VOLUME 30, NUMBER 3

JOURNAL *of* PENSION PLANNING & COMPLIANCE

Editor-in-Chief: Bruce J. McNeil

Defined Contribution Health Plans: HRAs and HSAs

BRIAN L. SHIKER

Brian L. Shiker is an associate in the Washington, DC, office of Hogan & Hartson LLP. He is a member of the tax practice group with a focus on employee benefits matters.

The cost and administrative burden of providing health care benefits to employees has grown rapidly in the last several years, and most observers believe that double-digit inflation will continue to plague sponsors of group health insurance for years to come.[1] Consequently, employers are eager for new and innovative ways in which to moderate the rising costs of providing health care benefits. Perhaps the most promising health care model to come along in recent years to fight increasing costs is the defined contribution health care plan (DC Health Plans).

There are two primary DC Health Plan forms today. The first is known as a Health Reimbursement Account (HRA) and the second is known as a Health Savings Account (HSA). Both are being heavily marketed to employers.[2] This article examines and compares the structure of these two DC Health Plan forms, and it discusses the tax and practical aspects of administering them.

WHAT ARE DC HEALTH PLANS?

The term "defined contribution" is used to describe this new breed of health plan because it is structured to limit an employer's contribution to a health plan to a specified amount. Such a structure is familiar to both employers and employees because it resembles the 401(k) plans already maintained by many employers. Just as with 401(k) plans, DC Health Plans make costs more predictable for employers, possibly at prices lower than traditional plans, and increase the control available to employees.

While most employers have yet to adopt DC Health Plans, many are beginning to investigate the various DC Health Plan structures available in the marketplace. The two most popular forms for a DC Health Plan are (1) the HRA and (2) the HSA.

While both DC Health Plan forms are recent creations, the HRA has been in use the longest. The IRS gave its imprimatur to HRAs in 2002 when it issued guidance on their use in Revenue Ruling 2002-41. Under an HRA, an employer establishes an unfunded bookkeeping account for each employee participating in the employer's health plan (an HRA Account). It then, typically on an annual basis, contributes a fixed amount of money to the employee's individual HRA Account and, in conjunction therewith, provides high deductible health insurance. The employee may use the money contributed to the HRA Account to pay deductibles or medical expenses not otherwise covered by the high deductible health insurance. Amounts that are not used by an employee during a given year may be rolled over from year to year. Upon an employee's termination of employment, he or she forfeits the balance of his or her HRA Account.

The availability of HSAs is a more recent phenomenon. They were created by President George W. Bush's Medicare Reform Act (the Act) in 2003.[3] Under an HSA, an employer[4] establishes a funded, non-forfeitable, tax-exempt trust (the HSA Account) on the behalf of each employee participating in the employer's health plan. It then, typically on an annual basis, contributes a fixed amount of money to the employee's individual HSA Account and, in conjunction therewith, provides high deductible health insurance. In addition to employer contributions, an employee is permitted to make additional contributions to his or her HSA Account. An employee may use the money contributed to the HSA Account by both the employee and the employer to pay deductibles or medical expenses not otherwise covered by the high deductible health insurance. Amounts that are not used by an employee during a given year may be rolled over from year to year. Upon an employee's termination of employment, he or she does not forfeit the balance of the HSA Account.

HRAs and HSAs raise multiple tax and practical issues that will be addressed below. This list of issues is not meant to be exclusive, but I have attempted to highlight the most common issues that an employer will face when implementing a DC Health Plan.

HRA'S TAX TREATMENT

The tax treatment of an HRA is straightforward. The employer's contribution is deductible; the employee is not taxed on the receipt of the benefit; and the rollover of unused funds is permissible.[5] The sole guidance for the tax treatment of HRAs is provided in Revenue Ruling 2002-41 and Notice 2002-45.

Employer Deductibility

Amounts an employer contributes to an individual's HRA Account are deductible by the employer in the year in which a reimbursement is made from the HRA Account to the employee. Internal Revenue Code Section 162 provides that employer contributions to group health plans, directly or indirectly, on the behalf of employees are deductible to the employer. Code Section 162(n)(3) defines a group health plan to be any plan that provides health care to employees and their dependents.

An HRA fits within the Section 162 deductibility requirements. It is a group health plan offered by an employer to provide health coverage to its employees. While an HRA may appear more complicated than a traditional group health plan, it is merely a self-insured health care plan tethered to a high deductible health insurance product. All the reimbursements paid by the employer out of an employee's HRA Account will be used solely to pay health care expenses. Therefore, the employer's contributions to the HRA Account will qualify as a program sponsored by or contributed to by an employer that provides health care to employees and dependents.

