Indirect Cash-Outs Disguised as Post-Death Payments to Participant's Beneficiary (or Estate) Also Are Not Allowed. Suppose Company A maintains an arrangement that reimburses the qualified medical expenses (as defined in Code § 213(d)) of participants and their spouses and tax dependents (as defined in Code § 152). After a participant dies, the arrangement continues to reimburse the qualified medical expenses of the deceased participant's surviving spouse and dependents. If any amount remains after the surviving spouse and dependents die, Company A either (a) pays an amount to the deceased participant's beneficiary (or estate), (b) purchases an annuity or life insurance benefit and transfers it to the deceased participant's beneficiary, or (c) makes any other payment or transfer of property. Would Company A's arrangement qualify as an HRA under Code § 105? The IRS has informally indicated that such an arrangement would not qualify as an HRA, and that all reimbursements made under the arrangement (not just those paid under the offending provision) would be includible in employees' federal gross income. The IRS also has informally indicated that any amounts remaining after the deceased participant's surviving spouse and dependents die would have to be forfeited in order for the arrangement to qualify as an HRA. Forfeitures would be necessary, the IRS reasoned, because Treasury Regulations § 1.105-2 provides that if amounts can be received other than for medical care of the employee or the employee's spouse or dependents, the exclusion from federal gross income under Code § 105(b) does not apply. In other words, for Company A's arrangement to be an HRA, benefits can only be paid if there are qualified medical expenses.[*]

* ABA Joint Committee on Employee Benefits (JCEB), Meeting With IRS and Treasury Officials (May 10–12, 2007), available at https://www.americanbar.org/content/dam/aba/events/employee_benefits/2007_irs.pdf (as visited Feb. 1, 2021). Although the answers in the JCEB report reflect the individual views of the officials present at the Q&A session and do not necessarily represent IRS or Treasury policy, the Q&As provide helpful insight into the issues addressed.

D. HRAs Must Be Funded Exclusively by Employer and Not With Salary Reductions or Otherwise Under a Cafeteria Plan

As a general rule, HRAs must be funded solely by the employer and not with salary reductions or otherwise under a cafeteria plan. (For a discussion of mandatory contributions see subsections B.3 and B.4.)

In some cases, compliance with this requirement can be easily demonstrated. For example, an HRA satisfies this funding restriction when the HRA is not integrated with employer-sponsored HDHC (e.g., the HRA provides only limited-scope dental or vision coverage), is funded solely by the employer outside of its cafeteria plan (thus, no salary reductions or flex credits are used to pay for the HRA coverage), and is provided to all employees (even to those who do not participate in employer-sponsored group health coverage).

Know Your Acronyms! We discuss these terms throughout this manual and define them in the Glossary, but here's a review:

- HRA = health reimbursement arrangement
- HSA = health savings account
- HDHC = high-deductible health coverage
- HDHP = high-deductible health plan (a particular type of HDHC required for HSA eligibility)
- Health FSA = health flexible spending arrangement
- CDHC = consumer-driven health care
- MERP = medical expense reimbursement plan

© 2021 Thomson Reuters/Tax & Accounting

When HRAs are coupled with HDHC that is funded by salary reductions or otherwise under a cafeteria plan, determining whether the HRAs are funded exclusively by the employer is more difficult: Which funds pay for the HRAs and which pay for the HDHC?

An HRA must be "paid for solely by the employer and not provided pursuant to a salary reduction election or otherwise under a [Code] § 125 cafeteria plan"; thus, an HRA may not be offered under, and may not be funded directly or indirectly by, a cafeteria plan.[36] This does not mean that the HRA cannot be offered in conjunction with a major medical plan (e.g., HDHC) that is funded in part with employee pre-tax salary reductions. In fact, IRS guidance makes it clear that an HRA can be linked with a major medical plan (i.e., participation in the HRA can be limited to employees who participate in the HDHC).[37] However, the HRA cannot be directly or indirectly funded by the cafeteria plan. In the subsections that follow, we discuss how to ensure (under current IRS guidance) that the HRA carryover benefit is funded solely by the employer outside of the cafeteria plan when the HRA is part of an integrated HRA+HDHC arrangement.

