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

Retirement and Insurance Service
Payroll Office Letter

Number: P-00-13 **Date: July 13, 2000**

SUBJECT: FEHB PREMIUM CONVERSION

In Payroll Office Letter No. 00-04, we informed you about the President's initiative to enhance the benefits package offered to Federal employees. In keeping with the President's directive, the Office of Personnel Management (OPM) will implement a "premium conversion plan" for most enrollees in the Federal Employees Health Benefits Program (FEHB). This is the first in a series of letters that will provide guidance to payroll offices about the implementation of FEHB Premium Conversion ("HB-PC"). In order to be able to provide timely information to you, this letter is being furnished a few days before the publication of the final implementing regulations.

GENERAL

By participating in HB-PC, employees will in effect have chosen to have their salary reduced and the amount of that reduction applied by their agency toward their FEHB premiums. Since the participating employees will not receive the amount of the salary reduction, it will not be considered gross income for tax purposes. For employees who participate in HB-PC, therefore, employment taxes will be reduced and they will take home more of their pay.

As a Federally qualified "cafeteria plan," HB-PC must comply with the requirements of Section 125 of the Internal Revenue Code. As such, OPM will execute a written plan document that will describe the plan provisions, discuss eligibility rules, and make certain other mandatory disclosures. To implement HB-PC, OPM will also amend the FEHB regulations at 5 CFR parts 890 and 892 and the allotment regulations at 5 CFR part 550; OMB has cleared the regulations and they will be published in the Federal Register during the week of July 17, 2000.

EFFECT OF HB-PC ON EMPLOYMENT TAXES

Federal Income Taxes

Like employee contributions to the Thrift Savings Plan (TSP), FEHB deductions from the pay of those participating in HB-PC will be excluded from gross pay before Federal income taxes are applied.

State and Local Income Taxes

Like employee contributions to the TSP, FEHB deductions from the pay of those participating in HB-PC will generally be excluded from gross pay before state and local income taxes are applied.

Each state and local government, however, makes individual determinations as to whether to allow the pre-tax treatment for deductions under premium conversion plans. We will research and advise agencies as to state and local laws regarding the treatment of FEHB deductions under HB-PC premium conversion plans. And, we will keep agencies up-to-date on any changes in applicable tax policy about which we become aware.

At the present time, we know that the state of New Jersey and the Commonwealth of Puerto Rico will not allow for the reduction of taxable income for FEHB deductions under HB-PC. It is important that your payroll systems are coded accordingly. Several agencies have asked specifically about the policy of the Commonwealth of Pennsylvania vis-a-vis the taxability of cafeteria plan deductions. We can now state that FEHB premiums deducted from the pay of HB-PC participants will be excluded from gross pay before Pennsylvania taxes are applied.

Although we have no specific information at this time, there may also be municipalities that will not allow for the reduction of taxable income for the FEHB premium deductions of HB-PC participants. We will inform you, if and when we become aware of these.

FICA Taxes

***Unlike* employee contributions to the TSP, FEHB premium deductions from the pay of those participating in HB-PC will also be excluded from gross pay before Old Age, Survivors, and Disability Insurance (OASDI) and Medicare taxes are applied. Agencies will see a benefit as employer FICA contributions will also be reduced in concert with the decrease in employee withholdings.**

ILLUSTRATION OF THE EFFECT OF HB-PC PARTICPATION ON TAKE-HOME PAY

To illustrate the positive effect that participation in HB-PC can have on the take-home pay of most employees, consider the case of Patricia White. Ms. White has $1,000 in gross pay and has $100 in FEHB premiums deducted from her pay each biweekly pay period. Ms. White has computed her take-home pay as both a prospective HB-PC participant and nonparticipant. She has found that, by participating in HB-PC, her tax withholdings will be reduced and her take-home pay increased by $40.65 per pay period:

	Nonparticipant In HB-PC	Participant in HB-PC	Difference
Gross pay	$1,000.00	$1,000.00	
FEHB premium deduction	*N/A*	*100.00*	
Adjusted (reduced) gross pay	1,000.00	900.00	-$100.00
FEHB premium deduction	*100.00*	*N/A*	
Basic life insurance	4.34	4.34	
FERS deduction (1.2%)	12.00	12.00	
TSP deduction (5%)	50.00	50.00	
Federal income tax (28%)	280.00	252.00	-28.00
OASDI tax (6.2%)	62.00	55.80	-6.20
Medicare tax (1.45%)	14.50	13.05	-1.45
State taxes (5%)	50.00	45.00	-5.00
Take-home pay	$427.16	$467.81	+$40.65

EFFECT OF HB-PC ON OTHER BENEFITS

The deductions for CSRS, FERS, FEGLI, and the TSP are based on “unadjusted” gross pay. As demonstrated in the illustration above, participation in HB-PC will have no effect on an employee’s CSRS, FERS, FEGLI, or TSP deductions.

