DCAP; also known as a Dependent Care Flexible Spending Account) are heavily impacted by these updates because Code §129, the statutory exclusion for employer-provided dependent care assistance, incorporates Code §21 and the Dependent Care Credit. Although the final regulations do not differ significantly from the proposed regulations issued on May 24, 2006, there are important changes and clarifications that must be reviewed and incorporated by plan sponsors.

These final regulations are effective for taxable plan years beginning on or after August 14, 2007 (i.e. January 1, 2008). Plan sponsors should review their plan's documentation and procedures to ensure compliance with the new rules.

A copy of the regulations is available for download [here](#).

Healthcare - You Better Shop Around

*The Star Tribune, Minneapolis
Chen May Yee*

Bob Braschler's search for cataract surgery was a real eye-opener. The Mayo Clinic wanted to charge him more than \$20,000 for both eyes. Fairview Red Wing Medical Center quoted \$18,000. Braschler finally settled on Minnesota Eye Consultants, which charged \$10,000.

The baker from Red Wing, Minn., is just one example of how patients are shopping for medical care as they grapple with higher deductibles and co-insurance. A small but growing number of patients are calling multiple places to check prices before deciding where to go, something unheard of just a few years ago.

Hospitals are reacting in various ways. Most are adding staff to answer questions. They're trying to simplify pricing to make it less confusing. Some are even starting to drop prices to stay competitive.

CONTINUED ON PAGE 2

CONTINUED ON PAGE 4

Compliance Corner: Dependent Care Regulations Update

– CONTINUED FROM PAGE 1

Dependent Care in General

A dependent care assistance program allows employers to provide their employees with reimbursement of qualified dependent care expenses through a cafeteria plan on a pre-tax basis¹. Expenses are considered eligible only when certain conditions are met, including the requirement that eligible expenses must be employment-related². In other words, the care must be provided in order to allow the employee and their spouse to be gainfully employed. The IRS considers “gainfully employed” individuals to be those who are employed full-time, attend school full-time or are actively seeking employment. For this purpose, a full-time student is defined as an individual enrolled for the number of course hours considered to be a full-time course of study at an educational organization, during each of 5 calendar months of the taxpayer’s taxable year³.

Consistent with the Gulf Opportunity Zone Act of 2006, changes were made to the definitions of “qualifying individual” and “custodial parent”. The changes clarify that a qualifying individual is an individual who is a tax dependent as defined in Code §152 or any

individual who would otherwise qualify as a tax dependent under Code §152 but for the fact that:

- (i) the individual has income in excess of the exemption amount set forth in Code §151(d);
- (ii) the individual is a child of a Participant who is a tax dependent of another taxpayer under Code §152; or
- (iii) the individual is married and files a joint return with his/her spouse.

Additionally, a child to whom Code §152(e) applies (a child of divorced or separated parents who resides with one or both parents for more than half the year and receives over half of his/her support from one or both parents) may only be the qualifying individual of the “custodial parent” (as defined in Code §152(e)(3)) without regard to which parent claims the child on his or her tax return. Furthermore, children of parents who lived apart at all times during the last six months follow the same rules for children of divorced or separated parents⁴.

Highlights of Changes

The following list provides an overview of some of the changes and clarifications made by the final regulations:

¹ Code §129

² Although the IRS may indicate that a particular expense is deemed to be for the “care” of the individual, the expense does not qualify for tax-free reimbursement unless the expense is also necessary to enable the taxpayer to work or look for work.

³ Code §170(b)(1)(A)(ii); note that the enrollment for 5 calendar months need not be consecutive

⁴ Code §152

CONTINUED ON PAGE 3

Compliance Corner: Dependent Care Regulations Update

– CONTINUED FROM PAGE 2

Education Expenses – Expenses related to pre-school or similar programs below the kindergarten level may be employment-related expenses, even though educational activities may be a significant part of these programs. Expenses related to kindergarten and above are not employment-related expenses.

