

## **Health Reimbursement Arrangements**

### *A cutting edge tool for health insurance cost management*

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In 2002 the IRS issued guidance on a new type of tax-favored health plan, which they called a “health reimbursement arrangement”, or “HRA”. This guidance was good news for both employers and employees. Not only did the IRS give certainty where there had been confusion, but they also took a reasonable position on many plan design and operational issues. The end result is that a new type of employer-provided health plan exists which can be used in many different ways to provide pre-tax health reimbursements for employees.

In this article I’ll show how an HRA can be used to achieve one or more of the following:

- Reduce the employer’s cost of providing health insurance
- Reduce the shifting of health insurance costs from the employer to employees
- Eliminate “first-dollar” employee out-of-pocket costs such as co-pays
- Implement a “consumer-driven” health plan approach to make employees better consumers of healthcare services
- Provide tax-free health benefits for retirees
- Implement a “defined-contribution” health plan approach which gives business managers the ability to control the rate of future cost increases

### **What is an HRA?**

An HRA is very similar to another popular type of employee benefit health plan: a Section 125 Cafeteria Plan, or Flexible Spending Account (FSA). They are similar in that both provide reimbursement for qualified medical expenses as defined in Section 213 of the Internal Revenue Code (IRC). Most of the time an HRA will be offered along with the FSA, since they accomplish different things. Sometimes the FSA will cover medical expenses which cannot be reimbursed from the HRA, and sometimes the plan design will require that the FSA balance for the year must be used up before the HRA can be used for medical cost reimbursement. These are employer choices when designing the plan.

There are several very important differences between an HRA and an FSA, which give the HRA more flexibility. For example:

- The HRA is not subject to the “use-it-or-lose-it” rule. This means that unused HRA balances at the end of the year can be carried over into the future. This

gives employees a financial incentive to not use all of their HRA account. If an employee builds up a large HRA balance, then this can be used by the employee to offset a possible large medical expense in the future which is not insurance-covered. Also, an employer may allow unused HRA credits to be used by retirees, and may even add additional amounts to retiree HRA balances.

- The HRA does not need to provide the total annual benefit at one time, but can require monthly accruals of the benefit. Thus the employer has better cash flow management than with an FSA where the entire annual benefit is available to the employee on January 1<sup>st</sup> of each year. Also, the HRA is typically just a bookkeeping credit, and the employer only funds each month's claims as they arise. (In fact funding of the HRA may create some unwanted ERISA problems for employers whose benefit plans are subject to ERISA.)
- The HRA must be funded exclusively with employer money – no direct or indirect employee salary reduction is allowed.

If properly designed, HRA payments are tax-free to employees (and tax deductible to an employer that pays income taxes). Also, both the HRA and FSA are subject to nondiscrimination rules under IRC Section 105(h), which requires nondiscrimination as to both eligibility and benefits. HRA contributions cannot be based on age, compensation or years of service. Most employers will vary their HRA contributions based on the type of health insurance coverage chosen by the employee (single vs. family, etc.).

Similar to the FSA, an HRA is subject to both COBRA and HIPAA. In addition it is subject to the same claim substantiation rules as FSA's. Since many HRA's may be administered using debit cards, they will also be subject to the special debit card substantiation rules set forth by the IRS in the spring of 2003.

### **How an HRA Can Reduce Health Insurance Costs**

Many employers are now looking at the HRA as a vehicle to help them reduce, control and manage the costs associated with their health insurance plan. This is true whether the existing plan is fully insured, self-funded, an HMO or a PPO. One of the most common approaches is to combine an HRA implementation with a change to a higher deductible major medical plan. The cost savings result from reduced premiums for the higher deductible program. The HRA is used to give back to employees some portion of the premium savings. Also, the new major medical plan may eliminate co-pays for doctor visits, prescriptions, etc., so the employee has no out-of-pocket expense until the HRA balance is gone. At that time, the employee will incur out-of-pocket expense only until the deductible is reached. This is often called a "corridor deductible". The advantage is that many employees will not fully utilize their HRA balance, and will have no out-of-pocket expense at all. For these employees, carryover of unused HRA balances will offset the "corridor deductible" in the future, which means they would have no out-of-pocket expense. For employees who have higher medical expenses, their costs are limited to the "corridor". In general, employers have found that this approach will

provide a better health plan (less out-of-pocket costs) for a significant majority of their workforce.

### *EXAMPLE*

An employer currently has 200 employees receiving health insurance. The total premium cost for the insurance is currently \$1,000,000, with a deductible of \$250 per individual and \$1000 per family. By changing the deductible to \$2000 per individual and \$4500 per family, the premium cost can be reduced to \$500,000. The employer then gives employees an HRA credit (in total) of 70% of the savings (\$350,000). The employer's cost has been reduced from \$1,000,000 to \$850,000, a savings of 15%. The employees receive an average HRA credit of \$1,750 and co-pays are eliminated. Also, they are given a MasterCard debit card to pay for most prescriptions and doctor visits until their HRA balance for the year is gone.

Although every case is different, the general approach should apply to almost every employer that has a health insurance plan. Specific quotes need to be obtained for the higher deductible plan to determine the amount of the premium savings. The HRA credit amount is a decision of the employer which can change each year. This gives the employer the ability to manage costs more effectively in future years. It also gives employees an incentive to utilize less healthcare services, since they get to keep what they don't spend. This approach works very well in situations (very common today) where the employer is shifting health insurance premium cost increases to employees for budgetary reasons. The savings on insurance premiums are shared between employees and the employer, thus potentially creating a true "win-win" situation.

### **Summary**

Most employers should look into providing an HRA to their employees since IRS guidance is now available. An HRA is a very useful and flexible tool for both reducing costs and improving an employee benefit program. Since the amount of the HRA credit given to employees is an employer decision which can change from year-to-year (it can be 100% of the premium savings if desired) it can be designed to achieve many different objectives. In addition, HRA benefit amounts can be retained after retirement or other termination of employment so long as all HRA credits are provided by the employer and not through employee salary reduction. This gives the opportunity for employers to provide retiree health benefits in a way which was not previously available.

*For more information on HRA's and how to use them to, contact Jim Eldredge at 801-266-4461, ext 114 or email him at [jim.eldredge@utea.org](mailto:jim.eldredge@utea.org)*