ELIGIBILTY TO PARTICIPATE IN HB-PC

Employees in the Executive Branch of the Federal government, who are enrolled in the FEHB, whose pay is issued by an Executive Branch agency, and from whose pay FEHB premiums are deducted, are eligible to participate in HB-PC. Individuals from whose pay FEHB premiums are deducted, but who are employed outside of the Executive Branch, or whose pay is not issued by an agency of the Executive Branch, may also participate in HB-PC, if their employer agrees to offer them the ability to do so. The Judiciary Branch, the U.S. Postal Service, and some smaller Executive Branch agencies, with independent compensation-setting authority, have already implemented their own FEHB premium conversion plans; the employees of these entities will not participate in HB-PC.

At the present time, annuitants and compensationers, from whose benefits FEHB premiums are deducted, are not eligible to participate in HB-PC. There are special rules for reemployed annuitants; see below.

PARTCIPATION IN HB-PC IS AUTOMATIC

Because take-home pay will likely increase, we are confident that virtually all eligible employees will choose to participate in HB-PC. In fact, at the U.S. Postal Service, where a health benefits premium conversion plan has been in place since 1994, only approximately 300 out of 700,000 eligible employees opted not to participate. We have, therefore, decided that participation in HB-PC will be *automatic.* This means that employees, who have FEHB premiums deducted from their pay, will be deemed to have elected to pay for their FEHB premiums with pre-tax dollars, unless they affirmatively waive participation in HB-PC [waivers are discussed below]. Eligible employees, therefore, need take no action to participate in HB-PC and receive the pre-tax treatment of their FEHB deductions.

EFFECTIVE DATE OF HB-PC

The implementation of HB-PC is effective with the first payroll period beginning *on or after October 1, 2000.* In no case may a retroactive adjustment to taxable income be made for any FEHB premiums deducted from pay prior to the effective date of HB-PC.

For On-board Employees

Agencies must deduct premiums on a pre-tax basis from the pay of eligible employees, who are enrolled in the FEHB on the first day of the first pay period beginning *on or after October 1, 2000*, unless they have waived participation in HB-PC. This means that for most eligible employees, HB-PC will be effective on October 8, 2000 [pay period 22], with the first pre-tax FEHB deduction taking place on the associated pay date [circa October 30, 2000].

For New Employees (and others with an Initial Opportunity to Enroll in the FEHB)

Agencies must deduct premiums on a pre-tax basis from the pay of new employees and those with an initial opportunity to enroll in the FEHB, effective with the first applicable payroll period beginning on or after October 1, 2000, unless they have waived participation in HB-PC. The "applicable pay period" is the first pay period beginning after the employing office receives the enrollment request and that follows a pay period during any part of which the employee was in pay status.

INITIAL OPP0RTUNITY TO WAIVE PARTICIPATION IN HB-PC

Employees, whose participation in HB-PC will be automatic, will be provided an initial opportunity to waive their participation in HB-PC.
On-board Employees

The waiver of participation in HB-PC for employees, who are on board on the effective date of HB-PC, must be received by the employing office BEFORE the start of the first pay period that begins *on or after October 1, 2000.* The FEHB premiums deducted from the pay of these employees for the first pay period that begins on or after October 1, 2000 must be on an after-tax basis.

Employees with an Initial Opportunity to Enroll in the FEHB after the Effective Date of HB-PC

The waiver of participation in HB-PC for employees, with an initial opportunity to enroll in the FEHB after the start of the first payroll period beginning on or after October 1, 2000, must be submitted WITH the election to enroll in the FEHB. As a consequence, the initial deduction of FEHB premiums from the pay of these employees will be on an after-tax basis.