Is There a Cap on the Permissible HRA Accrual? May Employers Allocate Interest to Individual HRAs? There is no specific IRS-imposed dollar cap on HRA accruals other than for excepted benefit HRAs (EBHRAs), which are available for plan years beginning on or after January 1, 2020, and are covered in Section XXVIII. However, IRS guidance on HRAs requires that HRA reimbursements not exceed a maximum dollar amount per coverage period (i.e., per plan year), as provided in the HRA plan document.[*] In addition, employers may choose to allocate notional investment returns on individual HRA accounts. When such accounts are actually funded, ERISA trust and plan asset compliance issues will arise.[†]

Note that HRAs are not required to be funded. HRAs are permitted to pay claims directly out of the general assets of the employer.

* Rev. Rul. 2002-41, 2002-28 I.R.B. 75 and IRS Notice 2002-45, 2002-28 I.R.B. 93.

† Informal, nonbinding remarks of Kevin Knopf (Treasury Department Office of Benefits Counsel), July 11, 2002 ECFC Conference.

May an Employer Cap the Amount of Carryover by Plan Design? Employers may choose, by plan design, to limit the aggregate exposure for HRA benefits by capping the carryover amount for participant accounts or requiring forfeiture of certain unused HRA accruals. Treasury officials have informally indicated that such plan design choices should be permissible so long as they are in compliance with the nondiscrimination requirements under Code § 105(h).[*] Note that such a design, while permissible, may raise non-legal concerns. For example, it may encourage a year-end "spending spree" to use amounts that would otherwise be forfeited, during which participants may incur expenses could have been delayed (or were not even needed at that time). This incentive may be the opposite of what the employer wants.

* Informal, nonbinding remarks of Kevin Knopf (Treasury Department Office of Benefits Counsel), July 11, 2002 ECFC Conference.

[36] Prop. Treas. Reg. § 1.125-1(q)(1)(viii); IRS Notice 2002-45, 2002-28 I.R.B. 93, Part I.

[37] Rev. Rul. 2002-41, 2002-28 I.R.B. 75, Situation I.

© 2021 Thomson Reuters/Tax & Accounting

May Employee or Retiree After-Tax Contributions Be Made for HRA Coverage? IRS guidance provides that an HRA must be "paid for solely by the employer and not provided pursuant to a salary reduction election or otherwise under a [Code] § 125 cafeteria plan."* Does this mean that employee contributions cannot make their way into the HRA? Even after-tax contributions? What about contributions for retirees? Perhaps an employer wishes to charge employees or retirees a portion of the cost of the HRA coverage (e.g., $20 per month).

Although a literal reading of the guidance would seem to preclude any employee contributions to an HRA, and the guidance does not clearly provide for employee after-tax funding of an HRA, we believe that such funding should be permissible for several reasons. First, it seems that the primary purpose of the rule is to prevent any possibility of employee pre-tax conversion of wages into tax-free HRA benefits. This is clearly not occurring with employee after-tax contributions. Moreover, the guidance clearly allows after-tax HRA contributions by COBRA continuees. More IRS guidance on the after-tax issue would be greatly welcomed.

A word of caution: If an HRA sponsored by an ERISA-covered employer is not integrated with employer-sponsored health coverage and accepts participant after-tax contributions, those contributions are ERISA plan assets that must be held in a trust. Also, an annual report (Form 5500) with financial schedules will be required.† While the issue is less clear, ERISA's trust and financial reporting requirements might also apply to the HRA portion of an integrated HRA+HDHC arrangement if the HRA requires participants to make after-tax contributions.

* IRS Notice 2002-45, 2002-28 I.R.B. 93, Part I.

† ERISA Tech. Rel. 92-01 does not apply to a self-insured plan that is funded solely with after-tax participant contributions. It relieves certain plans that accept participant contributions through a cafeteria plan from ERISA's trust requirement and certain reporting requirements.