Benefit Is Not Taxable to Employees

HRA reimbursements for medical care expenses are not taxable to employees. Specifically, Code Section 105(b) provides that any amount paid, directly or indirectly, to an employee to reimburse him or her for medical care expenses is not included in the employee's taxable income.

In Revenue Ruling 2002-41 and Notice 2002-45, the IRS applies the language of Code Section 105 to HRAs, and it states that reimbursements from such plans for medical care expenses are not included in an employee's gross income. The IRS states that in order to receive such favorable tax treatment HRAs must:

- Solely cover employees,[6] employees' spouses,[7] and employees' dependants;
- Provide only for the reimbursement of IRC § 213(d) medical care expenses; and
- Provide only for employer contributions to the individual HRA Accounts.

Reimbursement of Medical Care Expenses

The IRS emphasizes that HRA Accounts may only make reimbursements for Section 213(d) medical care expenses.[8] They may never provide any additional benefit, such as cash or life insurance, without losing their favorable tax treatment. If any HRA participant receives the right to any benefit other than a right to reimbursement for medical care expenses, *all* HRA reimbursements to all plan participants, including reimbursements for medical care expenses, will lose their favorable tax treatment and be includable in gross income under Code Section 105.

Employer Contributions and Salary Deferrals

The IRS guidance also emphasizes that contributions to the HRA Account portion of an HRA must be made solely by the employer. An employee may not elect to contribute salary deferrals to his or her HRA Account (Disqualifying Salary Deferrals). If an employee is permitted to make a Disqualifying Salary Deferral, the HRA Account portion of the HRA will constitute a Code Section 125 cafeteria plan.

Whether an HRA receives Disqualifying Salary Deferrals is not always easily determinable. If an HRA, however, offers employees the opportunity to make salary deferrals to pay for the medical insurance that is linked to the HRA, their HRA Accounts are not presumed to receive Disqualifying Salary Deferrals. Thus, an employer can allow employees to pay, through salary deferrals, a portion of the premium for high deductible medical insurance and concurrently create employer-funded HRA Accounts in which the same employees can pay down the deductibles for such medical insurance. More specifically, the IRS provides that an HRA Account will be considered to have received Disqualifying Salary Deferrals if:

1. An employee's salary deferrals exceed the cost of the medical insurance premium;

2. There is an indirect link between the HRA Account and the medical insurance;[9] or

3. An employee is permitted to use his or her HRA Account to pay any portion of the medical insurance premium.

Claims

The IRS also set forth claims requirements that must be met in order for an HRA to maintain favorable tax treatment. Claims submitted to HRAs must:

1. Be substantiated;[10]

2. Not be attributable to a deduction allowed under Code Section 213 from a prior taxable year; and

3. Not be reimbursed for a medical care expense if the expense was incurred prior to the inception of the HRA or prior to the employee's employment.

Failure to comply with these claims requirements will result in the loss of an HRA's favorable tax treatment.

Rollovers

Rollovers of unused contributions are not permitted in a traditional health flexible spending account. However, rollovers are desirable because the ability to roll over unused contributions provides employees with greater flexibility regarding medical treatment, provides them with a more substantial security net for future medical needs and gives employees the ability to actively allocate their HRA Account balances between current medical needs and saving for the future. Revenue Ruling 2002-41 and Notice 2002-45 establish that employees may roll over their HRA Account balances from one year to another without such amount becoming taxable. The rollover feature effectively permits an employee to save employer contributions to his or her HRA Account for future medical care expenses.

Cafeteria Plan Status

The IRS provides that employees may rollover HRA Account balances because the HRA Account portion of an HRA is not a Code Section 125 cafeteria plan.[11] The HRA Account feature is distinct from a cafeteria plan because cafeteria plans:

1. Must provide an employee with a choice between cash and a benefit; and

2. Are funded through salary deferrals.[12]

Contributions to HRA Accounts are made on a discretionary basis by the employer out of its assets and, as a result, do not qualify as salary deferrals. Further, an employee is not given a choice between the receipt of cash and a contribution to the HRA Account; an employee's salary will not be increased if the employer chooses not to offer the HRA. Since the HRA does not meet the statutory requirements of a cafeteria plan, it will not be subject to the cafeteria plan regulations that prohibit the rollover of contributions.