SUBSEQUENT OPPORTUNITIES TO PARTICIPATE OR WAIVE PARTICIPATION IN HB-PC

Generally, once employees participate in or waived participation in HB-PC, they may not change their HB-PC status, except (1) during the annual FEHB Open Season or (2) upon experiencing a "qualifying life event" [fully defined in the new regulations].

FEHB Open Season

During the FEHB Open Season, employees will have an opportunity to elect to participate or waive their participation in HB-PC. All elections to participate or waive participation in HB-PC during the Open Season will be effective with the first payroll period beginning *after the following December 31.* An Open Season election to participate or waive participation in HB-PC must be received no later than the last day of the Open Season to be considered timely filed. Should an agency accept a late Open Season enrollment election, it must also accept a late election to participate or waive participation in HB-PC; under no circumstances, however, may the HB-PC election be retroactive.

Please note that the effective date of an employee's election to participate or waive participation in HB-PC will be the same as the effective date of the Open Season FEHB enrollment election. Thus, where an employee opts during the FEHB Open Season to participate in HB-PC, there will likely be payroll paid dates in the subsequent calendar year for which FEHB deductions will be made on an after-tax basis. Similarly, where employees opt during the FEHB Open Season to waive their participation in HB-PC, there will likely be payroll paid dates in the subsequent calendar year for which FEHB deductions will be made on a pre-tax basis.

The following example will illustrate this point:

Mark Marks had previously waived participation in HB-PC. He opted to participate again in HB-PC during the November 2000 Open Season. Mr. Marks is paid on a biweekly basis, with the following payroll periods:

Payroll Period	*Beginning Date*	*Ending Date*	*Pay Day*	*Pre- Or After-tax*
01	***12/17/00***	***12/30/00***	***1/9/01***	***After-tax***
02	***12/31/00***	***1/13/01***	***1/23/01***	***After-tax***
03	***1/14/01***	***1/27/01***	***2/6/01***	***Pre-tax***

Mr. Marks' payroll office would treat his FEHB deductions on an after-tax basis through the end of payroll period 02.

"Qualifying Life Event"

Under HB-PC, an employee will be able to make an election to participate or waive participation in HB-PC upon experiencing a "qualifying life event" (QLE). Employees will have up to 60 days after the QLE to make a HB-PC election.

Except in one area, the list of events that permit employees to change their FEHB enrollment will also allow them to make a HB-PC election. The exception relates to the reduction of FEHB coverage – i.e., cancellations of enrollment or changes from self-and-family to self-only coverage. Whereas employees who do not participate in HB-PC may elect to reduce their FEHB coverage at any time, HB-PC participants will be able to reduce their FEHB coverage only during an FEHB Open Season or in association with a QLE.

For employees who change their FEHB enrollment upon experiencing a QLE, an election to change their HB-PC status will generally be effective on the same date as the change in FEHB enrollment.

Moses Johnson will be married on January 28, 2001. To provide coverage for his spouse, Moses changes his FEHB enrollment from self-only to self-and-family coverage. At the same time, he submits a request to change his HB-PC participation status from non-participating to participating. Both Moses' change in FEHB enrollment and in his HB-PC participation will be effective on January 28, 2001.

For employees who make a retroactive change in their FEHB enrollment upon experiencing a QLE, however, an election to change their HB-PC status will NOT be effective on the same date as the change in FEHB enrollment. Rather, the HB-PC election must be prospective and will be effective on the first day of the following pay period.

Myra Tyler gave birth on January 15, 2001. To provide coverage for her baby, Ms. Tyler elects on January 25, 2001 to change her FEHB enrollment from self-only to self-and-family coverage. At the same time, she submits a request to change her HB-PC participation status from non-participating to participating. Even though Ms. Tyler's change in FEHB enrollment is effective retroactively to January 14, 2001 (the first day of the pay period), her HB-PC participation election will be effective on January 28, 2001.

ALL HB-PC ELECTIONS ARE PROSPECTIVE

IRS rules require that ALL elections to participate in HB-PC or to waive participation in HB-PC be prospective. In other words, under no circumstances may there be a retroactive adjustment to taxable income as a result of an employee's HB-PC election. This is true even in situations where employees make authorized retroactive FEHB enrollment elections due to a change in family status or in the event of an administrative error by the agency [both of which are discussed later].

