

**HRAs or HSAs,  
How Does an Employer Decide?**

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**By**

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## **Introduction**

As health care costs soar, employers are forced to find ways to (1) cut costs and/or (2) shift more of the costs to participants. They are accomplishing this by increasing deductibles, co-pays and co-insurance amounts and reducing benefits. The theory is if participants are more responsible for paying health expenses they will be more responsible with their own dollars.

Two vehicles that employers are considering in cutting costs and/or shifting more of the cost to employees are Health Reimbursement Arrangements (HRAs) and Health Savings Accounts (HSAs). Because the interplay between these two vehicles in any year is very limited, an employer must decide which one is best for its situation. To assist an employer in deciding between HRAs and HSAs, the following discussion compares the important features of each in a question and answer format and then discusses their advantages and disadvantages.

## **Important Features**

### **What are they?**

**HRAs** - They are considered to be health reimbursement arrangements under Internal Revenue Code (Code) Section 105(h). They were authorized under Internal Revenue (IRS) Notice 2002-45 and Revenue Ruling 2002-41. They are funded by only employer contributions and can be used to reimburse “qualified medical expenses” and premiums designated by the employer. Unlike other health reimbursement plans, an employer may allow participants under a HRA to carry over any unspent amounts to future plan years, as designated by the employer.

**HSAs** - As part of the Medicare Prescription Drug Improvement and Modernization Act of 2003, Congress added Code Section 223 which created HSAs for tax years beginning after December 31, 2003. HSAs provide employees with a tax-free basis for paying current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. In general, HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of an employee and his or her spouse and dependents that are subject to rules similar to those applicable to individual retirement arrangements.

Within limits, contributions to HSAs are deductible if made by or for an eligible individual and are excludable from such individual’s income and wages for employment tax purposes if made by the employer of an eligible individual or made by the employee in the form of pre-tax salary reduction contributions. Distributions from HSAs for qualified medical expenses are not includible in the eligible individual’s gross income. Distributions that are not for qualified medical expenses are includible in an eligible individual’s gross income and are subject to an additional 10-percent tax. The additional 10-percent tax does not apply for distributions made after death, disability, or when the individual attains the age of Medicare eligibility (i.e., age 65).

**Which employers may sponsor?**

**HRA** - Any employer may sponsor an HRA.

**HSA** - Any employer may sponsor an HSA.

**Which employees may participate?**

**HRA** - An employer determines which employees and/or former employees will participate in the HRA. An employer may exclude any employee as long as the HRA satisfies the nondiscrimination requirements of Code Section 105(h). Self-employed individuals, including partners in a partnership and more-than-2% shareholders in a subchapter S corporation, cannot participate on a tax-favored basis, as provided in IRS Notice 2002-45.

**HSAs** - For any month, an eligible individual is defined under Code Section 223(c)(1)(A) as any individual who:

- Is covered only by a high-deductible health plan (HDHP) as of the first day of such month;
- Is not also covered by any other health plan that is not a HDHP (with certain exceptions for plans providing certain limited types of coverage);
- Is not enrolled in benefits under Medicare; and
- May not be claimed as a dependent on another person's tax return.

Under Code Section 223(c)(1)(B), an employee may be eligible for other "permitted coverage" or "permitted insurance" in addition to a HDHP and still be eligible to make or receive a contribution to a HSA.

Under Code Section 223(c)(3), "permitted insurance" includes:

- Insurance if substantially all of the coverage provided under such insurance relates to:
  - Insurance incurred under worker's compensation law,
  - Tort liability insurance, or
  - Property insurance (e.g., auto insurance).
- Insurance for a specified disease or illness (e.g., cancer insurance); and
- Insurance that provides a fixed amount per day (or other period) of hospitalization.

Under IRS Notice 2004-50, Q/A-8, the IRS provides that benefits for “permitted insurance” must be provided through insurance contracts and not on a self-insured basis. However, where benefits (such as workers’ compensation benefits provided in satisfaction of statutory requirement and any resulting benefits) for medical care are secondary or incidental to other benefits, the benefits will qualify as “permitted insurance” even if self-insured.

Under Code Section 223(c)(1)(B)(ii), “permitted coverage” includes coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

Under Code Section 223(c)(2)(A), a HDHP is an insured or self-insured health plan that satisfies certain requirements with respect to deductibles and out-of-pocket expenses. In the case of individual coverage, the plan must have an annual deductible of not less than \$1,100 for 2008, \$1,150 for 2009 and \$1,200 for 2010, and in the case of family coverage, the plan must have an annual deductible of not less than \$2,200 for 2008 \$2,300 for 2009 and \$2,400 for 2010. In addition, the plan's annual deductible for out-of-network services is not taken into account in determining the annual contribution limit. Rather, the annual contribution limit is determined by reference to the deductible for services within the network.

In addition, the maximum out-of-pocket expense limit on covered expenses cannot exceed \$5,600 for 2008, \$5,800 for 2009 and \$5,950 for 2010 in the case of individual coverage and \$11,200 for 2008, \$11,600 for 2009 and \$11,900 for 2010 in the case of family coverage under Code Section 223(c)(2)(A)(ii). Out-of-pocket expenses include deductibles, co-payments, and other amounts (other than premiums) that the individual must pay for covered benefits under the plan.

