

Part III. Administrative, Procedural, and Miscellaneous

Health Reimbursement Arrangements

Notice 2002-45

PURPOSE

This notice provides basic information about a type of employer-provided health reimbursement arrangement (HRA) described below. Published elsewhere in this bulletin is a revenue ruling providing guidance involving an HRA.

This notice is divided into eight parts. Part I of the notice describes HRAs and their general tax treatment. Part II of the notice outlines the benefits that may be offered under an HRA. Part III details who may be covered under an HRA. Part IV deals with the interaction between HRAs and cafeteria plans. Part V covers ordering rules for reimbursement from HRAs and § 125 health flexible spending arrangements. Part VI relates to the applicability of § 105(h) non-discrimination rules to HRAs. Part VII explains how to provide COBRA continuation coverage under HRAs. Part VIII addresses certain other matters.

I. Tax Treatment of HRAs Generally

An HRA is an arrangement that: (1) is paid for solely by the employer and not provided pursuant to salary reduction election or otherwise under a § 125 cafeteria plan; (2) reimburses the employee for medical care expenses (as defined by § 213(d) of the Internal Revenue Code) incurred by the employee and the employee's spouse and dependents (as defined in § 152); and (3) provides reimbursements up to a maximum dollar amount for a coverage period and any unused portion of the maximum dollar amount at the end of a coverage period is carried forward to increase the maximum reimbursement amount in subsequent coverage periods. To the extent that an HRA is an employer-provided accident or health plan, coverage and reimbursements of medical care expenses of an employee and the employee's spouse and dependents are generally excludable from the employee's gross income under §§ 106

and 105. Assuming that the maximum amount of reimbursement which is reasonably available to a participant under an HRA is not substantially in excess of the value of coverage under the HRA, an HRA is a flexible spending arrangement (FSA) as defined in § 106(c)(2).

II. Benefits under an HRA

To qualify for the exclusions under §§ 106 and 105, an HRA may only provide benefits that reimburse expenses for medical care as defined in § 213(d). Each medical care expense submitted for reimbursement must be substantiated. An HRA may not reimburse a medical care expense that is attributable to a deduction allowed under § 213 for any prior taxable year. Additionally, an HRA may neither reimburse a medical care expense that is incurred before the date the HRA is in existence nor reimburse a medical care expense that is incurred before the date an employee first becomes enrolled under the HRA. Reimbursements for insurance covering medical care expenses as defined in § 213(d)(1)(D) are allowable reimbursements under an HRA, including amounts paid for premiums for accident or health coverage for current employees, retirees, and COBRA qualified beneficiaries. However, see Part IV for a discussion relating to cases in which an employer provides an HRA in conjunction with another accident or health plan. If an HRA is an FSA, reimbursable medical care expenses may not include expenses for qualified long-term care services as defined in § 7702B(c). See §§ 106(c) and 213(d)(1)(C).

An HRA does not qualify for the exclusion under § 105(b) if any person has the right to receive cash or any other taxable or non-taxable benefit under the arrangement other than the reimbursement of medical care expenses. If any person has such a right under an arrangement currently or for any future year, all distributions to all persons made from the arrangement in the current tax year are included in gross income, even amounts paid to reimburse medical care expenses. For example, if an arrangement pays a death benefit without regard to medical care expenses, no amounts paid under the

arrangement to any person are reimbursements for medical care expenses excluded under § 105(b). See § 1.105-2 of the Income Tax Regulations. Arrangements formally outside the HRA that provide for the adjustment of an employee's compensation or an employee's receipt of any other benefit will be considered in determining whether the arrangement is an HRA and whether the benefits are eligible for the exclusions under §§ 106 and 105(b). If, for example, in the year an employee retires, the employee receives a bonus and the amount of the bonus is related to that employee's maximum reimbursement amount remaining in an HRA at the time of retirement, no amounts paid under the arrangement are reimbursements for medical care expenses for purposes of § 105(b). Similarly, if an employer provides severance pay only to employees who have reimbursement amounts remaining in a purported HRA at the time of termination of employment, no amounts paid under the arrangement are reimbursements for medical care expenses for purposes of § 105(b).

III. Coverage under an HRA

Medical care expense reimbursements under an HRA are excludable under § 105(b) to the extent the reimbursements are provided to the following individuals: current and former employees (including retired employees), their spouses and dependents (as defined in § 152 as modified by the last sentence of § 105(b)), and the spouses and dependents of deceased employees. The term "employee" does not include a self-employed individual as defined in § 401(c). See § 105(g).

