

## **HRAs for PEOs? Of course!**

Many PEOs today are offering higher deductible health plans on behalf of their worksite employers and employees in an effort to help curtail the rising costs of health insurance. HRAs (Health Reimbursement Arrangements) are put into place as a way of allowing employers to partially self fund the deductible, so that employees are not burdened by the drastic increase in out of pocket expenses. HRAs were defined in the IRS Revenue Rulings 2002-41 and 2002-45, and represented the Bush Administrations take on health care policy for the U.S. before it switched gears in late 2003 when it advocated Health Savings Accounts (HSAs). Both HRAs and HSAs have proliferated, however the market has determined that HSAs may have a more limited application than intended by the Bush administration, and, in fact, HRAs have been growing at a more impressive clip.

First, what is an HRA? Here is a the IRS press release in 2002 that provides a succinct description:

---

### **FROM THE OFFICE OF PUBLIC AFFAIRS**

June 26, 2002  
PO-3204

#### **Treasury and IRS Issue Guidance on Health Reimbursement**

Today the Treasury Department and the Internal Revenue Service issued guidance that clarifies the tax treatment of health reimbursement arrangements (HRAs) in which the employee's health benefit arrangement provides for employee-controlled reimbursement of medical costs.

"With this new guidance, we clear the way for employers to adopt health plans with patient-directed features so that employees have more choice and greater control over their health care coverage," stated Treasury Secretary Paul O'Neill.

The guidance, consisting of a notice and a revenue ruling, provides that medical benefits paid by Health Reimbursement Arrangements (HRAs) that meet certain requirements are not taxable. The guidance also clarifies that HRAs generally are not subject to the complex design requirements for health Flexible Spending Arrangements funded through salary reduction under a cafeteria plan.

The primary requirements for an HRA are that (1) the plan must be funded solely by the employer and cannot be funded by salary reduction, and (2) the plan may only provide

benefits for substantiated medical expenses. If the plan provides for payments or other benefits irrespective of medical expenses, all amounts paid by the plan become taxable, including prior medical reimbursements.

Under this guidance HRAs can:

- Allow the carryover of unused amounts to later years (i.e., the "use-it-or-lose-it rule" does not apply) and
- Reimburse employees for the purchase of health insurance.

In addition, the guidance provides that:

- HRAs may allow former employees, including retirees, continued access to unused reimbursements;
- HRAs may provide that an FSA funded by salary reduction reimburses expenses before the HRA; and
- HRAs are group health plans subject to the COBRA continuation requirements.

---

source: [irs.gov](http://irs.gov)

How do they work? Figure 1 is a typical HRA application, where the employer offers a higher deductible health plan, \$2000 in this example, and also offers a \$1500 HRA, so the participant appears to have only a \$500 deductible. Let's say there is a medical expense incurred of \$1000. The provider bills the carrier, which sends an EOB (explanation of benefits) showing that no monies are paid because the expense is charged to the policy deductible, to the participant. The participant then submits the EOB to the employer's HRA administrator, who then takes \$500 out of the employee's Health FSA account, then goes to the employer for the amount of \$500 to cover the HRAs portion of the expense. As more claims come in, the HRA administrator pays the participant out of the HRA account until \$2000 is met, at which point claims are insured under the terms of the overlying health policy.

HRAs have proliferated because employers are finding that their exposure in the HRA account is less than in the increased cost of premiums for a lower deductible health product. Studies show that 73% of American households are spending less than \$500 annually on health care. Employers have found that they are typically burning though 22% to 30% of their exposure in the HRA plan, since they only pay out of the HRA obligation if a claim is presented. While HSAs are considered to be more limited in application and restricted in use, HRAs are far more flexible and can be designed to meet the employers and employees needs. Here are HRA basics you need to know:

- HRAs can only be funded with employer dollars, never by employee payroll deduction
- HRA funds are most commonly kept in the employer's general business account, representing a contingent future liability for claims that may or may not come in.