FORM TO ELECT TO PARTICIPATE AND WAIVE PARTICIPATION IN HB-PC

We will provide agencies with a template to be used to support elections to participate and/or waive participation in HB-PC. The template will contain recommended language, as well as requisite statutory and regulatory citations. Agencies may incorporate their own unique agency-identifying information onto the template, such as organizational names and logos, and must locally reproduce the form. We are working with Employee Express to provide a paperless alternative in the near future.

GUIDELINES FOR EMPLOYEE TRANSFERS

Transfer Between Employing Offices Offering HB-PC

Generally, when employees transfer from one payroll office to another without a break in service of more than three days, their HB-PC status – i.e., whether or not they are participating in

HB-PC will continue *without change* in their new office. However, employees may elect to change their HB-PC status, if they *must* also elect a new FEHB plan because of the transfer – e.g., if the transfer is to a location outside of the geographic service area of their HMO. Where employees must also change their FEHB enrollment because of a transfer, their election to participate or waive participation in HB-PC will be effective at the same time as their change in FEHB enrollment.

Transfer From Employing Offices not Offering HB-PC

Employees who transfer from an employing office that does not offer HB-PC to one that does will automatically participate in HB-PC, unless they waive participation. If employees must change their FEHB enrollment, the waiver of participation in HB-PC will be effective at the same time as the change in FEHB enrollment. If employees are not required to change their FEHB enrollment, they may file a waiver up to 60 days after the effective date of the transfer; the waiver will be effective on the first day of the first pay period after the date the employing office receives it.

Communication of HB-PC Status

Agencies use various methods to communicate enrollment information upon the transfer of an employee with FEHB coverage -- we are aware of the use of the SF 75, the SF 1150, and a variety of internally developed forms and checklists. Regardless of the mechanism used, it is critical that the process provide the "gaining" office with the HB-PC status of the transferring

employee; that is, whether the employee participated or did not participate in HB-PC at the "losing" office.

GUIDELINES FOR PERIODS OF LWOP

Leave without pay (LWOP) is a "qualifying life event" for HB-PC purposes; thus, employees entering a period of LWOP may elect to change their HB-PC status. The return from a period of LWOP to pay status is also considered a "qualifying life event," allowing employees to elect to change their HB-PC status.

Upon entering a period of LWOP, employees will have three options to pay the employee share of the premium should they wish to continue FEHB coverage. These options are referred to in this letter as the *"Prepay", "Pay-as-you-go,"* and *"Catch-up"* options.

"Prepay"

Coinciding with the implementation of HB-PC, the new regulations authorize, but do not require, agencies to allow employees to prepay the FEHB premiums they expect to owe during the LWOP period prior to the onset of LWOP. The amount of FEHB premiums employees prepay may either be deducted from their pay or paid directly "out-of-pocket" to their agency. Payments made "out-of-pocket" may not reduce taxable income.

The amount of FEHB premiums that employees prepay will be treated on a pre-tax basis, if it is deducted from their pay and the employees participate in HB-PC. Similarly, for employees who do not participate in HB-PC, the amount prepaid must be deducted on an after-tax basis.

IRS rules limit the amount an employee may prepay on a pre-tax basis. Where a period of LWOP will span two tax years, the amount that may be prepaid on a pre-tax basis may not exceed the amount of FEHB premiums due for the remainder of the current tax year. If the employee wishes to prepay the amounts due for the subsequent tax year as well, the deductions must be afforded after-tax treatment; the employee may use the "Pay-As-You-Go" or "Catch-up" options for the amounts due for the subsequent tax year.

Sam Arsers participates in HB-PC and had $100 per month in FEHB premiums deducted from his pay. He will go on LWOP for three months beginning on October 31, 2000 and opts to continue his FEHB coverage. Mr. Arsers uses the pre-pay option to pay the $300 in FEHB premium payments that will be due while he is on LWOP. Mr. Arsers will receive pretax treatment for only $200 of his FEHB premium prepayment – the amount he will owe for the months of November and December 2000. The remaining $100 he prepaid – the amount due for January 2001 – must be afforded after-tax treatment.

"Pay-as-you-go"

Under the "Pay-as-you-go" option, employees would pay their share of the FEHB premium directly to their agency during LWOP status. These payments will generally be made with after-tax monies, since there would be no pay from which to make deductions. [Note that the

premiums could be paid with pre-tax dollars to the extent that employees have and use accrued sick or annual leave].