Constructive Receipt

The rollover of an HRA Account balance is also possible without losing favorable tax treatment because the rollover of the HRA Account will not be deemed to be a constructive receipt of income. Constructive receipt does not result if income is subject to substantial restrictions or there is a substantial risk of forfeiture.[13] So long as an HRA is structured so that the employer may terminate the plan at any time, a substantial risk of forfeiture exists. Further, if an employee may only access the funds in his or her HRA Account for medical care expenses, the funds are subject to substantial restrictions. Money subject to roll over, therefore, remains at substantial risk for forfeiture and subject to substantial restriction.

Distributions

As noted above, the IRS guidance provides that distributions may never be made from HRA Accounts for any reason other than the reimbursement of medical care expenses. As a result, employees who accumulate large HRA Account balances by rolling over their HRA Accounts from year to year may still only use such amounts to reimburse medical care expenses. Such prohibition may not be circumvented by adjusting an employee's salary or bonus to reflect a surplus HRA Account balance. HRAs may, however, allow an individual to continue to be reimbursed for medical care expenses after termination of employment until the entire HRA Account balance is exhausted.

HSA TAX TREATMENT

The tax treatment of an HSA is also straightforward. As with an HRA, the employer's contribution is deductible; the employee is not taxed on the receipt of the benefit; and the rollover of unused funds is permissible.[14] However, an HSA also permits employees to make their own contributions to their respective HSA Accounts. After age 65, HSA funds may be distributed to a participant for any reason without adverse tax consequences. HSAs were statutorily created by the Act, and the sole HSA guidance is provided in the recently released Notice 2004-2.

Employer Deductions

As with HRAs, amounts an employer contributes to an individual's HSA Account are deductible by the employer. Code Section 162 provides that employer contributions to group health plans, directly or indirectly, on the behalf of employees are deductible to the employer. Code Section 162(n)(3) defines a group health plan to be any plan that provides health care to employees and their dependents. An HSA fits within the Section 162 deductibility requirements in the same manner outlined above for HRAs.

Unlike an employer contribution to an HRA Account, an employer's contribution to an HSA Account is deductible by the employer in the year that the contribution was made to the employee's HSA Account. The employer is able to take a deduction in the year of the employer's contribution because the contribution to the employee is not forfeitable. Once the contribution has been made to an employee's account, the employer no longer has a claim to any of the contribution and the contribution is treated as "paid or incurred" for purposes of Code Section 162.

Employee Contributions

A significant difference between an HSA and an HRA is that the Act specifically provides employees with the option of making contributions to their own HSA Accounts. If made available by the employer, an employee may make contributions to his or her HSA Account on a pre-tax basis through the employer's cafeteria plan. If the employee does not have the option of making contributions on a pre-tax basis, any employee contributions become deductible when he or she computes his or her gross income. The contributions are deductible whether or not the employee itemizes his or her deduction.

Benefit Is Not Taxable to Employees

The Act provides that HSA reimbursements for qualified medical care expenses are not taxable to employees. Specifically, an HSA Account must meet the following requirements to qualify for favorable tax treatment:

- Be a funded, non-forfeitable trustee or custodian account;
- Provide only for the reimbursement of Section 213(d) medical care expenses; and
- Maintained in conjunction with a High Deductible Health Plan.

Trust or Custodial Account

Contributions to an HSA Account must be held in a non-forfeitable, tax-exempt trust or custodial account that has been established for the purposes of paying the beneficiary's medical expenses (the Trust Account). The

Trust Account must be held by a bank, a life insurance company, or other entity who demonstrates to the Secretary of the Treasury that it will maintain the Trust Account in a manner consistent with the HSA requirements. Contributions to the Trust Account may only be made in cash,[15] and they may not be commingled with other funds unless they are invested in a common trust fund or a common investment fund. The Trust Account's income and earnings are generally not subject to taxation, but they are subject to UBTI requirements,[16] as well as the prohibited transaction rules of Code Section 4975 (in the same manner as that section applies to IRAs).

The Act does not limit who may have responsibility for investing Trust Accounts. Trust Account investments may be employee-directed or may be made by the trustee or the employer that sponsors the HSA. The only limit placed on the investments of a Trust Account is that a Trust Account may not invest in life insurance contracts.

Reimbursement of Medical Care Expenses

Reimbursements may be made on the behalf of the HSA Account's beneficiary, spouse, or qualifying dependents for qualified medical expenses to the extent such expenses are not reimbursed by insurance or otherwise. As with HRAs, qualified medical expenses are defined as Code Section 213(d) medical care expenses.