The IRS provides in IRS Notice 2004-2, Q/A-3, a plan does not fail to qualify as a HDHP merely because it does not have a deductible (or has a small deductible) for preventive care (e.g., first dollar coverage for preventive care). However, except for preventive care, a plan may not provide benefits for any year until the deductible for that year has been met.

In Revenue Ruling 2004-38, the IRS provides that Individuals covered by both a HDHP that does not cover prescription drug benefits and a separate prescription drug plan (or rider) that provides benefits before individuals have satisfied the minimum annual deductible requirement on a first dollar basis, will not be eligible to make contributions to a HSA. Since a prescription drug program is not considered “permitted insurance”, such a program must meet the requirements for a HDHP and comply with the required minimum annual deductible requirement.

Under IRS Notice 2004-50, Q/A-12, “family coverage” under a HDHP is any coverage other than individual coverage. Therefore, family coverage would include a health plan covering one eligible employee and at least one other individual (whether or not the other individual is an eligible individual).

Under Code Section 223(c)(1)(A)(ii), an employee may not make or receive a contribution to a HSA if he or she is covered under:

- A spouse's or dependent's employer's health plan;
- A comprehensive major medical individual insurance policy; or
- A Health FSA or HRA unless coverage under such HRA or Health FSA is limited to "permitted coverage" or "permitted Insurance" or other benefits, as provided in IRS Notice 2004-50, Q/A-7 and Revenue Ruling 2004-45 .

### **Must the ERISA requirements be met?**

**HRA** - Yes. HRAs are considered to be "welfare benefit plans", as defined under ERISA Section 3(1) and as such the following main compliance obligations would have to be followed:

- Plan document must exist;
- Fiduciary standards must be followed;
- Fidelity bond must be purchased to cover every person who handles plan funds;
- Summary plan description (SPD) must be furnished automatically to plan participants;
- Summary of material modification (SMM) must be furnished automatically to plan participants when a plan is amended;
- Copies of certain plan documents must be furnished to participants and beneficiaries on written request;
- Form 5500 must be filed annually for each plan (subject to important exemptions, especially for small plans);
- Summary annual report (summarizing Form 5500 information) must be furnished automatically to plan participants for a plan that files a Form 5500 (except totally unfunded welfare plans);
- Claim procedures must be established and carefully followed when processing benefit claims and when reviewing appeals of denied claims;
- Plan assets, including participant contributions, may be used only to pay plan benefits and reasonable administrative expenses; and
- Plan assets may have to be held in trust, if benefits are funded.

**HSA** - In DOL Field Assistance Bulletin (FAB) 2004-1, the DOL provided that HSAs generally will not constitute "welfare benefit plans" under ERISA Section 3(1) if

employer involvement with the HSA is limited, whether or not the employee's HDHP is sponsored by an employer or obtained as individual coverage.

HSAs that meet the safe harbor for group or group-type insurance programs under DOL Regulations Section 2510.3-1(j) will not be considered ERISA welfare plans. Under that section, a group-type insurance plan is not an ERISA welfare plan if: (1) it is a "group-type" insurance program offered by an insurer to employees or members of an employee organization; (2) no contributions are made by an employer or employee organization; (3) participation in the program is completely voluntary; (4) the sole functions of the employer or employee organization are, without endorsing the program, to permit the insurer to publicize the program to employees or members, to collect premiums through payroll deductions or dues checkoffs, and to remit them to the insurer; and (5) the employer or employee organization receives no consideration in the form of cash or otherwise in connection with the program, other than reasonable compensation, excluding any profit, for administrative services actually rendered in connection with the payroll deductions or dues checkoffs.

In FAB 2004-1, the DOL treats HSAs differently from other group plans if the employer makes employer or salary reduction contributions to the HSA. Making such contributions will not necessarily be significant in determining the status of HSAs under ERISA.

Because of the personal nature of HSAs (employees and beneficiaries have total control over the accounts), the DOL indicates that the making of employer contributions is not a relevant factor in determining whether a HSA is an ERISA welfare plan.

Further in FAB 2004-1, the DOL indicates that a HSA will not be an ERISA welfare plan if the establishment of the HSA on the part of employees is voluntary and the employer does not:

- Limit the ability of eligible individuals to move their funds to another HSA, beyond restrictions imposed by the Code;
- Impose conditions on the utilization of HSA funds beyond those permitted under the Code;
- Make or influence the investment decisions with respect to funds contributed to a HSA;
- Represent that the HSA is an employee welfare benefit plan established or maintained by the employer; or
- Receive any payment or compensation in connection with the HSA.

An employer may limit the forwarding of contributions through its payroll system to a single HSA provider (or permit only a limited number of HSA providers to advertise or

market HSA products), and such an arrangement would not be subject to ERISA, unless there were restrictions in the movement to another HSA.