As noted above, when HRA coverage is coupled with HDHC that is funded by salary reductions or otherwise under a cafeteria plan, IRS guidance imposes additional requirements to ensure that no salary reduction (or elective employer contribution) funds make their way into the HRA. First, the HRA must not be directly funded by the cafeteria plan. Second, under a facts and circumstances analysis, the HRA must not be indirectly funded by the cafeteria plan.

1. *No Direct Cafeteria Plan Funding of HRA—the COBRA Rule*

The first requirement is satisfied if employee pre-tax salary reduction amounts do not directly fund the HRA component of an integrated HRA+HDHC major medical plan.

There will be impermissible direct funding through the cafeteria plan if either—

- the salary reduction agreement fails to affirmatively indicate that salary reductions are used solely for the HDHC (i.e., the non-HRA) portion of the integrated HRA+HDHC major medical plan (stated affirmatively: the salary reduction election form must state that salary reductions are used only to pay for the HDHC and not for any part of the HRA); or
- the employee pre-tax salary reductions (plus cashable employer flex credits) allocable to the HDHC portion of the integrated HRA+HDHC major medical plan are more than the COBRA applicable premium for the HDHC coverage (stated affirmatively: the salary reductions allocable to the HDHC must be less than or equal to the COBRA applicable premium for such coverage).

For example, if the COBRA applicable premium for the HDHC portion of an integrated HRA+HDHC major medical plan is $1,800 per year, the annual salary reduction election for such coverage must be less than or equal to $1,800. The COBRA applicable premium is generally the cost to the plan to provide such coverage. The 2% administrative charge permitted by COBRA is in addition to the applicable premium. The salary reduction must be less than the applicable premium for such coverage without consideration of the 2% administrative charge. For more information regarding the COBRA applicable premium and how to determine it, see Section XXV and *COBRA: The Developing Law* (Thomson Reuters/Tax & Accounting, 1990-present, updated quarterly).

 © 2021 Thomson Reuters/Tax & Accounting

2. No Indirect Cafeteria Plan Funding of HRA

A substantially less clear requirement is that an HRA may not interact with a cafeteria plan in such a way that it is indirectly funded by the cafeteria plan. Three examples of impermissible indirect cafeteria plan funding are described in IRS guidance, and discussed below. First, changes in HRA accruals may not "correlate" to salary reduction changes. Second, HRA funds may not be used for employer coverage that could be funded under the cafeteria plan. Third, an HRA is deemed to be indirectly funded by a cafeteria plan if there is a relationship between amounts credited to the HRA and amounts forfeited under a health FSA. These should be viewed as "unsafe harbors," but not as an exhaustive list. Other facts and circumstances must be examined to determine if there is impermissible linkage of an HRA and HDHC in a fashion that results in indirect cafeteria plan funding of the HRA.

a. HRA Accrual Amounts May Not Correlate to Salary Reduction Amounts

(i) Direct Positive Correlations Generally Prohibited

IRS guidance provides as follows (pertaining to an impermissible correlation between HRA accruals and salary reductions for the HDHC):

> An arrangement is not treated as an HRA [and is subject to Code § 125 and its rule prohibiting carryovers] if the arrangement interacts with a cafeteria plan in such a way as to permit employees to use salary reduction indirectly to fund the HRA. Therefore, where an employee who participates in a reimbursement arrangement has a choice among two or more specified accident or health plans to be used in conjunction with the reimbursement arrangement (or a choice among various maximum reimbursement amounts credited for a coverage period) and there is a correlation between the maximum reimbursement amount available under the HRA for the coverage period (disregarding amounts carried forward from previous coverage periods) and the amount of salary reduction election for the specified accident and health plan, then the salary reduction is attributed to the reimbursement arrangement even if the amount of salary reduction election is equal to or less than the actual cost of the other accident or health coverage.[38]

