



***Retirement and Insurance Service
Benefits Administration Letter***

Number: 00-204

Date: February 11, 2000

Subject: Federal Employees Health Benefits (FEHB) Program: Premium Conversion

This letter provides advance information about new rules the Office of Personnel Management (OPM) will soon issue to permit employees of all Executive branch agencies to pay their share of enrollment costs under the FEHB Program with pre-tax dollars, and thus increase their after-tax income.

The President has directed OPM to promptly issue guidance and take all necessary action to ensure smooth implementation across the Executive branch. Similar plans are already available to the majority of employees of private sector employers and State and local governments, as well as employees of the United States Postal Service, the Federal Judiciary, and several small Federal agencies.

Section 125 of the Internal Revenue Code allows an employer to provide a portion of an employee's salary in benefits rather than cash. Instead of paying a certain amount to an employee as taxable income, the employer uses it to purchase benefits for the employee. A health insurance premium conversion plan reduces an employee's taxable income by the amount of health insurance premiums an employee would otherwise have to pay. This enables the employee to save on Federal income tax, Social Security and Medicare tax and, if applicable, State and local income taxes.

Under the Internal Revenue Code, premium conversion plans are only available to current employees and only affect the portion of insurance premium that employees normally pay. Federal agencies will continue to be responsible for the Government share of premiums as provided in the FEHB law. The tax code imposes certain limitations on reducing health plan coverage during a calendar year and premium conversion may also slightly reduce the base for Social Security benefits. Accordingly, participation in premium conversion will be automatic unless employees waive it.

*Civil Service
Retirement
System*

*Federal Employees
Group Life
Insurance*

*Federal Employees
Health Benefits
Program*

*Federal Employees
Retirement
System*

We expect that the implementation of premium conversion can be completed not later than October 1, 2000. OPM will amend its rules and will prepare instructions for agency personnel and payroll offices, materials for employees, and procedures for employees who want to waive participation. The attachment to this letter provides additional information.

Attachment

A handwritten signature in black ink, reading "Abby L. Block". The signature is written in a cursive style with a long horizontal flourish at the end.

Abby L. Block, Chief
Insurance Policy
and Information Division



PRESIDENT EXTENDS HEALTH INSURANCE PREMIUM CONVERSION TO ALL EXECUTIVE BRANCH EMPLOYEES

February 7, 2000

Today, President Clinton announced that Federal employees throughout the Executive Branch of the Government will for the first time be able to take advantage of tax benefits that most employees in the country already enjoy. As a result, most employees participating in the Federal Employees Health Benefits Program will see an increase in their take-home pay and the Federal Government will become more competitive as an employer.

The President's Action Achieves Two Objectives.

Equal treatment for Federal employees. Right now, the majority of private sector employees and State and local government employees are able to take advantage of a tax code provision that increases their after-tax income. Employees of the United States Postal Service, the Federal Judiciary and a number of smaller Federal agencies already have this tax advantage, while the majority of Federal employees are now excluded. The President's action will allow all employees of Executive Branch agencies to enjoy the same tax benefit.

Improving the Government's ability to recruit and retain staff. Because most Federal agencies have been unable to provide their employees with the same tax benefit as other employers in the labor market, the President's action will improve the Government's competitive position as an employer.

Guidance to Federal Employees and Agencies. The President has directed the Office of Personnel Management to issue guidance promptly to ensure smooth implementation of premium conversion across the Executive Branch. At this time, we expect implementation can be completed by all agencies no later than October 1, 2000.

The Office of Personnel Management Will Continue to Pursue Improvements. The Office of Personnel Management is working on a series of initiatives to improve Federal compensation and benefits. For example, as announced in the President's Fiscal Year 2001 Budget, the Administration is seeking ways to strengthen the Federal Employees Health Benefits Program, including enhanced dental benefits and other improvements in the program.



HEALTH INSURANCE PREMIUM CONVERSION

QUESTIONS AND ANSWERS

Q. What is premium conversion and how does it work?

A. Premium conversion reduces an employee's taxable income by the amount of his or her insurance premium. As a result, the employee pays less tax.

Section 125 of the Internal Revenue Code allows an employer to provide a portion of an employee's salary in benefits rather than cash. Instead of being paid to the employee as taxable income, this amount is used to purchase benefits for the employee. The effect is that the employee's taxable income is reduced. Under a health insurance premium conversion arrangement, an employee's taxable income is reduced by the amount of health insurance premiums withheld from pay. Because taxable income is reduced, the amount of tax the employee must pay is reduced. The employee saves on Federal income tax, Social Security and Medicare tax and, if applicable, State and local income taxes.