**Can an employee participate in a Health FSA the same month and still be eligible?**

**HRA** - Yes. In IRS Notice 2002-45, the IRS provides that an employee may participate in a HRA and health FSA in the same month and the same year. If the expense is eligible to be paid by either the HRA or health FSA, the IRS indicated the HRA must pay the expense first unless the employer, in its HRA plan document, indicates that the health FSA will pay the expense first.

**HSA** - In Revenue Ruling 2004-45, the IRS provides that an employee cannot participate in a health FSA, HRA and HSA in the same month, unless the employee's situation is one of the following:

- The employee's expenses reimbursed under a Health FSA and/or a HRA are limited to dental, vision and/or preventive care benefits ("Limited Purpose Health FSA or HRA");
- If an employee suspends participation in a HRA for the year ("Suspended HRA");
- Health FSA or HRA pays expenses above the deductible of the HDHP ("Post-Deductible Health FSA or HRA"); or
- HRA pays or reimburses the employee's expenses incurred after the employee retires ("Retirement HRA").

**What types of contributions are allowed?**

**HRA** - In IRS Notice 2002-45, the IRS provides that HRAs must be funded solely by the employer and no pre- or post-employee salary reduction contributions are allowed.

**HSA** - In IRS Notice 2004-2, Q/A-16, the IRS provides that contributions to a HSA must be made in cash and further provides in IRS Notice 2004-50, Q/A-28 that they may be made by an eligible individual, the employer, a family member or any other third person. Contributions made by a family member or any other third person are deductible (within limits) in determining adjusted gross income (i.e., "above-the-line") of the eligible individual, as provided in IRS Notice 2004-2, Q/A-18. For any taxable year, HSA contributions must be made no later than the due date of the eligible individual's tax return (excluding extensions), as provided in IRS Notice 2004-2, Q/A-21.

Contributions made by an eligible individual's family members or any other person are deductible by the eligible individual to the extent the contributions would be deductible if made by that individual. However, the individual making the contribution cannot also deduct the contributions as medical expense deductions under Code Section 213.

In addition, employer contributions to a HSA (including pre-tax salary reduction or employer matching contributions made through a cafeteria plan) are excludable from

gross income and wages for employment tax purposes to the extent the contribution would be deductible if made by the employee, as provided in IRS Notice 2004-2, Q/A-19. The employee cannot deduct employer contributions on his or her federal income tax return as HSA contributions or as medical expense deductions under Code Section 213.

In making contributions to an employee's HSA, an employer's only responsibility is to determine whether its eligible employees are covered under a HDHP (and the deductible) or low deductible health plan or plans (including health FSAs and HRAs) sponsored by the employer and to determine its employees' ages for catch-up contributions.

### **What are the limits on contributions?**

**HRA** - There are no limits on HRA contributions imposed by the Internal Revenue Code or under IRS guidance. There is no requirement that the employer must contribute a stated amount to participants each year. The employer may vary the contribution to participants each year. In addition, an employer has complete freedom in deciding when contributions will be available for reimbursement by participants. If an employer is contributing \$2,400 per year to employees, it may credit the entire amount at the beginning of the year or incrementally during the plan year (e.g., \$200 per month).

**HSA** - The maximum annual contribution to a HSA is the sum of the limits determined separately for each month, based on status, eligibility and health plan coverage as of the first day of the month. Any individual who begins HDHP coverage in mid-month would not be eligible to make a HSA contribution until the beginning of the following month, as provided in IRS Notice 2004-50, Q/A-11.

**Example:** An individual enrolls in individual coverage under a HDHP in March 1, 2010 and remains covered until he or she terminates in late August 2010. He or she takes a job with an employer that does not sponsor a HDHP. How much can he or she contribute for 2010? He or she can contribute \$1,525 for 2010 (1/2 of the limit for 2010 because he or she had HDHP coverage for 6 months during 2010).

An individual, who becomes covered under a HDHP in a month other than January and who is covered by a HDHP in December of that year, may make a full deductible HSA contribution for the year if he or she has HDHP coverage for the entire "testing period," as provided in Code Section 223(b)(8). The testing period is the period beginning with the last month of the taxable year and ending on the last day of 12<sup>th</sup> month following such month. If an individual does not remain an eligible individual during the testing period, the amount of the contributions attributable to months preceding the month in which the individual was not an eligible individual (which could have not have been made but for the provision) will be includible in the individual's gross income. The amount is includible for the taxable year of the first day during the testing period that the individual was not an eligible individual. A 10-percent additional tax also applies to the

includible amount. An exception applies if the individual ceases to be an eligible individual by reason of death or disability.

**Example:** An individual enrolls in a HDHP effective on December 1, 2009 and is otherwise an eligible individual in that month. The individual is not an eligible individual in any other month in 2009. The individual can make a HSA contribution for 2009 as if he or she had been enrolled in the HDHP for all of 2009. If the individual ceases to be an eligible individual (e.g., if he or she ceases to be covered under a HDHP) in June 2010, an amount equal to the HSA deduction attributable to treating the individual as an eligible individual for January through November 2009 is included in the individual's income in 2009. In addition, a 10-percent additional tax applies to the amount includible.