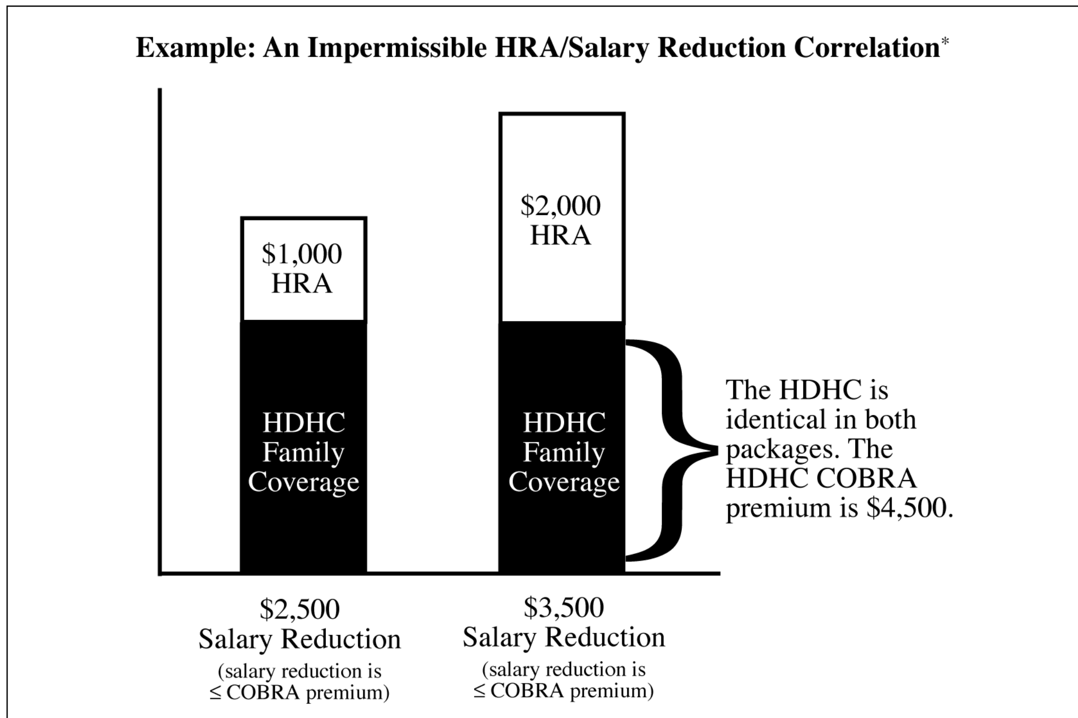
For example, an employer with a single HDHC option must not permit an employee to choose a higher salary reduction in order to receive a higher amount of HRA coverage.

Example: Impermissible Direct Positive Correlation Between Salary Reduction and HRA Credit. IRS guidance on HRAs provides an example of an impermissible arrangement in which an employer offers family medical coverage worth $4,500. The employee may choose to contribute either $2,500 or $3,500 for such coverage. If the employee elects the $2,500 salary reduction option, the employee receives a $1,000 credit to his or her HRA. If the employee elects the $3,500 option, he or she will receive a higher HRA credit of $2,000.* See below for an illustration of this example.

* IRS Notice 2002-45, 2002-28 I.R.B. 93, Part IV.

[38] IRS Notice 2002-45, 2002-28 I.R.B. 93, Part IV.