Q. How are health insurance premiums taxed now?

A. An employee receives salary and then has a withholding from salary to pay the premiums for health insurance. The employee must pay tax on the salary received, that is, the amount received before the health insurance premium is withheld. The employee pays tax on a larger amount of income than he or she receives as take-home pay.

Q. How much does an employee save with premium conversion?

A. To determine the amount saved, an employee must determine his or her highest combined tax rate and the total amount of health insurance premiums. If, for example, an employee's combined rate for Federal and local income taxes, Social Security tax and Medicare tax is 35%, and if the employee's annual health insurance premiums total \$1,400, the employee's annual reduction in taxes would be \$490 ($1,400 \times .35 = 490$).

Q. When will premium conversion begin?

A. The Office of Personnel Management expects that the implementation of premium conversion can be completed not later than October 1, 2000.

Q. Will there be an open season to sign up for premium conversion?

A. No. Participation in premium conversion will be automatic. Employees will have no forms to fill out, unless they waive participation.



- Q. Why would an employee waive premium conversion?
- A. In the vast majority of cases, employees will want to participate in premium conversion. In a limited number of circumstances, however, it may be to an employee's advantage to waive it. The Internal Revenue Code imposes certain annual limitations that may affect some employees who expect to change plans during a calendar year. Also, because premium conversion reduces the amount of taxable income, it may also slightly reduce the base on which Social Security benefits are calculated. The Office of Personnel Management's guidance will include a full explanation that will help employees decide whether to participate in premium conversion.
- Q. What about employees who already have premium conversion?
- A. Employees of the United States Postal Service, the Federal Judiciary, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the Federal Reserve System already have health insurance premium conversion. They are not affected by the President's action to extend premium conversion to other agencies.
- Q. Will the Government still pay the same share of my premium?
- A. Yes. The Government will still pay the same share of premiums as provided in the Federal Employees Health Benefits Act. The premium conversion plan only affects the portion of premiums now paid by employees.
- Q. Is this a permanent benefit?
- A. Yes, but each year employees may decide whether they want to participate for the following year.
- Q. Is the plan "Family Friendly?"
- A. Absolutely. The plan will make health premiums more affordable and will increase employees' take-home pay.
- Q. Is this benefit comparable to what the private sector offers to its employees?
- A. Yes, most large private sector employers, as well as most State and local governments, offer their employees premium conversion plans.
- Q. Will this put me in a different grade or step?
- A. No. Participating in the premium conversion plan will not affect your grade and step. It will only reduce the amount of tax you pay.



- Q. Was there a change in tax policy that permitted this recent development?
- A. No. Section 125 of the Internal Revenue Code already permitted employers to offer premium conversion plans.
- Q. Will this pre-tax benefit also apply to retirees, survivors, and former spouses who are receiving civil service benefits?
- A. No. Under section 125 of the Internal Revenue Code, the tax advantages of a premium conversion plan are only available to current employees.
- Q. Can I purchase health benefits outside of the Federal Employees Health Benefits Program with pre-tax dollars?
- A. No, the tax advantage only applies to premiums for the Federal Employees Health Benefits Program.
- Q. Will a premium conversion plan help the Federal Government better manage its human resources?
- A. The plan will enhance the Federal Government's ability to compete with the private sector in recruiting and retaining qualified employees. Agencies have expressed a strong desire for pre-tax benefits as recruitment and retention tools.
- Q. How many Federal employees will now be able to benefit from the tax advantages of a premium conversion plan?
- A. Approximately 1.6 million Federal employees will now be able to enjoy the tax advantages already enjoyed by almost 1 million employees of the Postal Service and other smaller Federal agencies.
- Q. What is a flexible spending account?
- A. A flexible spending account (FSA) is an arrangement under which an employee elects to have his or her employer place a portion of salary into an account that can be used to reimburse the employee for medical or dependent-care costs. Subject to restrictions in the Internal Revenue Code and Internal Revenue Service regulations, the amounts placed in the account are not subject to taxation at the time they are placed there or at the time they are disbursed from the account.

The agencies mentioned above that now offer health insurance premium conversion also offer FSAs, which are commonly available to private-sector employees and State and local government employees. The Office of Personnel Management is considering the feasibility of extending FSAs and other modern benefit options to all employees in the Executive Branch.