The maximum monthly contribution for eligible individuals with individual coverage under a HDHP, as provided in Code Section 223(b)(2) is 1/12 of \$2,900 for 2008, \$3,000 for 2009 and \$3,050 for 2010. For eligible individuals with family coverage under a HDHP, the maximum monthly contribution, as provided in Code Section 223(b)(2)(B) is 1/12 of \$5,800 for 2008, \$5,950 for 2009 and \$6,150 for 2010 .

In addition to the maximum contribution amount, catch-up contributions are provided under Code 223(b)(3). If an employee has reached age 55 by the end of the taxable year, the HSA annual contribution limit is increased by \$700 for 2006, \$800 for 2007, \$900 for 2008, and \$1,000 for 2009 and 2010 and thereafter. As with the annual contribution limit, the catch-up contribution is also computed on a monthly basis.

Administration and account maintenance fees paid by the account holder or the employer directly to the trustee or custodian are not counted toward the annual maximum contribution limit to the HSA, as provided in IRS Notice 2004-50, Q/A-71.

Contributions, including catch-up contributions, cannot be made beginning with the month that an individual is enrolled in Medicare, as provided in IRS Notice 2004-50, Q/A-2.

**EXAMPLE:**

If an employee attains age 65 and enrolls in Medicare in July 2010 and had been participating in single coverage under a HDHP with an annual deductible of \$1,200, such individual is no longer eligible to make HSA contributions (including catch-up contributions) after June 2010. The monthly contribution limit is \$337.50 ( $\$3,050 + \$1,000/12$ ) for both the regular HSA contribution and the catch-up contribution. The individual may make HSA contributions for January through June totaling \$2,025 ( $6 \times \$337.50$ ), but may not make any contributions for July through December, 2010 or thereafter.

In the case of married couples, if either spouse has family coverage, both are treated as having family coverage, unless they do not cover each other and cover other dependents, as provided in Revenue Ruling 2005-25. Both spouses may make the

catch-up contributions for individuals age 55 or over without exceeding the family coverage limit. If a married couple each has family coverage (covering different children, but not the other spouse), the maximum contribution they can make for themselves for any calendar year cannot exceed one family coverage limit, plus any catch-up contributions.

### **Must benefits under the plan be funded?**

**HRA** - No. The DOL has not required employers to fund the contributions promised under a HRA. An employer can choose to establish a Voluntary Employee Beneficiary Association (VEBA), a tax exempt trust under Code Section 501(c)(9), to fund HSA contributions. If an employer does not establish a VEBA and allows participants to carry-over unspent contributions to future years, such carry-over will be deemed to be an unfunded obligation on its balance sheet.

**HSA** - Yes. Code Section 223(d)(1) requires that HSA contributions must be invested in an eligible trust or custodial account. The trust or custodial account must meet the following requirements:

- The trustee or custodian must be a bank, an insurance company or another person who demonstrates to the satisfaction of the IRS that the manner in which such person will administer the trust or custodial account will be consistent with the HSA requirements;
- No part of the trust or custodial account is invested in life insurance contracts;
- The assets of the trust or custodial account are not commingled with property except in a common trust fund; and
- The interest of an individual in the balance in his or her account is nonforfeitable.

In IRS Notice 2004-2, Q/A 20, the IRS provides that an employee may invest in any vehicle approved for IRAs (e.g., bank accounts annuities, certificate of deposit, stocks mutual funds, or bonds). Code Section 223(d)(1)(C) and IRS Notice 2004-50, Q/A-65 provides that HSAs may not invest in life insurance contracts, or in collectibles. HSAs may, however, invest in certain types of bullion or coins. The trust or custodial agreement may restrict investments to certain types of permissible investments, as provided in IRS Notice 2004-50, Q/A-65. HSA trust or custodial account assets may only be commingled in a common trust fund or common investment fund, as provided in Code Section 223(d)(1)(D). No other arrangement is permitted.

Code Section 223(e)(2) and IRS Notice 2004-50, Q/A-67 provide that an employee is prohibited from making certain investments that are considered “prohibited transactions” under Code Section 4975(c). These transactions involve certain sales, exchanges or leasing of property between an individual and his or her HSA or (any other interference with the independent status of the account) and, should they occur, the account would lose its tax-exempt status by reason of Code Sections 223(e)(2) and 408(e)(2)(A) and

the entire account balance would be treated as having been distributed to the employee in the year during which the prohibited transactions occurred. The value of the entire account would be included in the employee's income and taxed as ordinary income. In addition, if the employee is under age 65, the "distribution" would also be subject to the additional 10-percent penalty tax imposed on premature distributions.

### **Once contributions are made, can they be forfeited?**

**HRA** - Yes. In Revenue Ruling 2002-41 and IRS Notice 2002-45, the IRS allows unused HSA contributions to be carried over from year to year without becoming subject to federal tax. An employer can determine the number of years of the carry over, the amount of the carry over and under what circumstances HRA contributions will be forfeited. An employer may provide that an employee will forfeit his or her HRA contributions if he or she terminates employment unless he or she has reached a specified age and/or completed specified years of service. If an employee has completed these requirements, the HRA amounts can be used after termination and during retirement.

