

CLIENT ALERT

First IRS letter ruling on "Health Reimbursement Arrangements"

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The IRS has issued its first private letter ruling approving a health reimbursement arrangement ("HRA"). PLR 200329014 (July 18, 2003). <http://www.irs.gov/pub/irs-wd/0329014.pdf>. Under an HRA, an employer can make contributions to an individual health account on an employee's behalf. The money must come from employer contributions, i.e., no employee salary reduction contributions or after-tax contributions are allowed. The employee can either use the funds to reimburse himself, his spouse and his dependents for medical expenses incurred during the current year or can carry over any unused balance to use in future years.

Key points of the ruling include.

- (1) The IRS had no problem with the fact that the employer would only make an HRA contribution on behalf of employees who made salary reduction contributions to the employer's medical flexible spending account (FSA). This represents an easy way around the "no employee contributions" rule for HRAs.
- (2) The amount of contributions was based on the withholding from an employee's paycheck, i.e., number of exemptions claimed, marital status, etc. Normally, HRAs, as self-insured arrangements, must satisfy non-discrimination standards set forth in Section 105 of the Internal Revenue Code. Since the formula used by the employer in this case had the effect of "reverse discrimination," i.e., contributions for highly compensated employees generally were less than for non-highly compensated employees, the IRS raised no discrimination issues with this somewhat unique design.
- (3) The IRS allowed the employer to make available a pro rata portion of its annual HRA contribution to employees each payday. Under an FSA, once an employee commits to a certain level of deferrals, that amount must be available for the employee to draw upon from day one.

HRAs are becoming more popular because of their carryover feature. In contrast, FSAs are subject to a "use it or lose it" rule. Although HRAs cannot be funded with employee salary reduction contributions, much the same result can be obtained by giving employees a lower increase in base pay and placing the remainder in an HRA. The carryover feature allows HRAs to be used to fund post-retirement medical benefits on a "defined contribution" rather than a "defined benefit" basis, a technique that, in effect, transfers the risk of health care cost inflation to the employee and eliminates retiree health care expense as a charge against E&P.

If you are interested in learning more about HRAs and their possible use in conjunction with other types of employer-sponsored health care arrangements, please contact your regular Crowell & Moring contact or any attorney on our [Health Care team](#).

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.