Specialty Day Camps & Boarding School – The rules provide that specialty day camps, even those with educational components, are eligible dependent care services. However, summer school and tutoring expenses, which are purely educational in nature, are ineligible services. Furthermore, with regard to boarding school, the day care aspect of boarding school is an eligible expense. Therefore, boarding school costs must be appropriately divided between day care and other ineligible expenses like food and education.

Overnight Care and Overnight Camp – In a situation where one spouse works during the day and the other works at night and sleeps during the day, overnight care for a qualifying child may be considered an employment-related expense. This should not be confused with an overnight camp, which is not considered an eligible expense.

Room & Board – Additional costs to provide room and board for an in-home caregiver in excess of usual household expenses are eligible for reimbursement.

However, the caregiver cannot be the employee's spouse, child under the age of 19 or other dependent.

Transportation Expenses – An employee's travel expenses to and from day care facilities are not eligible for reimbursement. However, the cost of transportation (e.g. transportation to an after-school program not on the school's premises) furnished **by a dependent care provider** may be an employment-related expense.

Agency Fees & Applications – Indirect expenses such as application and agency fees and deposits may be reimbursable **only if** the employee is **required** to pay the fees to obtain the care and only if the care is in fact provided.

Short-term Absences – Short, temporary absences from work may be disregarded for taxpayers who must continue to pay for dependent care expenses during the absence. Whether an absence is short and temporary depends on the facts and circumstances of the situation; however the final regulations stipulate that an absence of up to two consecutive weeks due to brief illness or vacation is a short-term or temporary absence. An absence extending beyond two weeks may still be considered short-term if certain conditions apply, however the rules make clear that an absence of four months would never be considered short-term.

CONTINUED ON PAGE 4

Compliance Corner: Dependent Care Regulations Update

– CONTINUED FROM PAGE 3

Part-time Employment - With regard to part-time employment, an individual working part time must apportion amounts for days worked versus days not worked. On the other hand, if the part-time employee is required to pay for care on a periodic basis (including non-working days), no apportionment is necessary.

Payments to Related Individuals - Payments to a taxpayer's spouse or to a parent of the taxpayer's child who is not the taxpayer's spouse are not qualified expenses.

Compliance is Mandatory

Dependent care assistance plans offer valuable benefits to both plan sponsors and employees. However, failure to comply with IRS rules and regulations can lead to considerable consequences for both plan sponsors and participants. Ensuring your plan is up-to-date begins with properly understanding the rules in place and keeping current with all pertinent updates and changes. Plan sponsors and administrators should regularly review their plan documents and procedures for inaccuracies, inconsistencies and ambiguities that may cause confusion or result in compliance concerns. 🍷

Healthcare - You Better Shop Around

– CONTINUED FROM PAGE 1

It's no consumer revolution, but it may be the start of one.

Shopping for medical care "has grown and will continue to grow, as more of the burden of healthcare is put on consumers," said Doug Thorson, finance director at Children's Hospitals and Clinics of Minnesota.

Medical prices used to be trade secrets, jealously guarded by the hospitals and insurers that negotiated them. But with employers shifting more cost to employees, they have become everybody's business.

Price Transparency

Now hospitals and insurers are tripping over one another to recite the new mantra of price transparency.

Park Nicollet Health Services cut prices across the board by 10 to 15 percent in the past four years, bringing them closer to the discounted rates insurers actually pay, Chief Financial Officer David Cooke said.

CONTINUED ON PAGE 5

Healthcare - You Better Shop Around

– CONTINUED FROM PAGE 4

While just one of the four major insurers in Minnesota paid less as a result of the adjustment, it does mean that anyone checking Park Nicollet's Web site these days will find lower prices posted.

Similarly, Children's has reduced prices for MRI and CT scans by 10 to 30 percent after patients called to complain that they were finding lower prices elsewhere.

In addition, hospitals are looking for ways to untangle their Byzantine pricing, which is designed to make sense to insurers and not to patients.

Children's says that it plans to start charging a flat fee for common procedures such as tonsillectomies, instead of charging for time spent in the operating room.

The Twin Cities' biggest hospital group, Allina Hospitals and Clinics, is talking about bundling care for chronic conditions. For example, the hospital might offer one price for a year's worth of diabetic care.