The Act modifies the definition of medical expenses in Code Section 213(d) to provide that qualified medical expenses generally do not include payments for health insurance premiums. However, the Act specifically excludes the following premium payments from such general prohibition:

- COBRA premiums;
- Premium payments for a qualified long-term care insurance contract as defined by Code Section 7702B;
- Premium payments for any health plan maintained while the individual is receiving unemployment compensation under any federal or state law; or
- For those age 65 or older, premium payments for any health insurance other than a Medicare supplemental policy.[17]

High Deductible Health Plan

An employee may only participate in an HSA if:

1. He or she is participating in a high deductible health plan (HDHP); and

2. He or she is not covered under any other health plan that provides the same benefits as the HDHP.[18]

An HDHP is a health plan that has an annual deductible of not less than $1,000 for individual coverage, and $2,000 for family coverage. The maximum out-of-pocket expenses under an HDHP cannot exceed $5,000 for individual coverage or $10,000 for family coverage. If the HDHP is a network plan, the plan's annual deductible and out-of-pocket limitations for out-of-network expenses are not considered in determining whether the plan qualifies as an HDHP. A plan will not fail to qualify as a HDHP simply because it does not have a deductible for preventative care.[19] In the case of family coverage, a health plan with stacked deductibles will not qualify as an HDHP if benefits are provided to any individual before the family deductible is met.

Despite the prohibition against other coverage, an employee may maintain limited forms of insurance or other coverage for accidents, disability, dental care, vision care, or long-term care. Further, the Act permits certain "permitted" insurance or other coverage in addition to the HDHP coverage (even though such insurance or coverage provides benefits also covered by the HDHP.) Permitted insurance or coverage includes:

1. Insurance for which substantially all of the coverage is provided by workers' compensation insurance, tort liabilities insurance, or property insurance;

2. Insurance for a specified disease or condition (such as cancer insurance); and

3. Hospital indemnity insurance.

Certain individuals are still not permitted to maintain HSA Accounts even if they participate in an HDHP. Specifically, the following individuals cannot maintain HSA Accounts:

- Individuals who may be claimed as tax dependents of another individual;

- Individuals covered under a spouse's or dependent's employer's health plan;

- Individuals covered under a comprehensive major medical insurance policy; and

- Individuals covered under a Health FSA or HRA unless coverage under such HRA or Health FSA is limited to permitted benefits or specific benefits not provided by the HDHP.

In addition, individuals who are eligible for Medicare cannot continue to have contributions made for them or make contributions to an HSA Account on a tax-deductible basis.

Claims

The IRS explains in Notice 2004-2 that employers are not required to seek any form of substantiation prior to making a distribution to an HSA Account beneficiary. Substantiation is not required because the HSA Account is a separate Trust Account that is owned and controlled by the employee, not the employer. Without control over the HSA Account, an employer cannot be held responsible for monitoring the use of the distributions. However, the IRS may still require an employee to substantiate qualified medical expenses to it at some later date.

Contribution Limits

Unlike HRAs, HSAs have contribution limits. The maximum annual contribution (calculated on a monthly basis) for an employee with individual coverage in 2004 is the lesser of the annual deductible for the HDHP or $2,600.[20] The maximum annual contribution (calculated on a monthly basis) for an employee with family coverage in 2004 is the lesser of the annual deductible for the HDHP or $5,150.[21] The family coverage contribution limit is the same whether or not both spouses have an HSA Account or are eligible to participate in an HDHP.[22] These annual limits take into account both employer and employee contributions, and they must be reduced by any contributions to an Archer MSA[23] during the same year.

Individuals age 55 or older are permitted to make contributions above the regular contribution limits. Such additional contributions may be made as provided in Figure 1.

Figure 1. Additional Contribution Amounts for Years 2004 through 2009 and After

Year	Additional Contribution Amount
2004	$500
2005	$600
2006	$700
2007	$800
2008	$900
2009 and after	$1,000

Rollovers

As with HRAs, employees may rollover their HSA Account contributions from one year to the next. However, unlike HRAs, employees do not forfeit their HSA Account balances upon termination of employment. The rollover feature of an HSA Account is inherent in the non-forfeitable nature of an HSA Account, and it is specifically provided for in the Act.

