2006 Planning - Health Reimbursement Arrangements (HRAs)

We wanted to inform you about health reimbursement arrangements, which you as an employer can offer to your employees. The IRS's thumbs up for health reimbursement arrangements (HRA) promises to usher in a new generation of employer-sponsored health plans that are more participant-directed.

An HRA is a plan through which you can agree to reimburse your employees for substantiated medical expenses without funding for full medical coverage. If an HRA is established in accordance with the IRS rules, your employees will receive these benefits tax-free and you will get a tax deduction for the benefits. You can also use these plans to supplement other group health plans you provide to your employees, including high-deductible health plans.

Although the HRA may sound similar to a flexible spending account (FSA) for health care or a health savings account (HSA), it is very different. The principle differences between an HRA and these other accounts are:

1. An HRA must be funded through contributions you make as the employer. The IRS will not permit any form of employee contributions, whether they are salary reduction contributions or otherwise, to fund an HRA. Employees contribute to an FSA through salary reductions. Employees and employers both can contribute to an HSA, but employers are not required to contribute.
2. There is no "use it or lose it" rule for HRAs or HSAs-once you fund the HRA or HSA, your employees do not have to use the money for medical expenses by the end of the year in which contributions are made, as they do with a medical FSA. They can carry over employer contributions.
3. You do not have to make the full annual contribution available to employees at the beginning of the year as you have to do with a medical FSA. You can fund these plans at regular intervals, such as each pay period. Because of this rule you won't lose money with an HRA or HSA, as you can with an FSA, when an employee leaves early in the year.

The Tax Relief and Health Care Act of 2006 also helps make HRAs more attractive. It provides that amounts in a HRA may be transferred to a Health Savings Account (HSA) on a one time basis without any negative tax consequences. Amounts transferred before January 1, 2012 and equal the lesser of (1) the balance in the HRA as of September 21, 2006 or (2) the balance in the HRA as of the date of the distribution, are excludable from gross income and wages for employment tax purposes. This presents a great opportunity for someone to straddle the fence for a few years and opt for an HRA now but leave open the possibility of a later move to an HSA as situations change.

We recommend that you schedule the commencement of this type of plan to begin on January 1 or at the beginning of your benefit year in order to maximize the tax benefits of the plan. If you have any questions about this type of plan or require assistance in setting a plan up, please contact our office at your convenience.