"Catch-up"

Most employees will choose to pay their FEHB premiums via the "Catch-up" option. Under this option, the agency would have already remitted the employee share of the FEHB premium to OPM while the employee was in LWOP status. The employees would then have incurred a debt to their agency and become liable to repay it upon return to pay status.

The repayment of the debt will be treated on a pre-tax basis, if it is deducted from pay and the employee is a participant in HB-PC at the time the deduction is made. In other words, for their debt repayment to be afforded pre-tax treatment, employees must participate in HB-PC at the time the deduction from pay is made; it does not matter whether an employee participated in HB-PC at the time the debt was incurred. Where employees participate in HB-PC, *both* their FEHB deductions for the current pay period *and* the amount deducted from their pay for the debt repayment must be afforded pre-tax treatment. If, on the other hand, the employee is not a participant in HB-PC at the time the deduction for the debt repayment is made, the amount deducted must be on an after-tax basis.

For employees who choose to repay their debt to their agency "out-of-pocket," the amount remitted may not reduce taxable income.

REVISED PROCEDURES FOR REEMPLOYED ANNUITANTS

For reemployed annuitants to be able to participate in HB-PC, their FEHB premiums must be deducted from their pay as employees, not from their retirement annuities. Thus, to be able to afford reemployed annuitants an opportunity to participate in HB-PC, we will institute new guidelines for the administration of FEHB enrollments during periods of reemployment. These new guidelines will be effective with the first pay period beginning *on or after October 1, 2000*, coinciding with the implementation of HB-PC.

Annuitants Enrolled in FEHB

Most annuitants will be enrolled in the FEHB as of the effective date of HB-PC. These annuitants, like other employees, will automatically participate in HB-PC, provided they are employed in a position that conveys FEHB eligibility and by an agency covered by HB-PC. Therefore, agencies must deduct FEHB premiums on a pre-tax basis from the pay of these individuals, effective with the first day of the first pay period beginning *on or after October 1, 2000*, unless they affirmatively waive participation in HB-PC.

Like other employees, reemployed annuitants, who will automatically participate in HB-PC, will have an initial opportunity to waive their participation in HB-PC. Unlike other employees, however, reemployed annuitants will be afforded up to 60 calendar days to submit their waiver of participation in HB-PC. The waiver will be effective on the first day of the first pay period after the date the employing office receives it. There may be no retroactive adjustment to taxable income as a result of the processing of a waiver of participation in HB-PC.

Annuitants Who are Not Enrolled in FEHB

Some reemployed annuitants, who are not enrolled in the FEHB as annuitants, will elect to enroll as employees. Agencies must automatically deduct FEHB premiums on a pre-tax basis from the pay of these reemployed annuitants, effective with the first applicable pay period beginning *on or after October 1, 2000*. The "applicable pay period" is the first pay period beginning after the employing office receives the enrollment request and that follows a pay period during any part of which the reemployed annuitant was in pay status. These reemployed annuitants may file an election to waive participation in HB-PC up to 60 days after their entry on duty. The waiver will be effective on the first day of the first pay period after the date the employing office receives it. There may be no retroactive adjustment to taxable income as a result of the processing of a waiver.

Transfer-in FEHB Enrollment

As of the effective date of their participation in HB-PC, the employing office must *transfer-in* the FEHB enrollment of reemployed annuitants from their retirement systems. We are developing detailed procedures and guidelines pertaining to the transfer of the FEHB enrollment of reemployed annuitants that participate in HB-PC; they will be distributed under cover of a future Payroll Office Letter.

Our retirement system cannot tell us which of our annuitants have become reemployed. Thus, to ensure a timely and accurate transfer of enrollments to you in October, we need to begin now to build a file of reemployed annuitants enrolled in the FEHB. We ask that you work with your personnel office counterparts to identify the reemployed annuitants in your agency and provide to us by *August 4, 2000*, some basic information about them.

Our preference is to receive the information via email [to finance@opm.gov], with a spreadsheet file attachment. Include your name, voice and fax numbers in the body of your email. We will also accept the information by regular mail, with an enclosed diskette addressed to:

Meyer J. Persow
Attn: Reemployed Annuitants
1900 E Street NW, Room 3H28
Washington DC 20415

The spreadsheet file should contain a record for each of your reemployed annuitants with the following data fields:

- **Last name**
- **First name**
- **Middle initial**
- **Date of birth [dd/mm/yyyy]**
- **Social Security Number [no hyphens]**
- **Payroll office number [no hyphens]**
- **1st day of 1st pay period beginning on or after 10/1/00 [dd/mm/yyyy].**
- **Add [A] or Delete [D]***

***** The names submitted to us on the initial file would all have an "A" in this field.***

If, for some reason, you cannot create a spreadsheet file, you may fax a listing with the requisite information to us to 202-606-4909.