The non-forfeitable nature of HSA Account contributions makes the rollover of contributions from one year to the next even more valuable than under HRAs. In addition to the rollover benefits outlined above for HRAs, the HSA Account rollover contributions may be saved for future medical expenses that are incurred after an employee terminates employment. This feature allows an HSA to serve as a form of retiree health care savings. Further, the employee may elect to use his or her HSA Account contributions for non-medical expenses after age 65 without incurring any penalties. These two additional factors make HSA Accounts valuable from a retirement planning perspective.

Distributions

A tax-free distribution may be made to a beneficiary from an HSA Account for qualified medical expenses at any time. If a distribution is made from an HSA Account other than for a qualified medical expense, (1) the distribution is included in the account beneficiary's gross income, and (2) the distribution is subject to an additional 10 percent tax. Unlike with an HRA, the use of HSA Account contributions for other than qualified medical expenses will not adversely impact any other employees who participate in the HSA.

The 10 percent tax penalty does not apply to any distributions from an HSA Account that are made in the following instances (regular income tax does still apply):

- Payments made following the account beneficiary's death;[24]

- Payments made after the account beneficiary becomes eligible for Medicare (age 65);

- Payments made after the account beneficiary becomes disabled as defined under Code Section 72;

- The return of excess contributions in accordance with the statute's requirements; and

- Permissible rollover contributions from one HSA maintained by the beneficiary to another.[25]

PRACTICAL ISSUES

As employers become comfortable with the tax treatment of HRAs and HSAs and put such plans into place, they are confronted with a variety of practical issues. While some answers to these practical issues are found either in the Act or Notice 2004-2, with respect to HSAs, or Revenue Ruling 2002-41, Notice 2002-45 or in the application by analogy of prior IRS guidance, with respect to HRAs, many issues will be left to the individual employers to be resolved. A discussion follows of some of the most important practical issues raised. Again, the list is not meant to be exhaustive.

COBRA

Participants in group health plans who lose coverage due to a COBRA qualifying event have the right to elect to continue their health coverage.[26] The IRS has provided divergent guidance on COBRA with respect to HSAs and HRAs.

HSAs

Only the HDHP offered in conjunction with an HSA is subject to COBRA. Notice 2004-2 specifically provides that HSAs are not subject to COBRA. The IRS reasons that HSAs are equivalent to Archer MSAs, and Archer MSAs are not subject to COBRA. However, because the HDHP offered in conjunction with an HSA is an employer-provided group health plan,[27] it remains subject to COBRA.

HRAs

Both the medical insurance portion and the HRA Account portion of an HRA fall within the definition of a group health plan and must be covered by COBRA. Specifically, Revenue Ruling 2002-41 and Notice 2002-45 stated that the HRA Account portion of an HRA qualifies as a group health plan.

Revenue Ruling 2002-41 and Notice 2002-45 stated that employers, upon an individual's election of COBRA, must provide for continued coverage under an HRA at the same level as existed at the time of the COBRA qualifying event. Further, the employer must increase the HRA Account balance of a COBRA beneficiary at the same time and in the same increments as similarly situated non-COBRA beneficiaries. This means that employers must allow individuals on COBRA to retain the HRA Account balances they had accrued at the time of the COBRA qualifying event. Furthermore, an employer must make an additional and equal contribution to a COBRA beneficiary's HRA Account when it makes contributions on behalf of all other employees. The IRS emphasized that even if an employer permits an employee to continue to apply for reimbursements from his or her HRA Account after the COBRA qualifying event, the employer must comply with the full weight of COBRA as outlined above.

There is a question of how many COBRA elections are required in relation to HRAs. In other words, must an employee be given separate COBRA elections for the HRA and the related high-deductible insurance, or may the employer require employees to elect the two features in a bundle? The answer to this question lies in the plan design. If active employees are permitted to participate in the HRA only in conjunction with their participation in an underlying health plan, then a single COBRA election should be acceptable. However, if active employees may participate in the HRA independent of participation in an underlying health plan, then separate COBRA elections must be offered.

While the IRS has addressed the application of COBRA to HRAs, it has provided only limited guidance on how to determine the monthly premium that may be charged to individuals for the maintenance of COBRA. Revenue Ruling 2002-41 and Notice 2002-45 clarify that the COBRA premium may not be based on the amount of an employee's HRA Account balance at the time of the COBRA qualifying event.