An HRA may continue to reimburse former employees or retired employees for medical care expenses after termination of employment or retirement (even if the employee does not elect COBRA continuation coverage). For example, an HRA may have a provision that reimburses a former employee for medical care expenses only up to an amount equal to the unused reimbursement amount remaining at retirement or other termination of employment. The plan may also provide that the maximum reimbursement

amount available after retirement or other termination of employment is reduced for any administrative costs of continuing such coverage. Additionally, an HRA may or may not provide for an increase in the amount available for reimbursement of medical care expenses after the employee retires or otherwise terminates employment (even if the employee does not elect COBRA continuation coverage).

IV. HRAs and Cafeteria Plans

Employer contributions to an HRA may not be attributable to salary reduction or otherwise provided under a § 125 cafeteria plan. An accident or health plan funded pursuant to salary reduction is not an HRA and is subject to the rules under § 125. However, an HRA is not considered to be paid for pursuant to salary reduction merely because it is provided in conjunction with a cafeteria plan. Additionally, if an employer offers employees a choice between employer-provided non-taxable benefits (*e.g.*, coverage under an HRA and coverage under a health maintenance organization (HMO)), with no cash or other taxable benefits available to employees, the choice is not an election to which § 125 applies.

If an employer provides an HRA only in conjunction with another accident or health plan and that other plan is provided pursuant to a salary reduction election under a cafeteria plan, then all the facts and circumstances are considered in determining whether the salary reduction is attributable to the HRA. Assuming that the terms of the salary reduction election indicate that the salary reduction is used only to pay for the specified accident or health plan offered in conjunction with the HRA and not to pay for the HRA itself, the mere fact that an employee may participate in the HRA only if the employee participates in a specified accident or health plan funded pursuant to a salary reduction election does not necessarily result in the salary reduction being attributed to the HRA. In such situations, if the salary reduction election for a coverage period to fund the specified accident or health plan offered in conjunction with the HRA exceeds the actual cost of the specified accident or health plan coverage for such coverage period, the salary reduction is attributable to the HRA. For purposes of this rule, "salary reduction"

includes a choice to forgo receipt of any benefits that would be taxable but for the fact they are offered under a § 125 cafeteria plan.

For any coverage period, for purposes solely of determining whether a salary reduction election exceeds the cost of coverage, the actual cost of the specified accident or health plan coverage for the coverage period may be determined pursuant to the rules for determining the COBRA applicable premium under § 4980B(f)(4). For example, assume that an employer offers an HRA and an employee who participates in the HRA must also participate in the corresponding employee-only or family coverage offered in a high-deductible accident and health plan. If the COBRA applicable premium for the high-deductible accident and health coverage would be \$1,800 for the employee-only coverage and \$4,500 for family coverage if such coverage were offered separately from the HRA, then the annual maximum allowable salary reduction election in this case is \$1,800 for employee-only coverage and \$4,500 for family coverage in order for the salary reduction to be treated as not attributable to the HRA.

An arrangement is not treated as an HRA if the arrangement interacts with a cafeteria plan in such a way as to permit employees to use salary reduction indirectly to fund the HRA. Therefore, where an employee who participates in a reimbursement arrangement has a choice among two or more specified accident or health plans to be used in conjunction with the reimbursement arrangement (or a choice among various maximum reimbursement amounts credited for a coverage period) and there is a correlation between the maximum reimbursement amount available under the HRA for the coverage period (disregarding amounts carried forward from previous coverage periods) and the amount of salary reduction election for the specified accident and health plan, then the salary reduction is attributed to the reimbursement arrangement even if the amount of salary reduction election is equal to or less than the actual cost of the other accident or health coverage.

For example, assume an employer offers a reimbursement arrangement plus other specified accident or health plan

coverage with the actual cost for family coverage for the specified accident or health plan being \$4,500 and the employee having a choice to salary reduce \$2,500 or \$3,500 to fund this coverage. An employee who elects family coverage and \$2,500 salary reduction receives a \$1,000 maximum reimbursement amount under the reimbursement arrangement for the coverage period and an employee who elects family coverage and \$3,500 salary reduction receives a \$2,000 maximum reimbursement amount under the reimbursement arrangement for the coverage period. In this case, although the maximum allowable salary reduction is not exceeded, a portion of the salary reduction is attributed to the reimbursement arrangement because the increase in salary reduction election is related to a larger maximum reimbursement amount in the reimbursement arrangement for the coverage period. This arrangement is not an HRA and is subject to § 125.

Similarly, assume an employer provides a reimbursement arrangement in conjunction with another accident or health plan. Employees participating in the reimbursement arrangement are reimbursed up to \$1,000 each year for substantiated § 213(d) medical care expenses and unused amounts remaining at the end of the year are carried forward for reimbursements in later years. The employee-share of the annual premium for the other accident or health plan is \$1,500. Employees have a choice either to use amounts in the reimbursement arrangement to pay for the premium for the other accident or health plan or to pay that premium pursuant to a salary reduction election. Under this plan, the reimbursement arrangement does not reimburse any portion of the premium paid by salary reduction. Because an employee may use the reimbursement arrangement to pay a portion of the premium in lieu of electing to salary reduce, the reimbursement arrangement is indirectly funded pursuant to salary reduction. This arrangement does not meet the definition of an HRA because it is funded by salary reduction and it is subject to the rules under § 125.