For patients who have serious, expensive conditions, price is unlikely to be a big consideration. Most will continue to choose

doctors based on reputation or quality, asking questions such as how many times a doctor has done a procedure. And for obvious reasons, shopping for healthcare has its natural limits.

"You don't want to start [treatment] and say, 'Oops, we found something else, Mr. Jones. Would you like to shop around?'" said Andy McCoy, vice president of revenue management at Fairview. "It's not like the brakes on your car."

Braschlers went shopping

Bob and Nancy Braschler own Braschler's Bakery and Coffee Shop in Red Wing, a pretty river town an hour's drive south of the Twin Cities.

Like many small-business owners, the Braschlers struggle to pay their health premiums, which have surged ahead of general inflation.

To keep premiums manageable, they opted for a high-deductible policy from Blue Cross and Blue Shield of Minnesota. It has a \$637 monthly premium, with a \$5,000 deductible. Last year, they opened a health savings account, which

CONTINUED ON PAGE 6

Healthcare - You Better Shop Around

– CONTINUED FROM PAGE 5

allows them to put aside pretax dollars for medical expenses.

The Braschlers have had few medical problems, but when they have, Nancy Braschler has been known to call hospitals to demand that they break down the charges.

"I like to know what I'm paying for," she said.

A 2005 Minnesota law required hospitals to make public their charges for the 50 most common medical procedures. In 2006, the state required the same of insurers, who have an incentive to steer patients to the cheapest providers, as that cuts their costs.

"Consumers are becoming more interested, particularly for things [priced] below their deductible," said Tina Frontera, senior director for cost and quality initiatives at Medica, a large Minnesota insurer.

Most queries tend to be for elective and lower-cost procedures, such as maternity services, lower-back procedures and MRI scans.

Insurers get significantly more phone queries and hits on their Web sites between October and December, when people are choosing their

health plans for the next year, or using up what's left in their flexible spending accounts.

A HealthPartners software program called a medical cost calculator had 30,000 hits in 2006, with numbers peaking at the end of the year.

"Does it change where they go?" asked Scott Aebischer, senior vice president for customer services at HealthPartners. "We don't know that yet."

It did for Braschler, 64.

Several years ago, he noticed his eyes getting sensitive to bright light. He stopped going down to the river, a beloved activity for the family, living on a bluff overlooking the Mississippi. The sun's reflection off the water hurt his eyes.

An ophthalmologist in Red Wing diagnosed cataracts in both eyes.

Nancy Braschler called the Mayo Clinic in Rochester, which quoted a range of \$10,800 to \$11,800 for cataract removal, she recalled. "Then they said, per eye. I said what?"

CONTINUED ON PAGE 7

Healthcare - You Better Shop Around

– CONTINUED FROM PAGE 6

She called the local Fairview Hospital: \$9,000 per eye. Then she called Minnesota Eye Consultants for a third quote: \$5,000 to \$6,000 per eye.

She called Fairview and Mayo back and found out the estimates included several thousand dollars in hospital fees. Minnesota Eye Consultants, with 12 branches around the Twin Cities, doesn't own a hospital.

Mayo and Fairview confirmed the estimates. Mayo doctors remove cataracts in a hospital rather than in an outpatient setting, saying it's safer for patients in case of complications, according to Mark Norby, who is secretary of the clinic's fee committee.

Mayo has seen a big jump in the number of people calling about prices, and "my sense is they are calling multiple places," Norby said. Mayo has adjusted prices downward slightly in recent years, he said.

Everybody Saves

After talking to a friend who had the same procedure done at Minnesota Eye Consultants, Bob Braschler had surgery on one eye in mid-May and on the second eye in early June.

No matter where they had gone, the Braschlers were liable only for their \$5,000 deductible. But that wasn't the point.

"I don't care if it's insurance or us," Nancy Braschler said. "We're all paying for it. If even 50 percent of people in Red Wing had it done for half the cost," she postulated, "think of the savings in healthcare costs!"

She says she now may buy her Lipitor cholesterol-lowering drug from an online pharmacy. That pains her, she said, because she believes in supporting local merchants. 🍷

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