- HRAs fall under Section 105 of the IRS Code, and operate as a qualified plan requiring a plan document, non discrimination testing, and claims compliance similar to that of Flex Plans
- HRAs can have a carry over provision if set forth in the plan document. A carry over provision will create a future contingent liability for future claims that may, or may not, be presented. Most of our HRA clients do not offer a carry over provision in their plan.
- HRAs are not necessarily tied to any particular type of insurance, and are therefore much more flexible than HSAs. Many employers use stand alone HRAs for health, dental or vision benefits
- HRAs have been relatively ignored since the Bush Administration switched to HSAs in late 2003, and almost all regulatory efforts have been directed towards HSAs. This means HRAs are relatively open in scope, and it is very important to have the plan detailed fully in the plan document.
- HRAs, as an ERISA plan, are subject to COBRA regulations, thus terminating employees must be offered the HRA as a benefit. Since there is very little guidance on setting the amount of COBRA premium, this must be specified in the plan document.
- Employers are outsourcing HRA administration to remain in compliance with HIPAA privacy rules

As an example to illustrate HRA growth, our Flex, HRA and COBRA administration firm has many insurance broker clients across the country setting up HRAs for their clients. This author was amazed to see recently that over 18% of our TPA's book of business is comprised of HRAs. As a former PEO owner, this author has always believed that HRAs are a very good fit for the PEO client demographics, and, in fact, a number of our PEO clients are moving towards offering HRAs to their worksite employers and employees.

HRAs in the co-employment environment gives rise to a separate set of issues that are not defined in depth in the IRS regulations to date. While space in this article is limited, here are some issues to consider in offering HRAs to your PEO client base.

First, the HRAs are most typically, if not exclusively, put in place on a client by client basis. This puts each worksite employer at risk for its own worksite employees, and the PEO is not spreading risk across multiple employers. HRAs are regulated federally, however state insurance regulators will also get involved if they perceive that the PEO is offering a type of self funded insurance across its employee base, and each state may look at this differently. If the HRAs are administered on a client by client basis, then typically state regulatory concerns are avoided.

Next, the PEO should address in its service agreement how the HRA funds will be handled. As the HR department, the PEO can take and distribute funds, but it would be prudent to make it clear in writing that the PEO is handling worksite employer HRA funds on behalf of the worksite employer, and the worksite employer is responsible for all HRA obligations to the worksite employees assigned to that worksite employer.

Next, careful attention should be given to the documentation strategy for the PEO itself, and for the worksite employers offering the HRA benefit to their worksite employees. A balance should be struck to keep plans separate, yet also keep administration costs low to accommodate a high number of worksite employer HRA plans.

Additionally, PEO enrollers and staff should be trained to explain and enroll the new HRA benefit, and to answer the typical HRA participant questions that will come up.

Since HRAs are relatively new as a ‘consumer directed healthcare’ tool, many experts, accounts and attorneys have entered the fray and there is much information in the marketplace on the operation of HRAs that may appear conflicting. This is to be expected, however in the co-employment arena it is this author’s recommendation to consult your benefits counsel and to draw on the experience of those PEOs that have successfully launched the HRA benefit, because in the realm of HRA benefits, as in life, there is no substitute for experience.

#### About the Author

Tom Jacobs, JD MBA is CEO of [eflexgroup.com](http://eflexgroup.com), a third party administrator of Section 125, 132, Flex, HRA, and COBRA, service over 75 PEO clients. Tom has served on the NAPEO Board of Directors, and current serves on the NAPEO Legal Advisory Council. He was formerly in a private law practice in the area of employment law, real estate and insurance defense litigation. Questions can be directed to Tom at [tomj@eflexgroup.com](mailto:tomj@eflexgroup.com), (608)243-8277.

© Tom Jacobs, J.D., [eflexgroup](http://eflexgroup.com), inc. 10/1/2006