**HSA** - No. Once HSA contributions are made to the HSA trust or custodial account, Code Section 223(d)(1)(E) provides that the eligible individual's HSA balance is nonforfeitable at all times. This means that once contributions are made, the eligible individual's HSA trust or custodial account cannot be subject to a vesting schedule or returned to the employer once the employee terminates employment.

Because the eligible individual's interest in his or her HSA trust or custodial account is nonforfeitable, Code 223(f)(5) and IRS Notice 2004-2, Q/A-23 provide that he or she has the ability to roll over amounts into a HSA from a MSA or another HSA on a tax-free basis. Rollovers need not be made in cash, as provided in IRS Notice 2004-2, Q/A-23. Amounts rolled over from another HSA or a MSA are not taken into account under the annual contribution limits.

An individual may make only one rollover contribution to a HSA during a one-year period, as provided IRS 2004-50, Q/A-55. To qualify as a rollover, any amount paid or distributed from a HSA to an eligible individual must be paid over to a HSA within 60 days after the date of receipt of the payment or distribution.

Rollovers from an IRA, from a HRA, or from a Health FSA to a HSA are now permitted.

In addition, in IRS Notice 2004-50, Q/A-56, the IRS provides that an eligible individual may also transfer amounts from one HSA to another and there is no limit on the number of trustee-to-trustee transfers allowed during any year.

### **When can withdrawals be made?**

**HRA** - An employer decides which expenses its HRA may reimburse and when. In order to receive reimbursement, a participant must follow the claim substantiation

procedures specified in the summary plan description. These procedures must follow the requirements of ERISA Section 503. Any withdrawals made to reimburse “qualified medical expenses” are not included in participants’ incomes under Code Sections 105 and 106. Under IRS Notice 2002-45, the IRS indicates that all benefits received under a HRA are taxable if any HRA amounts can be received in cash or in the form of any other taxable or nontaxable benefits. A HRA that pays accumulated balances in cash as a death benefit to a dependent following the participant’s death will be disqualified, causing all other legitimate reimbursements to all participants to be taxable. The HRA may be designed to only reimburse those expenses incurred during the current plan year or during current plan and any prior plan year since the HRA had been established.

**HSA** - Since HSA contributions are nonforfeitable, the eligible individual controls when withdrawals are made and for what purpose. In Notice 2004-2, Q/A-24, the IRS indicates that an individual is permitted to receive distributions from a HSA at any time. In IRS 2004-50, Q/A-79, the IRS further states that trust or custodial agreements are prohibited from containing provisions restricting distributions only for the eligible individual’s qualified medical expenses and confirming that the eligible individual is entitled to distributions for any purpose and only the eligible individual may determine how the HSA distributions will be used.

Under Code Section 223(f)(2) and IRS Notice 2004-2, Q/As 25-26, distributions from a HSA for “qualified medical expenses” of the individual and his or her spouse or dependents generally are excludable from gross income and can be made at anytime. In general, amounts in a HSA can be used for “qualified medical expenses” even if the individual is not currently eligible for contributions to a HSA, as long as the expense is incurred after the HSA is established, as provided in IRS Notice 2004-2, Q/As-25 and 26.

In addition, administrative and account maintenance fees withdrawn from HSAs are treated as non-taxable distributions, as provided in IRS Notice 2004-50, Q/A-69. Since these amounts are not treated as taxable distributions, they are not subject to the additional 10-percent excise tax, as explained below.

Under Code Section 223(f)(1), distributions from a HSA that are not for used to pay medical care expenses are includible in the employee’s gross income. Distributions includible in gross income are also subject to an additional 10-percent tax unless made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65), as provided in Code Section 223(f)(4).

### **What are “qualified medical expenses”?**

**HRAs** - A HRA may only reimburse “qualified medical expenses,” as defined in Code Section 213(d). The out-of-pocket medical expenses that can be reimbursed are the same as those that a health FSA can reimburse. These include co-pays, deductibles, and medical expenses that are not covered by the employer’s major medical plan. The IRS indicated in IRS Notice 2002-45 that a HRA may also provide reimbursement for

premiums for accident or health coverage of current employees, retirees and COBRA beneficiaries.

An employer is not required to reimburse all medical care expenses under Code Section 213(d), but may limit reimbursement under its HRA to certain designated medical care expenses, such as expenses for preventive care or designated prescription drugs.

**HSAs** - “Qualified medical expenses” include expenditures for medical care, as defined in Code Section 213(d) for the eligible individual and his or her legal spouse or tax dependents to the extent that such amounts are not reimburse by insurance or otherwise as provided in Code Section 223(d)(2)(A) and IRS Notice 2004-2, Q/A-26. Over-the-counter medications are also included in the definition.

Under Code Section 223(d)(2)(B), the definition of “qualified medical expense” does not include expenses for insurance coverage except for:

- A qualified long-term care insurance contract;
- Premiums for COBRA coverage;
- Premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law; and
- For those age 65 or over (whether or not entitled to Medicare), any deductible health insurance other than a Medicare supplemental policy.

For purposes of determining the itemized deduction for medical expenses, distributions from a HSA for qualified medical expenses are not treated as expenses paid for medical care under Code Section 213.

