



SPECIAL Alert

In This Issue

In this third issue of the McGrawWentworth Special Alert for 2005, we will review two recent revenue rulings that clarify Health Reimbursement Arrangements (HRAs) and Health Saving Account (HSAs). These rulings provide additional guidance on several plan design considerations that have not been clear in the past.

The HRA guidance outlines how the account should be structured to ensure it is only providing benefits for Section 213(d) expenses. The HSA guidance addresses the maximum contributions permitted if family coverage is elected.

We welcome your comments and suggestions regarding this issue of our Special Alert. For more information on this article, please contact your Account Manager or visit the McGrawWentworth web site at www.mcgrawwentworth.com.

“Recent HRA & HSA Guidance”

The IRS recently issued two Revenue Rulings to clarify Health Reimbursement Arrangements (HRAs) and Health Saving Accounts (HSAs). These accounts are designed to help employees pay the deductible in a Consumer Driven Health Plan arrangement. The new revenue rulings answer questions on both of these accounts.



Section 213(d) eligible. The employer cannot allow a cash-out option and maintain a tax-favored status. In three of the four scenarios, the accounts did not qualify as tax-favored HRAs because they directly or indirectly violated the cash-out provision.

In the failing situations:

- One plan permitted employees to receive a cash payment equal to all or part of the unreimbursed account balance when their employment ended.
- Another plan permitted a named beneficiary to receive a cash payment equal to all or part of the unreimbursed account balance if the employee died.
- The third plan allowed employees to elect a separately administered “option plan” at the beginning of the plan year. If the employee elected the option plan, the HRA plan would not allow year-end account balances to roll over. Instead, year-end balances were forfeited, but the employee could transfer the forfeited amount into a number of retirement options. If the employee did not choose the “option plan,” the unused

Revenue Ruling 2005-24 Health Reimbursement Arrangements

The IRS officially endorsed Health Reimbursement Arrangements in 2002. Although the IRS did not offer an overwhelming amount of detail, it was clear that only the employer could fund these accounts.

The new ruling presents four different situations involving employer-sponsored HRA programs. The ruling explains the specific HRA designs required if employees wish to avoid paying taxes on plan proceeds and year-end account balance rollovers. To qualify for these tax advantages, HRA funds may be used only for Section 213(d) qualified medical expenses. Employers can limit covered expenses under their HRA plans. Their plan document must outline which expenses will be covered. However, to qualify the expense must be

amounts were permitted to roll over.

These three scenarios allowed the employee to use the account for a purpose other than paying qualified Section 213(d) medical expenses. Plans that allow funds to be used for other purposes are no longer eligible as tax-favored health reimbursement arrangements.

The fourth scenario *did* qualify for IRS tax-favored status. It included the following key provisions:

- Paid 100% from employer contributions.
- Reimbursed only 213(d) eligible medical expenses for the employee, the spouse and any Section 152 eligible dependents. The expenses were reimbursable because they were not covered under any other plan.
- Permitted carryover for any unused account balances at year end.
- Allowed any eligible benefits to be paid for the surviving spouse and/or surviving dependents if an employee dies. If the surviving spouse and any eligible dependents



die, any account balance is forfeited to the employer.

- Forfeited to the employer any account balance remaining if an employee with no surviving spouse or eligible dependent dies.
- Required the employer to contribute the value of all or a part of a retired employee's accumulated unused vacation and sick leave to the HRA when the employee retires.
- Satisfied the nondiscrimination requirements of Section 105(h) for a self-funded medical plan.

The IRS issued this ruling to answer many questions on what would constitute a tax-favored

HRA arrangement. Because the initial IRS ruling contained very few specific requirements, these plans have been set up and administered in many different ways.

Accounts that pay cash or offer any non-taxable benefit other than covering eligible Section 213(d) medical expenses will not qualify as an HRA. An acceptable HRA can be used only to reimburse non-covered eligible Section 213(d) medical expenses.

The government also cleared up a strategy that many employers have been considering, a strategy that

would allow the employer to deposit the value of any unused sick or vacation days into the HRA when the employee retires. To allow this vacation "cash out" into an HRA, this provision must apply to all eligible employees who retire, must occur automatically and must be mandatory.

Revenue Ruling 2005-25 Health Savings Accounts

The 2003 Medicare Modernization and Improvement Act introduced Health Saving Accounts or HSAs as an attractive way to save for unreimbursed medical expenses and even retiree medical expenses. These accounts must meet certain requirements. The guidance in Revenue Ruling 2005-25 addresses contributions to an HSA account when family high deductible health plan coverage is elected.

In order to contribute to an HSA, an individual must be covered by a qualifying high deductible health plan (HDHP) and no other comprehensive health coverage with the exception of vision, dental, dread disease coverage and so on. This guidance addresses the contributions that are permitted when an individual is a qualifying individual but covers family members that have comprehensive health coverage in addition to the high deductible health plan coverage.

The IRS limits the amount you can contribute to an HSA each year. The limits are based on the coverage you choose (self only or family) and the deductible amount of the high deductible health plan. The limits for 2005 are as follows:

- **Self only coverage:** lesser of plan deductible or \$2,650

NOTABLE THOUGHTS

**IF YOU'RE NOT FAILING EVERY NOW AND AGAIN,
IT'S A SIGN YOU ARE PLAYING IT SAFE.**

WOODY ALLEN, FILM DIRECTOR AND ACTOR

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- **Family coverage:** lesser of plan deductible or \$5,250

The length of time the deductible accumulates and any embedded deductible amounts can affect these contribution limits.

The new rulings present three situations in which an employee's HDHP covers the family and the spouse has coverage under another comprehensive group health plan. If the HDHP covers the family, the spouse's comprehensive health plan cannot also cover the employee and allow the employee to make contributions to the HSA.

The Revenue Ruling allows the employee to deduct the maximum family coverage contribution in each case regardless of whether any dependents have comprehensive health coverage through another source. The IRS ruling allows the following:

- An eligible employee does not become ineligible to contribute to an HSA, merely because the spouse has non-HDHP family coverage, providing the non-HDHP plan does not cover the employee.
- The maximum amount the employee can contribute depends on whether the coverage is self-only or a family HDHP.

It is important to understand that if an individual is covered by the spouse's non-HDHP plan coverage, the individual would not be eligible to contribute to the HSA because the individual would have

comprehensive health coverage in addition to the HDHP. However, the coverage status of other family members will not affect the contribution level.

Permitted contributions are determined by the coverage level elected (self-only or family) and age, if eligible for catch

up contributions. The fact other family members have comprehensive health coverage in addition to coverage under the HDHP

will not impact the individual's maximum contribution amount.

Conclusion

More and more employers are exploring consumer driven health options with either an HRA or an HSA to help pay the large deductible. HRAs and HSAs are very different, and there are still some gray areas when it comes to account administration and plan design. Although the government has issued significant guidance to clarify the gray areas, many questions remain.

McGraw Wentworth will keep you posted on any additional guidance issued on HRAs and HSAs. **MW**