© 2021 Thomson Reuters/Tax & Accounting



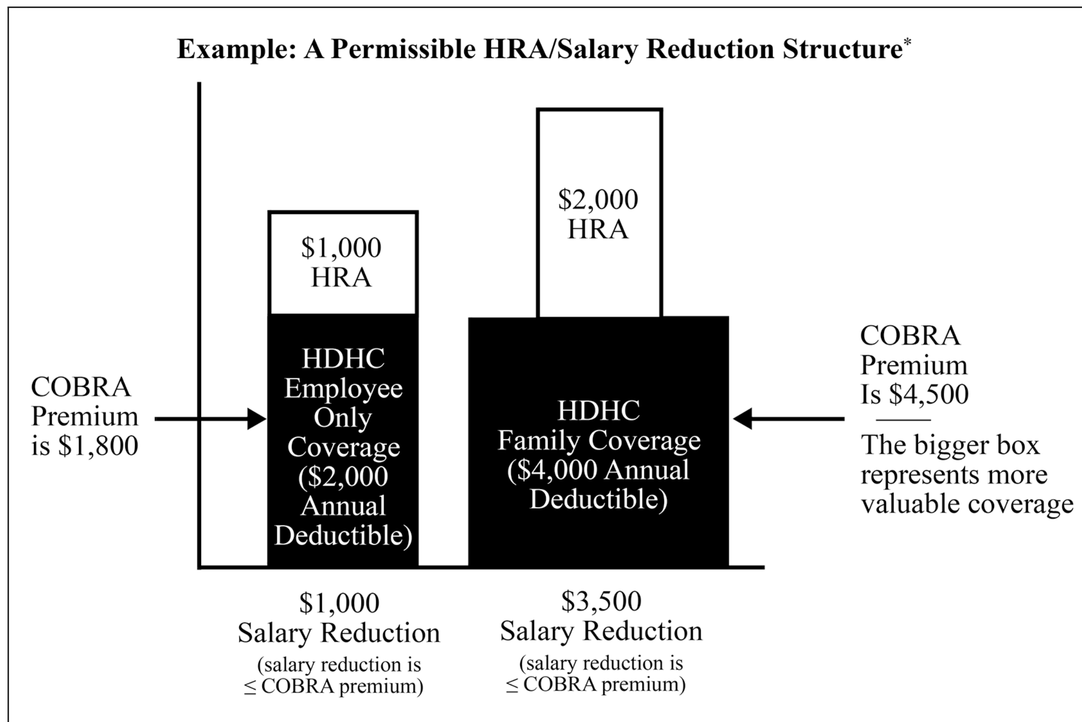
* This graphic illustrates the fact situation in IRS Notice 2002-45, 2002-28 I.R.B. 93, Part IV, that, according to the IRS, constitutes an impermissible correlation.

The extent to which this rule affects an employer's ability to offer multiple high-deductible medical plan options in conjunction with an HRA, each with a different salary reduction amount and different HRA reimbursement amount, is at best unclear. Does the rule prohibit only direct correlation between HRA accruals and salary reductions (e.g., every increase in salary reduction correlates to an increase in the HRA)? Clearly, some correlation exists between the level of salary reduction and HRA accruals by the very nature of contributory health coverage (e.g., HDHC with the HRA is available only if a pre-tax salary reduction is made).

IRS guidance permits such an "on/off" correlation[39] as well as higher salary reduction amounts when family coverage (with a higher HRA accrual) is elected. For example, it is permissible to charge a higher salary reduction amount for a family HRA+HDHC package than for an employee-only HRA+HDHC package, even if it results in a higher HRA amount than for the employee-only HRA+HDHC package. See the illustration below.

[39] In its first private letter ruling regarding HRAs, the IRS issued a favorable ruling on an HRA under which only employees who had elected to salary-reduce their premiums for the employer's health insurance plan could participate. Priv. Ltr. Rul. 200329014 (Apr. 1, 2003).

 © 2021 Thomson Reuters/Tax & Accounting



* This graphic illustrates the IRS-approved fact situation in Rev. Rul. 2002-41, 2002-28 I.R.B. 75.

Is any other positive correlation between increases in HRA accruals and salary reductions permitted? Presumably, it is permissible to vary either HRA accruals or salary reductions so long as the other is held constant. Treasury officials have informally indicated that this should be permissible.[40] We do not think that an employer that offers multiple major medical plan options in conjunction with an HRA should be required to impose uniform salary reduction amounts for all options (notwithstanding differences attributable to different levels of coverage) or a uniform HRA reimbursement amount for all options.