After you submit your initial file, we will need you to advise us of changes that occur from that point through your implementation date for HB-PC. Thus, each time, and as soon as feasible after, you hire a reemployed annuitant or one separates from your agency, a new spreadsheet file must be submitted to us. The file will contain a record, with each of the above fields, for each reemployed annuitant you have hired ["A"] or who has separated from your agency ["D"].

On or about October 6, 2000, we will send you a listing of the reemployed annuitants, whose FEHB enrollments we will transfer to you on the first day of your first pay period beginning on or after October 1, 2000. We will ask that you immediately reconcile it with your records and return a confirmation to us.

Agency Must Contribute Employer Share of Premium

Currently, the employer share of the FEHB premium for reemployed annuitants is paid from an OPM appropriation. Effective with these new rules, the employing agency must contribute the employer share of the FEHB premium for all reemployed annuitants who are enrolled in the FEHB as employees. The agency must continue to contribute the employer share of the FEHB premium for the period during which it has reemployed annuitants on board who are enrolled in the FEHB as employees. The employer contribution for reemployed annuitants will be remitted to OPM in the same manner as that for other employees.

Separation from Active Service

The participation in HB-PC of reemployed annuitants will end on the last day of their last pay period as employees. Thus, when reemployed annuitants, who participate in HB-PC, separate

from active service, their FEHB enrollment must be transferred back to their retirement systems for administration.

GUIDELINES FOR EMPLOYEES PAYING BOTH SHARES OF FEHB PREMIUM

Certain employees pay both the employee and the Government share of the FEHB premium by payroll deduction. These employees include certain temporary employees, student employees (e.g., student aides or Stay-in-Schools), and individuals working a "mixed" tour-of-duty (i.e., combining periods of full-time, part-time, and intermittent tours of duty during the year). Generally, these individuals will have both the employee and Government share of the FEHB premium deducted from their pay. As a consequence, the total amount deducted – i.e., both the employee and Government share -- would be made on a pre-tax basis, unless they have waived participation in HB-PC.

CORRECTION OF ADMINISTRATIVE ERRORS

Administrative errors will likely occur in the processing of employee elections to participate or waive participation in HB-PC. Furthermore, errors will continue to occur with regard to FEHB withholdings. It is very important to note that IRS rules allow for NO adjustments to taxable income as a result of the correction of such errors, even where it is clear that the agency, and not the employee, is at fault. In processing a correction, the actual amount of FEHB premiums deducted from the pay of an HB-PC participant will be afforded pre-tax treatment.

The following examples will, perhaps, clarify this point. Assume an employee, Susan Lee, has $100 per pay period deducted from her pay for FEHB.

Scenario I: Ms. Lee's employing agency mistakenly deducts $150 during the last pay period prior to the effective date of her election to participate in HB-PC. To correct the error, the agency deducts $50 for FEHB from Ms. Lee's pay in the following pay period, during which she has become a participant in HB-PC. Despite the fact that, if not for the error, $100 would have been deducted from her pay, only $50 is treated on a pre-tax basis.

Scenario 2: Ms. Lee's employing agency mistakenly makes no FEHB deduction during the last pay period prior to the effective date of her election to participate in HB-PC. To correct the error, the agency deducts $200 from Ms. Lee's pay in the following pay period, during which she has become a participant in HB-PC. Despite the fact that, if not for the error, only $100 would have been deducted from her pay, $200 is afforded pre-tax treatment.

Scenario 3: Ms. Lee's employing agency mistakenly does not process her election to participate in HB-PC. As a consequence, Ms. Lee's $100 FEHB deduction is not afforded pre-tax treatment. To correct the error, the agency changes Ms. Lee's HB-PC status to "participant" in the following pay period. Despite the fact that if not for the error, Ms. Lee would have had $200 deducted from her pay on a pre-tax basis, only $100 may be excluded from employment taxes.