For example, an employee with an HRA Account balance of $1,500 and an employee with an HRA Account balance of $350 must pay the same monthly COBRA premium. The IRS has not released specific guidance regarding the method for calculating the COBRA premium, other than to state that the premium should be calculated in accordance with Code Section 4980B. The IRS guidance regarding the application of COBRA to Health FSAs, however, provides a useful model. In the Health FSA context, the participant pays 102 percent of the monthly salary deferral in order to receive the COBRA benefit. Similarly, in the context of continuing participation in an HRA, an employee probably should pay a COBRA premium equal to 102 percent of the monthly employer contribution (*i.e.*, the annual employer contribution divided by 12). The Health FSA guidance is applicable because both the Health FSA and an HRA Account rely on individual accounts maintained by an employer. The analogy, however, is not perfect because while the Health FSA premium corresponds to employee contributions, the HRA relies on employer contributions.

Coordination with Health FSAs

HSAs

Whether an employee may maintain a Health FSA in conjunction with an HSA Account is not clear. The problem with maintaining both an HSA Account and a Health FSA account exists because a Health FSA account is accessible prior to the exhaustion of the HDHP's deductible. As a result, an employee with a Health FSA may not comply with the requirement that an employee only be covered by an HDHP.

The problematic coordination of Health FSAs and HSA Accounts is recognized by the IRS in Notice 2004-2. The IRS is seeking comments on the issues, and it will hopefully issue additional guidance on the subject soon. However, many commentators believe that the IRS will ultimately permit some form of coordination.

HRAs

After the adoption of an HRA, many employers will continue to sponsor Health FSAs. Revenue Ruling 2002-41 and Notice 2002-45 address the order in which claims may be made to the HRA and the Health FSA. The IRS stated that an employee must exhaust his or her entire HRA Account balance before he or she may claim reimbursements from a Health FSA. However, an employee may request reimbursement from his or her Health FSA prior to requesting reimbursement from his or her HRA Account if the claim is either not covered by the HRA or the HRA specifically provides for such ordering. An employee may never seek simultaneous reimbursement from his or her HRA Account and his or her Health FSA.

Claims Substantiation/Fraud

Between HSAs and HRAs, only HRAs are subject to claim substantiation requirements. As outlined above, employers are not required to create claims substantiation procedures with respect to HSA Accounts because HSA Accounts are maintained by the employee, not the employer. If an employee elects to fraudulently claim reimbursements for non-qualified medical expenses, only he or she will bear the wrath of the IRS.

Employers who maintain HRAs, on the other hand, have two reasons to create strict claims substantiation procedures. First, because the HRA Accounts are funded with employer funds, the potential for fraudulent claims is great. Employees may be tempted to create claims for false medical expenses in order to obtain reimbursements from their HRA Accounts. Employees in need of cash or employees with few medical expenses may be tempted to create false claims in order to take advantage of the employer contributions to their HRA Accounts. Second, Revenue Ruling 2002-41 and Notice 2002-45 require an HRA to substantiate claims.

While the recent IRS guidance does not set forth the manner in which claims must be substantiated, the IRS regulations regarding Health FSAs are instructive and provide a good model for employers.[28] First, existing claims substantiation regulations require that the participant provide a written statement from an independent third party stating (1) that the medical expense has been incurred; and (2) the amount of the expense. An example of such a statement is a doctor's bill or receipt. Second, the participant must provide a written statement declaring that the medical expense has not been reimbursed or is not reimbursable under any other health plan coverage. An administrator might also require the participant to declare that he or she will not make a claim for the same expense under any coexisting health flex spending account or other form of health benefits insurance or plan, and certify that the expense was incurred for the participant or the participant's eligible dependent. The following is a sample participant statement:

> I certify (1) that these medical expenses were incurred for me or for my eligible dependent, and (2) that these expenses have not been reimbursed and are not reimbursable under my insured medical plan or any other health plan, such as my spouse's or dependent's health plan. I understand that the expense for which I am reimbursed may not be used to claim any federal income tax deduction or credit. I certify that I will not claim reimbursement for this expense under any health flexible spending account plan that I participate in through my employer or my spouse's or dependent's employer.

Finally, the existing Health FSA regulations require that claims be administered by someone other than the participant. This requirement simply means that the employer or a third party must administer claims for reimbursement from the HRA.

By adopting claims procedures similar to those described above, employers can comply with the IRS' srequirements for favorable tax treatment of HRAs and protect themselves from fraudulent claims.

