US Employee Benefits Services Group.

Reimbursement Accounts

What they are, How they work, Why they're important

Pre-Tax Health Expense Accounts

As the cost of group health coverage continues to climb, companies are seeking ways to help employees pay for out-of-pocket medical costs. In this paper, we will examine three of them: the Health Reimbursement Arrangement, or HRA; the Health Savings Account, or HSA; and the health Flexible Spending Account, or FSA. Each has its own merits and drawbacks. With a clear understanding of these, you can select a program that meets the needs of your company and your employees. These brief descriptions will help you get started. Find detailed information in IRS Publication 969[1].

Health Reimbursement Arrangement (HRA)

An HRA is an individually-designed group health benefit plan that reimburses employees tax-free for qualified out-of-pocket health expenses. The plan is funded solely by the employer, with no employee contributions allowed. There is no limit on the amount the employer may contribute, and the employer has much discretion in designing the plan. As long as the expenses are qualified under Section 213(d) of the Internal Revenue Code, the plan may reimburse them to participating employees. Qualified expenses include health insurance premiums — a unique feature of the HRA. Employers may limit or restrict reimbursement of particular expenses, as long as their choices are within IRS guidelines.

Employers may decide that HRA balances can roll over from one year to the next, but that is not required. In fact, the plan may be designed so that balances rolled over from one year to the next can also be accessed after an employee retires. Employer plan design discretion extends to the establishment of plan year maximum reimbursements in any category of expense — dental or vision, for example. However, employers have no discretion about paying out cash or other benefit balances in the HRA to employees — it is not allowed.

Health Savings Account (HSA)

An HSA is an account that can only be used in conjunction with a High-Deductible Health Plan (HDHP). For purposes of the HSA, an HDHP is defined in 2016 as an insurance plan with a deductible of at least $1,300 for an individual or $2,600 for family coverage, and maximum out-of-pocket amounts of $6,550 for an individual or $13,100 for a family.

The account can be funded by the employer or the employee, and contributions are tax deductible up to the legal limit. For 2016, the HSA contribution limit is $3,350 for an individual and $6,750 for a family. Catch-up contributions of an extra $1,000 are allowed for those age 55 and older. When used to pay for qualified medical expenses, HSA withdrawals are not taxable. However, if an employee withdraws money from the HSA to pay for non-qualified expenses, he or she will pay income tax and a penalty tax of 20% on the amount withdrawn, unless he or she is permanently disabled or over the age of 65. In that case, income taxes are still payable, but there is no penalty tax.

The money in the HSA belongs to the employee and can be held there even after the employee has left the company or retired. The account can be invested at the account holder's discretion, much like an IRA. Also like an IRA, investment earnings on the account grow tax-deferred. The money can be used in retirement to pay for qualified medical expenses, still without taxes. Once the account holder reaches age 65 or becomes totally and permanently disabled, withdrawals can be made without a penalty tax. Income taxes will still be payable, though.

Health Flexible Spending Account (FSA)

A health FSA is an account set up by an employer through a Section 125 Cafeteria Plan. It is funded by payroll deduction. The employee decides how much to

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1 https://www.irs.gov/pub/irs-pdf/p969.pdf

contribute, up to the limit set by the IRS ($2,550 for 2016) or a different amount set by the plan. This decision is made before the start of the plan year, and a portion of the amount is withheld from each paycheck during the year. The amount set aside in the FSA is not taxable as income, so qualified expenses are paid with before-tax money. The employer may also contribute to an FSA, as long as the amount is within the IRS limits.

Once the plan year begins, the full amount designated by the employee is available to pay for qualified medical expenses (like deductibles and co-pays), including items not covered by the health plan (for example, vision care and hearing aids). However, any funds in the FSA that are not used by the end of the plan (with some exceptions) are forfeited. That's why it's important for employees to understand their FSA and to plan appropriately.

Key Feature Comparison

	HRA	HSA	Health FSA
Who contributes?	Only the employer	The employer, the employee (or any other person)	The employer, the employee, or both
Maximum annual contribution, 2016	No limit	$3,350 for self-only coverage; $6,750 for family coverage; plus $1,000 for people age 55 or over	$2,550 through payroll deduction
Who is eligible?	Employees enrolled in certain non-HRA group coverage. Plan may not discriminate in favor of highly compensated individuals.	Individual covered by an HDHP, not covered by another health plan that isn't an HDHP, not enrolled in Medicare, and may not be claimed as a tax dependent	Employer decides eligibility, but plan may not discriminate in favor of highly compensated individuals, and must comply with IRC Section 125.
Allowable medical expenses	Qualified medical expenses as defined in IRC 213(d). Also allowed: group health insurance premiums, long-term care insurance premiums, amounts not covered by another plan.	Qualified medical expenses as defined in IRC Section 213(d). Also, certain long-term care insurance premiums, COBRA premiums, health covered during unemployment, Medicare premiums for those 65 and older.	Qualified medical expenses as defined in IRC Section 213(d). Plan may limit to a subset of those. May not pay for health insurance premiums, long-term care coverage, or amounts covered by another plan.
Carryover year to year and balances	Carryovers year to year generally allowed. Employer may not refund any part of the balance to the employee.	Carryovers year to year generally allowed.	Carryovers from year to year not allowed, unless employer elects to allow either: a $500 carryover to the next year, or a grace period up to 2 ½ months after plan year end to use the balance.
Portability	No, employer owns the account.	Yes, employee owns the account.	No.
Potential employee tax benefits	Employer contributions not subject to payroll taxes, and not included in income; when used to pay qualified expenses, reimbursements not taxable.	Employee contributions pre-tax or tax deductible; account earnings non-taxable while in the account; employer contributions not included in income; distributions to pay qualified expenses are tax-free.	Generally, contributions by employer or employee not included in income and not subject to payroll taxes; when used to pay qualified expenses, reimbursements not taxable.

With these basic features in mind, we hope your choice of tax-deferred accounts is easier. If not, please contact us. At USEBSG, we take pride in working with our clients to help them make the right choices for their unique situations. We can be reached at info@usebsg.com.