### **Can any restrictions be placed on withdrawals?**

**HRA** - Yes. Since an employer designs the HRA program, it can determine what amounts may be reimbursed under the HRA, when withdrawals will be made and in what amounts.

**HSA** - No. As indicated above, an employer or a HSA trustee or custodian can not place any restrictions on withdrawals.

Under IRS Notice 2004-50, Q/A-79, a HSA trustee or custodian can place reasonable restrictions on both frequency and the minimum amount from a HSA. A trustee or custodian can prohibit distributions for amounts of less than \$50 or only allow a certain number of distributions per month.

Under IRS Notice 2004-50, Q/A-79, a HSA trust or custodial agreement can not restrict the account holder’s ability to rollover or transfer an amount from that HSA.

HSA trustees or custodians or employers are not permitted to determine whether HSA distributions are used for qualified medical expenses. Individuals who establish HSAs must make that determination and should maintain records of their medical expenses sufficient to show that the distributions have been made exclusively for qualified medical expenses and are therefore excludable from gross income.

**Is an employee eligible to receive a reimbursement after he or she terminates employment with the employer?**

**HRA** - It depends. An employer may design its HRA program to reimburse former employees for qualified medical expenses even if they do not elect coverage COBRA. The employer may specify what terms the former employee must satisfy (age and/or years of service) to receive reimburse under the HRA

**HSA** - Yes. Since an eligible individual's HSA is nonforfeitable, as indicated above, he or she is free use the HSA to reimburse qualified medical expenses after termination. With the eligible individual's right to rollover or transfer HSA balances to another HSA, his or her HSA is completely portable.

**Does COBRA apply?**

**HRA** - Yes. Since HRAs are considered group health plans, they are subject to COBRA's requirements. COBRA requires that health coverage be continued for qualified beneficiaries upon the occurrence of certain specified qualifying events such as death, divorce, or termination of employment.

**HSA** - No. Under IRS Notice 2004-2, Q/A-35, the IRS indicates that COBRA does not apply to HSAs.

**Does HIPAA Apply?**

**HRA** - Yes. Since HRAs are considered "group health plans," they are subject to HIPAA's portability, nondiscrimination and privacy rules.

**HSA** - No, unless the HSA is considered to be an ERISA welfare plan.

**Can withdrawals be made after the participant's death to his or her spouse or other dependents?**

**HRA** - Yes, but only if the employer designs the HRA program to reimburse the qualified medical expenses of the participant's spouse or dependent after his or her death. If a spouse or other dependents are considered qualified beneficiaries under COBRA, HRA coverage may be continued.

**HSA** - If the HSA account holder's surviving spouse is the named beneficiary of the HSA, then, after the death of the HSA account holder, the HSA becomes the HSA of the

surviving spouse and the amount of the HSA balance may be deducted when computing the decedent's taxable estate, pursuant to the estate tax marital deduction, as provided in Code Section 223(f)(8). In IRS Notice 2004-2, Q/A-31, the IRS provides that the surviving spouse is not required to include any amount in gross income as a result of the death; the general rules applicable to the HSA apply to the surviving spouse's HSA (e.g., the surviving spouse is subject to income tax only on distributions from the HSA for nonqualified expenses). The surviving spouse can exclude from gross income amounts withdrawn from the HSA for expenses incurred by the decedent prior to death, to the extent they otherwise are qualified medical expenses.

If, upon death, the HSA passes to a named beneficiary other than the decedent's surviving spouse, Code Section 223(f)(8) provides that the HSA ceases to be a HSA as of the date of the decedent's death, and the beneficiary is required to include the fair market value of HSA assets as of the date of death in gross income for the taxable year that includes the date of death. The amount includible in income is reduced by the amount in the HSA used, within one year after death, to pay qualified medical expenses incurred by the decedent prior to the death. As is the case with other HSA distributions, whether the expenses are qualified medical expenses is determined as of the time the expenses were incurred. In computing taxable income, the beneficiary may claim a deduction for that portion of the federal estate tax on the decedent's estate that was attributable to the amount of the HSA balance.

If there is no named beneficiary of the decedent's HSA, the HSA ceases to be a HSA as of the date of death, and the fair market value of the assets in the HSA as of such date is includible in the decedent's gross income for the year of the death.

This rule applies in all cases in which there is no named beneficiary, even if the surviving spouse ultimately obtains the right to the HSA assets (e.g., if the surviving spouse is the sole beneficiary of the decedent's estate).

### **Are there any nondiscrimination requirements that have to be met?**

**HRA** - Yes. HRAs are subject to the nondiscrimination requirements described in Code Section 105(h). HRAs are considered nondiscriminatory only if they do not favor highly compensated individuals with regard to eligibility to participate or the type of benefits provided.

Under Code Section 105(h)(3), a HRA is discriminatory for eligibility unless it benefits:

- 70-percent or more of all employees;
- 80-percent of employees eligible to benefit, as long as 70-percent or more of the employees are eligible to benefit under the plan; or
- A nondiscriminatory classification of employees.