Discrimination Rules

HSAs

The Act specifically provides that HSAs are subject to certain non-discrimination rules. Specifically, the nondiscrimination requirement provides that comparable contributions to HSA Accounts must be made to all comparable participating employees with the same coverage category (*e.g.*, individual or family). HSA Account contributions are considered comparable if they are either the same amount or the same percentage of the HDHP deductible. The comparability requirement does not apply to contributions that are made through a cafeteria plan. The discrimination test may be run separately for part-time employees. If the non-discrimination test is not satisfied, an excise tax is imposed that equals 35 percent of the aggregate amount contributed by the employer to the HSA Accounts during that taxable period.

HRAs

The HRA Account portion of an HRA is subject to the discrimination rules of Code Section 105(h). Revenue Ruling 2002-41 and Notice 2002-45 emphasize that the HRA Account portion is subject to Code Section 105(h) and Treasury Regulations Section 1.105-11 because the HRA Account portion of the HRA is a self-insured medical expense reimbursement plan. As long as HRAs are made available to all employees and employer contributions to employee's HRA Accounts are uniform, an HRA should not run afoul of Code Section 105(h).

Investments

HSAs

An employer that establishes an HSA must also establish how the individual HSA Accounts should be invested. As outlined above, the employer may elect that the investment of HSA Accounts may either be participant directed or directed by the trustee or the sponsoring employer. As with 401(k) plans, employees are more likely to prefer to control the investment of their HSA Accounts. This will be especially true if employees make contributions to their own HSA Accounts. However, the ultimate decision is that of the employer.

The determination of the HSA Account investment options should be based on what the employer believes are the goals of the participating employees. If the employer believes that the participating employees do not intend to immediately apply the bulk of their HSA Accounts to pay for present medical expenses, than the portfolio of investment options should emphasize long-term investments such as equities. Such an investment portfolio would look much like a 401(k) plan. If the employer believes that the participating employees intend to make more immediate use of their HSA Accounts, the portfolio of investments should focus on liquid short-term investments such as money markets. An employer may wish to hire an investment manager to make the determination of the investment options.

HRAs

An employer that establishes an HRA does not face any decision regarding the investment of HRA Accounts. Because HRA Accounts are simply bookkeeping accounts, there are no assets to invest. However, if an employer desires to provide some return on HRA Account contributions, it may elect to determine the rate of such return by using an index or a pre-determined interest rate.

ERISA Compliance Issues

ERISA governs employer-sponsored welfare plans that provide medical benefits to employees. ERISA-governed health plans must, *inter alia*, comply with the ERISA reporting requirements. Specifically, ERISA reporting requirements require that each health plan:

1. Have its own set of plan documents, such as summary plan descriptions; and

2. File its own annual IRS Form 5500 (assuming the plan has at least 100 participants).

To date, there has been no Department of Labor (DOL) guidance regarding whether HRAs or HSAs are group health plans under ERISA.

HSAs

The DOL is not likely to consider an HSA a health plan for purposes of ERISA. This is because an HSA Account is closer to an Archer MSA than a traditional group health plan. By analogy with an Archer MSA, an HSA Account is likely to viewed by both the IRS and the DOL as the equivalent of an IRA, not a health plan.[29] As with an IRA and an Archer MSA, the HSA Account is a non-forfeitable account owned by the employee, not the employer.

HRAs

The DOL has not yet determined whether an HRA Account is a separate group health plan, or merely part of a single group health plan that combines insured and self-insured features. There is little case law or other legal guidance respecting how to determine the number of group health plans sponsored by an employer. Generally, the greater the overlap in the administration of the respective features of an aggregate group health arrangement, the more likely the arrangement will be treated as a single group health plan for ERISA purposes.[30] An employer must make a decision, based on the facts of his or her particular situation, whether or not to treat an HRA as a single plan or two plans, and comply with ERISA's reporting requirements accordingly.

CONCLUSION

HSAs and HRAs provide an exciting new possibility for employers who seek to better control their health care costs. These plans also represent an opportunity for employees to become more active in the management of the health care that they receive. As outlined in this article, the choice between an HSA and an HRA deserves an employer's careful consideration. The administrative, practical, and tax implications of each must be carefully considered. With the rise of two prominent DC Health Plan formats, DC Health Plans will see increasing usage in years to come.

