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MEMORANDUM

May 31, 2005

TO: Clients

FROM: Groom Law Group

RE: Recent IRS Guidance on FSA//HSA/HRA Accounts

The Internal Revenue Service (IRS) recently issued guidance that impacts Flexible Spending Arrangements (FSAs), Health Savings Accounts (HSAs), and Health Reimbursement Arrangements (HRAs) as follows:

- Notice 2005-42 (May 18, 2005): provides cafeteria plans with the ability to extend the plan year for a FSA for an additional 2-1/2 months.
- Rev. Rul. 2005-25 (April 13, 2005): clarifies that coverage of a spouse plus dependents under a non-high deductible health plan does not disqualify an individual who is enrolled in a high deductible health plan from HSA participation.
- Rev. Rul. 2005-24 (April 5, 2005): clarifies that it is acceptable for an employer to base the level of its HRA contributions for retiring employees on the value of unused sick/vacation leave, and also reinforces the IRS position that HRA funds may never be converted to use for a non-medical purpose without adverse tax consequences.

A brief background of FSAs, HSAs and HRAs and further discussion of this guidance follows.

A. <u>FSA Notice</u>

1. <u>Background</u>

An FSA is an arrangement offered through an employer's Code section 125 cafeteria plan, under which employees agree to salary reduce a certain amount each year on a pre-tax basis to pay for eligible medical expenses or dependent care expenses. The employer is also permitted to contribute to an FSA, although this is less common. Any

FSA funds remaining after all reimbursable claims are paid for the plan year must be forfeited ("use it or lose it" rule). Prior to Notice 2005-42, a participant in a health or dependent care FSA was required to incur claims during the 12 month plan year in order to receive reimbursement for those claims from his or her FSA account. Any expense incurred after the close of the 12th month was not reimbursable from the account for that year.

2. Notice 2005-42

Notice 2005-42 allows a cafeteria plan to provide a maximum extended period of 2-1/2 months beyond the close of the plan year for participants to incur reimbursable claims for a particular plan year. After that time, any remaining FSA amounts must be forfeited. A plan is not required to adopt this rule, or to provide the full 2-1/2 month extension (i.e., a lesser period is acceptable). If a plan does wish to incorporate this rule, the cafeteria plan document must be amended prior to the end of its plan year (either calendar or fiscal) for which the change will be effective, and must identify the benefits under the cafeteria plan to which the extended period will apply. As a practical matter, health and dependent care FSAs are the only benefits for which an extension of this type appears to make sense, and the extension could be limited to just one of these benefits. The new rule cannot be applied retroactively to earlier plan years.

The IRS has indicated informally that it would be permissible for a plan to impose a cap on the amount of benefits that are subject to the 2-1/2 month extension as long as the cap is applied uniformly to all plan participants. Further, if an employer has more than one cafeteria plan, the extension can be limited to only one cafeteria plan.

3. Observations

This Notice is the IRS's response to requests from Congress and the public to eliminate the "use-it-or-lose it" rule. Last December, Treasury wrote to Senator Charles Grassley that, absent a statutory change, Treasury does not have the authority to change the use-it-or-lose-it rule, which appears in the IRS proposed cafeteria plan regulations dating back to 1984. While that point is debatable, the 2-1/2 month extension does provide a plan with the ability to give an FSA participant additional time to use amounts elected for the FSA plan year, theoretically reducing the potential for forfeitures. Considerations for employees in this area include the following.

- The extension will result in additional administrative complexity for the plan administrator, particularly if the participant makes another FSA election the following year (e.g., salary reductions and claims must be attributed to the appropriate plan year).

- If the participant elects an HSA during the extension period (see "B" below for description of HSA), use of the health FSA during the extension period will, according to informal IRS comments, have to be limited as described in Code section 223 and Rev. Rul. 2004-45 (which describes the circumstances in which a health FSA and HRA can be used with an HSA).

- If the extension is adopted for the health FSA, individuals who elect COBRA for the health FSA will be entitled to the same extended period that applies to active participants.

B. Health Savings Account Ruling

1. Background

An HSA is a funded account, similar to an IRA, to which employers, employees and other individuals may make annual contributions within specified limits.[1] These contribution limits for 2005 are the lesser of: (i) $2,650 (self-only coverage) or $5,250 (family coverage), or (ii) the deductible under the high deductible health plan. Individuals who are age 55 or over are eligible for an additional catch-up contribution of $600 for 2005. The earnings in the HSA grow on a tax-free basis, and, if used for medical expenses of the account owner, spouse, or dependents, may be withdrawn on a tax-free basis. In order to participate in an HSA, an individual must be covered under a "high deductible health plan," defined as a plan with a minimum annual deductible of $1,000 for self-only or $2,000 for family coverage and an annual out-of pocket cap that does not exceed $5,100 for self-only coverage or $10,200 for family coverage. With limited exceptions, an individual may not be covered under any non-high deductible health plan during the time that he or she is participating in an HSA.

2. Rev. Rul. 2005-25

Code section 223(c)(4) defines "family" coverage as any coverage other than self-only coverage. As noted above, in order to be eligible to make contributions to an HSA, an individual must be covered by an HDHP and no other non-HDHP, with limited exceptions. This raises the question of whether the separate health coverage of an individual's spouse, if it includes individuals other than the spouse (e.g., children), would be considered "family" coverage that taints an individual's HSA eligibility. In this Revenue Ruling, the IRS clarifies that as long as an individual is not covered under his or her spouse's "family" coverage (i.e., the coverage includes the spouse and children, but not the individual), that individual's HSA eligibility is not affected.

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[1] Employee contributions may be made either on a pre-tax basis through the employer's cafeteria plan, or by employees on their own outside the cafeteria plan, and deducted.