HRAs are discriminatory for benefits under Code Section 105(h)(4) if the type and amount of benefits available to highly compensated individuals are not also available on the same basis to other participants. The comparison is based on benefits subject to reimbursement, rather than actual benefit payments or reimbursements under the plan, and on dollar amounts, rather than percentages of pay.

For purposes of these tests, highly compensated individuals are defined in Code Section 105(h)(5) as those who are:

- Among the five highest-paid officers of the employer,
- Shareholders who own more than 10-percent in value of the employer's stock, or
- The highest paid 25-percent of all employees.

Under Code Section 105(h)(1), excess reimbursements by highly compensated individuals in discriminatory plans are treated as taxable benefits.

**HSA** - If the HSAs contain only employee contributions, there are no nondiscrimination rules. If HSA contributions are in the form of pre-tax salary reduction contributions made through a cafeteria plan, the IRS provides, in IRS Notice 2004-50, Q/A 47, that these contributions are subject to the nondiscrimination rules under Code Section 125.

If an employer makes contributions to employees' HSAs it must satisfy the following "comparability rules" or be subject to subject to an excise tax as provided in Code Section 4980G. If an employer makes contributions to employees' HSAs, the employer must make available comparable contributions (e.g. same amount or the same percentage of deductible) on behalf of all employees with comparable coverage during the same period (e.g. single/family) with certain exceptions, as explained below.

An employer is now allowed to make larger HSA contributions for non-highly compensated employees than for highly compensated employees. Highly compensated employees are defined under Code Section 414(q) (i.e., 5% or greater owners and employees earning in excess of \$100,000 for 2007, \$105,000 for 2008 and \$110,000 for 2009, as provided in Code section 4980G(d)). The comparable contribution rules will continue to apply to the contributions made to non-highly compensated employees so that the employer must make available comparable contributions on behalf of all non-highly compensated employees with comparable coverage during the same period. This means that an employer can make a contribution to just the non-highly compensated employees, but all the non-highly compensated employees must receive the same contribution based on coverage.

For determining contributions, family coverage has now been subdivided into additional categories of family HDHP coverage: self-plus-one, self-plus- two, and self-plus-three or more. An employer may contribute different amounts for each of these new categories of family coverage, but its contribution for the self-plus-three or more categories must be

greater or equal to the contribution for employees in the self-plus-two-or-more category, and its contribution with respect to self-plus-two category must be greater than or equal to the contribution in the self-plus-one category, as provided in Treasury regulation Section 54.4980G-1,Q/A-2.

**EXAMPLE:** An employer maintains and contributes to the HSAs of eligible employees who elect coverage under the HDHP. The HDHP has the following coverage options: self-only, self-plus-one, self-plus-two, and self-plus-three or more.

The employer contributes \$500 to the HSA of each eligible employee with self-only HDHP coverage, \$750 to the HSA of each eligible employee with self-plus-one HDHP coverage, \$900 to the HSA of each eligible employee with self-plus-two HDHP coverage and \$1,000 to the HSA of each eligible employee with self-plus-three or more HDHP coverage. The employer's contributions satisfy the comparability rules.

If an employee has not established a HSA at the time the employer funds its employees' HSA, the employer complies with the comparability rules by contributing comparable amounts plus reasonable interest to an employee's HSA when the employee establishes the HSA, taking into account each month that the employee was a comparable participating employee, as provided in Treasury Regulation Section 54.4980G-4,Q/A-6. The determination of whether a rate of interest used by an employer is reasonable is based on all of the facts and circumstances. If an employer calculates interest using the Federal short-term rate as determined by the IRS, it will be deemed by the IRS to be a reasonable interest rate.

If an employee has not established a HSA by December 31 of any year or has not informed the employer of timely establishment, an employer will comply with the comparability requirements if it complies with a notice and contribution requirements, as provided in Treasury Regulation Section 54.4980G-4,Q/A-14.

To comply with the notice requirement for any calendar year, an employer must give all employees who have established a HSA or not informed the employer of such establishment a written notice stating if each HSA-eligible employee, by the last day of February of the following year, both establishes a HSA and notifies the employer that he or she has done so, he or she will receive a comparable contribution to his or her HSA for the calendar year. The employer must provide the notice no later than January 15 of the following calendar year.

To comply with the contribution requirement for a calendar year, an employer must make comparable contribution (plus reasonable interest) by April 15 of the following calendar year to the HSA of each eligible employee who establishes a HSA by December 31 and so notifies the employer that he or she has established a HSA, or if the employer has already contributed to that employee's HSA, the employer must not require the employee to provide additional notices to the employer in order to receive contributions.

Contributions to independent contractors, sole proprietors and partners in a partnership are not taken into account under the comparability rules, as provided in Treasury Regulations Section 54.4980G-3, Q/A-1, Q/A-2 and Q/A 3.

The comparability rule may apply separately to part-time employees (i.e., employees who are customarily employed for fewer than 30 hours per week) and former employees, as provided in Treasury Regulation Section 54.4980G-3, Q/A-5. This comparability rule does apply separately to groups of collectively bargaining employees, if health benefits are the subject of good faith bargaining between such employee representatives and such employer or employers, as provided in Treasury Regulation Section 54.4980G-3, Q/A-6.