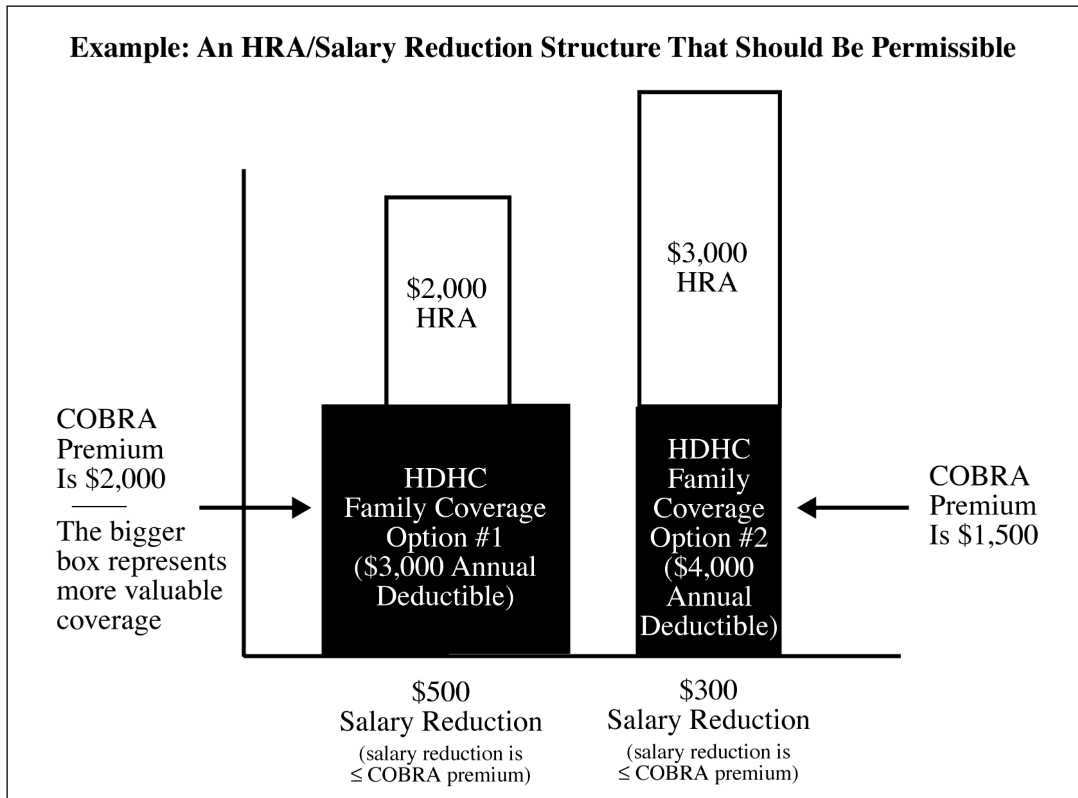
(ii) Inverse Correlations Might Be Permissible

The example in the box above generally provides that an employee may not have a positive correlation between the amount of HRA coverage and the salary reduction amount—e.g., it is generally impermissible if a higher salary reduction amount yields a higher HRA amount.

What if an employer has multiple medical plan options in conjunction with the HRA? May the integrated HRA+HDHC arrangement be structured so that HRA reimbursement amounts increase as salary reduction amounts decrease (an inverse correlation)? For example, assume that an employer offers two medical plan options in conjunction with an HRA. Option 1 offers major medical with a $3,000 deductible. The applicable premium for such coverage for the year is $2,000. The required salary reduction amount is $500, and the HRA amount is $2,000. Alternatively, employees can choose Option 2, which offers a major medical plan with a $4,000 deductible and an applicable premium of $1,500. The salary reduction amount for Option 2 is $300, and the HRA amount is $3,000. See below for an illustration of this example.

[40] Informal, nonbinding remarks of Kevin Knopf (Treasury Department Office of Benefits Counsel) at July 11, 2002 ECFC Conference.

© 2021 Thomson Reuters/Tax & Accounting



This design would appear to be permissible because the employee is not electing a higher salary reduction amount for a higher HRA accrual (quite the opposite is true). Treasury officials have informally indicated that such an "inverse correlation" should be permissible, but that arrangements in which there is a positive correlation would be examined under a "facts and circumstances" analysis.[41] Without additional formal guidance, employers will have to make a good faith determination, with the assistance of legal counsel, as to whether there is an impermissible correlation between HRA coverage amounts and salary reductions.

b. HRA May Not Be Used to Fund Employer Coverage That Could Be Funded Under the Cafeteria Plan

IRS guidance prohibits HRA funds from being used to pay the employee's share of HDHC (major medical) in lieu of cafeteria plan salary reduction contributions.