ENDNOTES

1. According to a recent article in the *Pension & Benefits Reporter*, employers will face a 12.6 percent increase in health care costs for their employees this year. "Report Says Health Care Costs Continue Double Digit Increases," 30 *Pension & Benefits Reporter* 41 at 2299.
2. Numerous major health insurers are now promoting defined contribution health plans. These include Definity Health, Vivius, Inc., Aetna U.S. Healthcare and BlueCross BlueShield of Massachusetts.
3. Health Savings Accounts are authorized under Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. No. 108-173, which added Section 223 to the Internal Revenue Code of 1986, as amended.
4. An HSA Account may also be established by an individual, much as an individual would establish an IRA. However, because the focus of this article is employer-provided health coverage, individually established HSA Accounts will not addressed.
5. For purposes of this tax discussion, we assume that all amounts for which employees are reimbursed qualify as medical expenses under IRC § 213.
6. The term employee includes both current and former employees, including retirees. Former and retired employees may continue to receive medical care expense reimbursements after their termination.
7. For purposes of both HSAs and HRAs a spouse is determined in accordance with state laws, unless such laws are inconsistent with the federal Defense of Marriage Act. The federal Defense of Marriage Act of 1996, Pub. L. No. 104-199, effectively precludes the use of HRAs and HSAs by domestic partners.
8. The IRS recently issued guidance that qualified medical care expenses include over the counter medicines. *See* Rev. Rul. 2003-102.
9. An example of an indirect link is the corresponding increase of an employer's contribution to an employee's HRA Account when an employee increases his or her salary deferral.
10. The IRS has not indicated the manner in which claims should be substantiated.
11. In addition to the prohibition of rollovers, the following cafeteria plan prohibitions are not applicable to HRAs: (1) the requirement that the maximum amount of reimbursement be available at all times during the coverage period, (2) the mandatory 12 month coverage period and (3) all medical expenses must be reimbursed during the same coverage period in which incurred.
12. A cafeteria plan is defined in IRC § 125(d) and Prop. Treas. Reg. § 1.125-2.
13. Constructive receipt is defined in Treasury Regulation Section 1.451-2.
14. For purposes of this tax discussion, we assume that all amounts for which employees are reimbursed qualify as medical expenses under IRC § 213.
15. A non-cash contribution may be made to an HSA Account if the contribution is made as a rollover from either another HSA or from an Archer MSA.
16. UBTI means unrelated business taxable income. The UBTI rules are set forth in IRC §§ 511–515. The application of UBTI to HSAs is analogous to its application to IRAs.
17. An HSA Account may reimburse a beneficiary for Medicare Part A, Medicare Part B, a Medicare HMO, or for employer-sponsored retiree health insurance. An HSA Account may not be used to pay premiums on a Medigap policy.
18. An HSA Account is not required to be established with the same entity that provides the HDHP.
19. It is not entirely clear what Congress meant by "preventive care." The IRS has asked for comments of the appropriate standard. Notice 2004-2.
20. IRC § 223(g) provides for a cost of living adjustment to the contribution limits.
21. The contribution limit is $0 if an individual is Medicare eligible.
22. If both spouses have HDHP coverage, the lowest annual deductible is used for purposes of determining the contribution limit.
23. Archer MSA means Archer medical savings accounts. Archer MSAs are viewed as the precursor to HSAs.
24. If the employee's spouse is the designated named beneficiary, the transfer to the spouse will be tax-free and the HSA Account will continue to be treated as an HSA Account.

25. A permissible rollover contribution is any amount distributed from an HSA Account to an account beneficiary that is deposited into an HSA Account for the benefit of *that* beneficiary within 60 days after the distribution is received. An account beneficiary may roll over his or her account balance only once every 12 months. Rollovers between HSAs are permitted on a tax-free basis and amounts from an Archer MSA may be rolled into an HSA Account without detrimental tax consequences.
26. IRC § 4980B outlines the requirements for continuation coverage. It applies to employers with 20 or more employees.
27. IRC § 162(n)(3) provides the definition of a group health plan.
28. Prop. Treas. Reg. § 1.125-2 Q/A-7(b)(5) contains the claims substantiation requirements.
29. IRAs are not subject to ERISA reporting requirements.
30. *See generally District of Columbia v. Greater Washington Board of Trade*, 504 U.S. 125, 113 S. Ct. 580 (1992) (discussing what constitutes an ERISA plan in the context of an ERISA state law preemption question).

Reprinted from *Journal of Pension Planning & Compliance*,
Volume 30, Number 3, Fall 2004, pages 96-113,
with permission from Aspen Publishers Inc.,
A WoltersKluwer Company, New York, NY 1-800-638-8437,
www.aspenpublishers.com

A WoltersKluwer Company