3. Observation

It is helpful that the IRS has adopted a flexible position that an individual's spouse may maintain health coverage for the spouse and children without eliminating an individual's ability to maintain self-only HDHP coverage and contribute to an HSA. The IRS limited the facts of the ruling to situations in which an individual, under the terms of the spouse's health plan, does not have coverage under that plan (i.e., coverage is limited to the spouse and children). Presumably, if the individual was covered under the terms of the health plan, he or she could not contribute to an HSA (even if he or she did not use such coverage).

Unfortunately, the IRS did not use this opportunity to clarify how, if at all, an individual could contribute to an HSA if his or her spouse had an FSA. Rev. Rul. 2004-45 states that being "covered" by a spouse's health FSA would make an individual ineligible to contribute to an HSA. However, that Revenue Ruling does not explain when an individual will be considered to be "covered" by a spouse's FSA. Absent specific formal guidance on this point, a reasonable argument could be made that, if an individual does not submit expenses to his or her spouse's FSA, that person was not "covered" by the FSA. However, IRS officials have made informal statements indicating that they do not agree with this approach.

C. HRA Ruling

1. Background

A Health Reimbursement Arrangement (HRA) is an arrangement under which an employer agrees to reimburse a specified amount of medical expenses for employees each year (including former employees), and allows unused amounts to carry over from one year to the next. HRAs were first approved by the IRS in July 2002 (Notice 2002-45 and Rev. Rul. 2002-41). An HRA can be funded or unfunded, and the IRS guidance is flexible enough to allow many variations in plan design. For example, the HRA may, but need not, be provided with an accompanying insured plan. In addition, an employer is permitted to incorporate restrictions into the plan design, such as a vesting schedule or a limitation on the amount that can be carried over from year to year.

HRA funds may be used to reimburse health care expenses that are incurred by the employee and his spouse and dependents under Code section 152 (generally, individuals for whom the employee provides over half of the support for the calendar year, and who either live with the taxpayer, or satisfy a specified relationship such as child, sibling, parent, etc.). Upon death of the employee, the surviving spouse and eligible dependents, if any, may continue drawing on the HRA to pay for medical expenses until its depletion. However, when the spouse remarries or dies, and when there are no longer dependents, any amounts remaining in the HRA must be forfeited. If an employee dies without a surviving spouse or dependents, any amounts in the HRA at the time of death must be forfeited.

2. Rev. Rul. 2005-24

Rev. Rul. 2005-24 presents four hypothetical situations involving HRAs as follows:

- Situation 1 demonstrates that an employer is permitted to base the level of its HRA credits/contributions on the value of all or a portion of a retired employee's unused sick and vacation leave, as long as such contribution is made "automatically and on a mandatory basis" under the terms of the plan, and the employee is not given the choice to receive such amounts in cash.

- Situations 2 and 3 demonstrate that amounts in an HRA may not be paid to an employee, an employee's estate, or an employee's beneficiary for a non-medical purpose, even if such amounts are included in taxable income of the employee, beneficiary or estate. The Revenue Ruling states that the consequences of doing so are that all amounts distributed from the HRA are includable in the employee's income (even those amounts that were actually used to reimburse medical expenses).

- Situation 4 demonstrates that if an employee is able to receive an amount that is equivalent to his or her HRA forfeiture as a benefit under the employer's retirement plan (or in any other way), the IRS will view the arrangement as a violation of the rule that no amount may be distributed from an HRA for a non-medical purpose.

3. Observations

It is helpful to have confirmation that the IRS does not have any difficulty with an arrangement under which the employer automatically bases its credit/contribution on the value of unused sick/vacation leave, notwithstanding that this factor will vary from one individual to the next. The Revenue Ruling states as part of the facts that the plan complies with the nondiscrimination requirements of Code section 105(h). The IRS has indicated informally that employers can structure their HRA plan designs as described in this ruling without worrying about whether highly compensated individuals (generally the top-paid 25% of workforce) are receiving greater benefits than non-highly compensated individuals, in violation of Code section 105(h).

Unfortunately, by limiting Situation 1 to a fact pattern under which the employer "automatically and on a mandatory basis" converts the value of sick/vacation leave into an HRA contribution, the IRS stops short of endorsing an arrangement under which the employer allows employees to make a choice (e.g., a one-time election) between receiving the value unused sick or vacation leave in cash or having the cash credited or deposited to the HRA. Perhaps the IRS will address this issue in later guidance.

Situations 2 through 4 merely reiterate the IRS position, articulated in Notice 2002-45, that amounts may not be withdrawn from an HRA for any purpose other than to pay the medical expenses of the employee, spouse and dependents without incurring adverse tax consequences. The IRS will consider direct and indirect methods of avoiding this rule to be violations. Employers have a strong incentive to ensure that the HRA is properly administered, given that the IRS has taken the position that all amounts distributed from the HRA, even those that were used for legitimate medical expenses, could be characterized as income by the IRS. These amounts would be considered wages, resulting in inclusion for income tax as well as employment tax purposes.

As in Notice 2002-45, the IRS remains silent as to whether amounts from an HRA can be withdrawn on an after-tax basis to pay the medical expenses of a domestic partner. In the absence of guidance to the contrary, this would seem a reasonable position to take, based upon the position taken by the IRS in private letter rulings with respect to employer-provided health coverage for domestic partners. See, e.g., PLR 9850011; PLR 200108010.

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Our DC health plan team includes Tom Fitzgerald, Lou Mazawey, Bill Sweetnam, Brigen Winters, Mike Thrasher and Chris Keller. Please contact us with any questions on FSAs, HRAs or HSAs generally, or for further information on this IRS guidance.