EFFECT ON ORDER OF PRECEDENCE WHERE GROSS PAY IS INSUFFICIENT

Effective with the implementation of HB-PC, most agencies will be required to change the order of precedence for applying deductions, when gross pay is insufficient to cover all authorized deductions. At the present time, most, if not all, agencies deduct FEHB premiums immediately after FICA and Federal income taxes. Effective with the implementation of HB-PC, however, the FEHB premiums deducted from the pay of participating employees must be made BEFORE FICA and Federal income taxes in the order of precedence. Where employees do not participate in HB-PC, FEHB premiums will continue to be deducted from pay after FICA and Federal income taxes. In all cases, deductions for CSRS or FERS must continue to be made first.

PAYROLL SYSTEM REQUIREMENTS

Pre-tax/After-tax Indicator

Payroll systems must incorporate a coding structure to indicate whether each employee's FEHB premiums are to be deducted on a pre-tax or after-tax basis. As mentioned earlier, state and local taxing authorities will vary in their policies regarding whether FEHB deductions reduce taxable income. Agencies, therefore, should consider the incorporation of indicators for each category of tax withholding.

Agencies should be aware that OPM is undertaking a study to determine the design and cost options for another kind of cafeteria plan benefit – flexible spending accounts. Flexible spending accounts, in general terms, would allow employees to have money withheld on a pre-tax basis (reducing taxable income) and then use that money to pay the costs of dependent-care or medical/dental/vision care that is not covered by insurance. We believe, therefore, that the payroll system modifications implemented to support the HB-PC should be flexible. For instance, systems should have the capability to incorporate individual indicators for multiple cafeteria plan benefit deductions.

For HB-PC, the pre-tax/after tax indicator must meet the following minimum requirements:

Every employee record that contains an FEHB deduction code must also have a pre-tax/after-tax indicator.

Because the pre-tax treatment of FEHB deductions is automatic for most employees, the default pre-tax/after-tax indicator should be set to "pre-tax".

No employee record will indicate "after-tax", unless a waiver of participation in HB-PC has been filed.

Pay Subject to Employment Taxes

Payroll systems must have the capability to accumulate pay subject to employment taxes for employees who participate in HB-PC and for those who do not. For employees who participate in HB-PC, pay subject to taxes will be affected in the following manner:

Federal Income Tax

As with TSP contributions, pay subject to Federal income tax must be reduced by the amount of FEHB deductions.

State Income Tax

As with TSP contributions, pay subject to state income tax must be reduced by the amount of FEHB deductions, where applicable.

Local Income Tax

As with TSP contributions, pay subject to local income tax must be reduced by the amount of FEHB deductions, where applicable.

OASDI

***Unlike* TSP contributions, pay subject to OASDI must be reduced by the amount of FEHB deductions.**

Medicare

***Unlike* TSP contributions, pay subject to Medicare must be reduced by the amount of FEHB deductions.**

Forms 941 and W-2

As you know, agencies must file the Form 941 – Employer's Quarterly Federal Tax Return and the Form W-2 *- Wage and Tax Statement* - to report pay subject to taxes. FEHB premiums deducted on a pre-tax basis will not be included in the following items on the Forms 941 and W-2:

Total wages, tips, other compensation

Social security wages

Medicare wages

Agencies are encouraged to use box 14 of the W-2 to provide information to their employees on the amount of FEHB premiums deducted during the tax year.

Earnings and Leave Statements

To help employees understand the changes to their take-home pay, agencies should consider including some explanatory language on the initial earnings and leave statement under HB-PC. In addition, it may prove beneficial to both the agency and its employees if the earnings and leave statements were modified to reflect whether FEHB premiums have been deducted on a pre-tax or after-tax basis.

Data about Participants in HB-PC

As the plan sponsor, OPM is required to ensure that HB-PC complies with all legal requirements and report certain information annually to the IRS on the Form 5500. To be able to accomplish these responsibilities, OPM will periodically need information from agencies on the number of employees eligible for HB-PC and the number actually participating. We have not as yet determined the best way to capture these data, although we are considering the use of the semi-annual Headcount process. We will provide additional information to you about this requirement in a subsequent payroll office letter.

INQUIRIES

We are ready and able to assist you with the implementation of HB-PC in any way we can. So that we may have a record of them, we would prefer that you email your inquiries to us at finance@opm.gov. We can, however, be reached on 202-606-0606.

Robert A. Yuran, Chief
Financial Policy Staff
Retirement and Insurance Service