**EXAMPLE:** An employer offers its employees a HDHP with a \$1,500 deductible for self-only coverage. It has collectively bargained and non-collectively bargained employees. The collectively bargained employees are covered by a collectively bargained agreement under which health benefits were bargained in good faith. For 2009, the employer contributes \$500 to the HSAs of all eligible non-collectively bargained employees with self-only coverage under its HDHP. The employer does not contribute to the HSAs of the collectively bargained employees. The employer's contribution to the HSAs of non-collectively bargained employees would satisfy the comparability rules because they apply separately to its collectively bargained employees.

The comparability rule does not apply to amounts transferred from an employee's HSA or MSA or from a Health FSA, HRA or IRA or to contributions made through a cafeteria plan.

An employer's matching contributions to a cafeteria plan are not subject to the comparability rule. These contributions are subject to the cafeteria nondiscrimination rules, as provided in Treasury Regulations Section 54.4980G-5, Q/A-1.

If an employer has some employees who work full-time during the entire calendar year and other employees who work full-time for less than the entire calendar year, it meets the comparability rules if the contribution amount is comparable when determined on a month-to-month basis, as provided in Treasury Regulations Section 54.4980G-4, Q/A-2.

**EXAMPLE:** If the employer contributes \$240 to employees to the HSAs of each full-time employee who works the entire calendar year, the employer must contribute \$60 to the HSA of a full-time employee who works three months of the year.

The employer is not required to make contributions to any current or former employees who are participating in a HDHP not sponsored by the employer. If an employer does make contributions for all eligible current or former employees whether or not covered under the employer's HDHP, it then must make comparable contributions to all eligible current or former employees participating in any HDHP, whether or not sponsored by the employer as provided in Treasury IRS Regulations Section 54.4980G-3, Q/A-7 and Q/A-10.

An employer must establish a consistent policy for making its comparable HSA contributions to employees' HSAs during the calendar year. If it makes HSA contributions for one employee at the beginning of the calendar year, it must make contributions at the same time for all other eligible employees as provided in Treasury Regulations Section 54.4980G-4, Q/A-5.

### **Can amounts be transferred to another individual before death?**

**HRA** - No.

**HSA** - Yes. An eligible individual's interest in a HSA can be transferred under a divorce or separation agreement, as provided in Code Section 223(f)(7). In the event of such transfer, the distribution is not taxable or subject to the 10-percent excise tax and the spouse (or ex-spouse) becomes the account holder of the newly created HSA.

### **What are the reporting requirements?**

**HRA** - Since HRAs are considered welfare benefit plans under ERISA, they are subject to the reporting requirements under ERISA Section 103.

**HSA** - If an employer's HSA program is considered a welfare benefit plan under ERISA, it will be subject to the reporting requirements under ERISA Section 103.

In IRS Notice 2004-2, Q/A-34, the IRS indicates that eligible individuals will report contributions to their HSAs, contributions to their spouse's HSAs, any employer contributions and distributions on Form 8889. Form 8889 is an attachment to eligible individual's Form 1040.

The IRS has also indicated in IRS Notice 2004-2, Q/A-34, that employer contributions are required to be reported in Box 12 of the Form W-2 of an employee, using code W.

In addition, Code Section 223(h) authorizes the IRS to require HSA trustees and custodians to report certain information to the IRS and to the eligible individuals regarding contributions, distributions, the return of excess contributions and such other matters as the IRS deems appropriate. To satisfy this requirement, the IRS indicates that HSA trustees and custodians must report contributions to a HSA for a year on Form 5498-SA and distributions for the year on Form 1099-SA.

### **Why would an employer consider sponsoring either a HRA or HSA?**

**HRA** - An employer may want to consider the following factors:

- It has complete control in deciding:
  - What medical expenses will be reimbursed;

- What unused amounts can be carried over by participants; and
- For what period of time unused amounts can be carried over by participants.
- It can decide from year to year what amounts it will contribute; and
- HRAs can work with health FSAs.

**HSA** - An employer may want to consider the following factors:

- HDHPs have lower premiums;
- Employees will understand the true cost of health care by spending more of their own money;
- Employees can take a HSA with them when they leave; and
- HSAs are less costly to administer because there is no claim substantiation required.

### **Why would an employer not consider sponsoring either a HRA or HSA?**

**HRA** - An employer may want to consider the following factors.

- ERISA requirements will apply;
- Nondiscrimination requirements will apply;
- Claim substantiation is required;
- Possible funding issues; and
- COBRA application is still uncertain.

**HSA** - An employer may want to consider the following factors:

- Higher deductible health plans may be too radical of a design for its employees;
- Employees may not have funds to contribute to HSAs;
- Employees may spend HSA funds on non-medical expenses; and
- The employer may want more control over administration of its medical plans.

### **Final Thoughts**

In dealing with increased medical costs, employers are being forced to change their plan designs and delivery systems. HRAs and HSAs are only two considerations in dealing with the entire picture of increasing health costs and at best, provide only a

temporary fix to the problem. To provide a real solution to employers, there has to be a complete overhaul of the entire health care system.