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FSAs and COBRA, Just Like Riding a Bike

By Juli Hanshaw

Learning to ride a bike can be fun yet challenging. Along the way there may be falls and uncertainties. The training wheels assist in finding a good balance, but the true test of balance is when you start riding your bike once they are removed. The same can be said with COBRA and health flexible spending arrangements (FSAs). Once you learn how to balance, you'll never forget how to ride. Let's go for a test ride.

An FSA is an IRS-approved, tax exempt account that saves participants money on eligible medical expenses under Code Section 213(d). The money is exempt from federal income, Social Security and Medicare taxes, deducted from gross pay and deposited each pay period into participants' FSAs. As eligible expenses occur, participants can withdraw from the FSA for reimbursement up to the full amount of their annual election, even if they have not yet made sufficient contributions.

What happens to an FSA once an employee leaves? FSAs are group health plans, subject to COBRA. The IRS' final 1999 COBRA regulations limited the instances where the FSA must be offered. Before those regulations were issued, the FSA would have been offered for COBRA's full duration — 18, 29 or 36 months. The regulations allow an employer to "test" the FSA to determine the length and availability offered under COBRA.

Bolt on the training wheels and let's take a test run.

Test 1

The FSA must provide a maximum benefit that is no greater than two times the amount that employees can elect or no greater than the election amount plus \$500. Generally, as long as the employer is providing matching contributions that are no more than \$500, the FSA will pass this test.

Test 2

FSA participants must have other group health plan coverage available that is not

limited in scope (for example, dental or vision). If an employer offers group health coverage, the FSA will pass this test.

Test 3

Would COBRA qualified beneficiaries pay the same or more into the FSA than they can get out? Because FSAs elected under COBRA are subject to a 2-percent administrative fee, the FSA will typically pass this test.

Example. A monthly contribution of \$100 = \$1,200 yearly benefit. A monthly COBRA premium of \$102 (monthly amount plus two percent) = \$1,224 yearly premium. The premium (\$1,224) is equal to or greater than the benefit (\$1,200).

Test 4

If at the time of the qualifying event the employee has a negative account balance (the qualified beneficiary has spent more than he or she has paid in), an employer does not have to offer the FSA at all under COBRA. However, if a positive account balance exists, the employer would offer COBRA for the remainder of the plan year only.

Keep in mind, if the FSA *does not* pass any of the first three tests above, then the FSA must be offered to the qualified beneficiary for the entire COBRA period — 18, 29 or 36 months.

A Few Bumps in the Road

So far, so good. But in 2005, the IRS put a few bumps in the road by issuing Notice 2005-42. This allows plan sponsors to design plans with up to an additional 2½-month grace period following the end of the plan year, to incur expenses before the use-it-or-lose-it rule would apply.

With the additional time, participants can now use monies left in FSAs and have it applied against the prior year's level of available

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animus” toward Stylianou was involved in the termination of his COBRA coverage.

For similar reasons, the court dismissed claims that the coverage termination denied Stylianou due process of law under the U.S. and state constitutions and the state education law.

“Here, the Court finds the due process claims moot because, in the case of the first termination, plaintiffs’ benefits were actually restored, and in the case of the second termination, plaintiffs were provided with the opportunity to have their health benefits fully restored,” the court found.

COBRA Claim

The BOE contended that Stylianou and Tieber could not establish that they suffered actual economic damages when the COBRA coverage was terminated; therefore they were not entitled to relief.

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benefits or contributions, until the end of the grace period. This is an asset for active employees, but what about COBRA qualified beneficiaries?

Notice 2005-86 assisted with any questions by stating that a plan providing the grace period to participants covered on the last day of the plan year must include COBRA qualified beneficiaries. Therefore, if a participant still has an active FSA plan on the last day of the plan year, he or she would also be offered the grace period *at no additional charge*.

In addition, if an employee terminates employment during the grace period, that he or she is entitled to coverage during the entire grace period *without having to elect COBRA*. The rationale is that the former employee satisfied the requirement of having coverage on the last day of the plan year. Finally, the IRS clarified that a qualified beneficiary’s coverage during a grace period does not extend FSA coverage to the new plan year.

Now it’s time to take off the training wheels and go for a test ride. Once you learn the rules regarding COBRA and FSAs, it just like riding a bike; no matter how long it’s been since you last got on, you still remember how to ride.

Following a spin around the block, next month we will review more of how FSAs and COBRA interact, including FSA premium calculations, account balances when multiple qualified beneficiaries elect coverage independently and FSAs in an asset sale. 🏠

The court found it “undisputed” that Stylianou and Tieber did not receive a COBRA election notice on a timely basis. (A plan administrator that violates COBRA’s notice requirements may, in a court’s discretion, be liable for up to \$110 a day from the notice failure date. See ¶1520 of the *Guide*.) In supporting its contention that they did not suffer economic damages due to the lack of notice, the BOE cited *Partridge v. HIP of Greater New York* (see ¶1900, Case No. 397.) However, the court found the BOE’s conclusion unsupported by both COBRA’s plain language and case law.

In *Partridge*, the qualified beneficiary was not denied relief based upon a lack of “actual economic damages” *per se*; rather, it was because when the health coverage was terminated, she was immediately covered under another plan and therefore suffered no injury from the alleged notice failure. But here in contrast, Stylianou and Tieber “were completely without coverage for nearly one year before they were provided with the opportunity to elect retroactive coverage,” the court stated. Under those circumstances, the court declined to dismiss the COBRA claims due to a lack of actual economic damages.

Implications

To the extent the *Messer* decision stands for the proposition that COBRA notice penalties could be imposed even if the qualified beneficiary did not lose coverage (because the error was corrected), the result in the case is not that surprising or novel. Of course, further proceedings will determine whether penalties were appropriate.

What is somewhat unusual in this case is that Stylianou’s domestic partner, Linda Tieber, was essentially treated as a qualified beneficiary without any qualification. Under COBRA, the only individuals who can be “qualified beneficiaries” are employees, their spouses and their dependent children. Although Stylianou and Tieber registered in New York as domestic partners, that would not make Tieber a COBRA qualified beneficiary unless she qualified as a “spouse.”

The implication of this is if the court were to later award COBRA notice penalties due to the BOE’s failure to provide COBRA notices, these penalties ought not be imposed based on a notice failure regarding Tieber. Although she was treated as a covered “dependent” under the plan and the BOE provided contractual COBRA-like rights to domestic partners like Tieber, that should not necessarily provide Tieber with the same federal law statutory protections provided to spouses unless she qualifies as a spouse. 🏠