Example: Indirect Funding of HRA by Employee Is Not Allowed. Employees participating in the reimbursement arrangement are reimbursed up to $1,000 each year for substantiated Code § 213(d) medical care expenses and unused amounts remaining at the end of the year are carried forward for reimbursements in later years. The employee share of the annual premium for the other accident or health plan is $1,500. Employees have a choice either to use amounts in the reimbursement arrangement to pay for the premium for the other accident or health plan or to pay that premium pursuant to a salary reduction election. Under this plan, the reimbursement arrangement does not reimburse any portion of the premium paid by salary reduction. Because an employee may use the reimbursement arrangement to pay a portion of the premium in lieu of electing to salary-reduce, the reimbursement arrangement is indirectly funded pursuant to salary reduction. This arrangement does not meet the definition of an HRA because it is funded by salary reduction.*

* IRS Notice 2002-45, 2002-28 I.R.B. 93, Part IV.

[41] Informal, nonbinding remarks of Kevin Knopf (Treasury Department Office of Benefits Counsel) at July 11, 2002 ECFC Conference.

© 2021 Thomson Reuters/Tax & Accounting

Presumably, this prohibition is necessary to prevent an employee who has the option to direct HRA carryover amounts toward his or her cost of coverage from manipulating the HRA balance by increasing or decreasing future salary reduction funding. For example, if HRA balances could be directed toward the cost of coverage (in lieu of salary reductions), an employee could increase the amount in the HRA by agreeing to additional salary reductions. On the other hand, arrangements that limit employee discretion over salary reduction funding (e.g., by requiring that unused HRA amounts be used first before additional salary reduction funding) should not be prohibited. An argument can be made that such arrangements should be permissible since HRA balances cannot be manipulated. Treasury officials have informally indicated that an arrangement that restricts employee discretion with regard to salary reduction funding may be permissible.[42]

c. No Relationship Between HRA and FSA Forfeitures

IRS guidance prohibits employers from basing the amount credited to an HRA either directly or indirectly on the amount of health FSA forfeitures. If an impermissible correlation exists, the HRA will be treated as if it were funded by salary reductions and will be subject to the Code § 125 rules. According to the guidance, in determining whether such a relationship exists, "facts and circumstances taken into consideration include the manner in which salary reduction is implemented for other accident or health plans offered by the employer."[43] For example, a design under which employees' health FSA contributions are matched with contributions to an HRA, while not specifically addressed in formal guidance, would seem to be impermissible due to the prohibition against direct or indirect cafeteria plan funding of an HRA.

d. Analyze All Aspects of HRA+HDHC Plan

IRS guidance specifies several arrangements that are impermissible but leaves open the possibility that other arrangements would also run afoul of the requirement to keep HRAs separate from cafeteria plans. In trying to determine whether an impermissible correlation exists, plan sponsors should analyze all aspects of the integrated HRA+HDHC major medical plan.

The following are HRA design elements that may help to show that there is not impermissible linkage between an HRA and a cafeteria plan. Some of these elements are specifically dealt with in IRS guidance, and some are not. While the list is not exhaustive, and none of these factors taken alone will make an HRA bulletproof, they all should be considered:

- the plan document, employee communications, and forms clearly say that the HRA is 100% employer-funded and is offered outside of the cafeteria plan;
- the employee's share of the premium for the HDHC is less than what the carrier charges the employer for it;
- if the employer offers several HDHC options, the HRA amount remains fixed, regardless of which HDHC option the employee elects (e.g., a $500 HRA coupled with either $1,000, $2,000, or $3,000 deductible health insurance);
- if an employee drops the HDHC (e.g., at open enrollment the employee elects an HMO option instead), the employee's HRA coverage continues, at least for purposes of spending remaining amounts;
- there is a different waiting period for the HRA than for the HDHC; and
- the HRA is provided to employees who have HDHC through either the employer's HDHC or through a spouse's HDHC plan.

---

[42] Informal, nonbinding remarks of Kevin Knopf, Treasury Department, Office of Benefits Counsel, July 11, 2002 ECFC Conference.

[43] IRS Notice 2002-45, 2002-28 I.R.B. 93, Part IV.

© 2021 Thomson Reuters/Tax & Accounting