Further, if the amount credited to a reimbursement arrangement is directly or indirectly based on the amount forfeited under a § 125 FSA, the arrangement will be treated as funded by salary reduction.

For purposes of making this determination, facts and circumstances taken into consideration include the manner in which salary reduction is implemented for other accident or health plans offered by the employer.

Because an HRA is paid for solely by the employer and not pursuant to salary reduction, the following restrictions on health FSAs under § 125 are not applicable to HRAs: (1) the prohibition against a benefit that defers compensation by permitting employees to carry over unused elective contributions or plan benefits from one plan year to another plan year; (2) the requirement that the maximum amount of reimbursement must be available at all times during the coverage period; (3) the mandatory twelve-month period of coverage; and (4) except as otherwise provided in this notice, the limitation that medical expenses reimbursed must be incurred during the period of coverage. As a result, the maximum reimbursement amount for a coverage period (not including amounts carried forward from previous coverage periods) need not be available at all times during the coverage period. Also, an HRA may specify a coverage period for a reimbursement amount that is less than a year. Although claims incurred during one coverage period may be reimbursed in a later coverage period, an unreimbursed claim may be reimbursed in a later coverage period only if the individual was covered under the HRA when the claim was incurred. Additionally, the maximum reimbursement amount credited under the HRA in the future (not including amounts carried forward from previous coverage periods) may be increased or decreased. However, see § 1.105–11(c)(3)(ii) regarding operational discrimination in favor of highly compensated individuals (as defined in § 105(h)). Thus, if an increase in maximum reimbursement amounts in an HRA favors one or more highly compensated individuals, the HRA may violate these non-discrimination rules.

V. Ordering Rules for HRAs and § 125 Health FSAs

A medical care expense may not be reimbursed from a § 125 health FSA if the expense has been reimbursed or is reimbursable under any other accident or health plan. If coverage is provided under

both an HRA and a § 125 health FSA for the same medical care expenses, amounts available under an HRA must be exhausted before reimbursements may be made from the FSA. However, a § 125 health FSA will not violate this rule if coverage is provided under both an HRA and a § 125 health FSA and the FSA reimburses a medical care expense which is not reimbursable by the HRA. In no case may an employee be reimbursed for the same medical care expense by both an HRA and a § 125 health FSA.

Consistent with these rules, before a § 125 health FSA plan year begins, the plan document for the HRA may specify that coverage under the HRA is available only after expenses exceeding the dollar amount of the § 125 FSA have been paid. For example, if an employer sponsors a § 125 health FSA and an HRA, both of which provide coverage for the same medical care expenses, and the HRA plan document includes a provision that the HRA is not available for reimbursements of medical care expenses that are covered by the § 125 health FSA until after expenses exceeding the dollar amount of the § 125 FSA have been paid, then those medical care expenses may be reimbursed first from the § 125 health FSA and then from the HRA when the amount available under the § 125 FSA is exhausted.

VI. Nondiscrimination Rules Applicable to HRAs

Section 105(h) sets forth nondiscrimination rules for self-insured medical expense reimbursement plans. To the extent an HRA is a self-insured medical expense reimbursement plan, the nondiscrimination rules under § 105(h) apply to the HRA. See § 1.105–11.

VII. COBRA Continuation Coverage

An HRA is a group health plan generally subject to the COBRA continuation coverage requirements. If an individual elects COBRA continuation coverage, an HRA complies with these COBRA requirements by providing for the continuation of the maximum reimbursement amount for an individual at the time of the COBRA qualifying event and by increasing that maximum amount at the same time and by the same increment that it is increased for similarly situated non-

COBRA beneficiaries (and by decreasing it for claims reimbursed). Premiums are determined under the existing rules in § 4980B. An HRA complies with the COBRA requirements for calculating the applicable premium under § 4980B if the applicable premium is the same for qualified beneficiaries with different total reimbursement amounts available from the HRA (and otherwise also satisfies the requirements of § 4980B). For example, if the annual additional reimbursement amount credited under an HRA is \$1,000 and the maximum reimbursement amount remaining for two similarly situated qualified beneficiaries at the time of their qualifying events is \$500 and \$5,000, the applicable premium is the same for each individual.

The plan rules of an HRA may provide for continued reimbursements after a COBRA qualifying event regardless of whether a qualified beneficiary elects continuation coverage. For example, an HRA might allow reimbursements up to the unused maximum reimbursement amount following termination of employment. In such a situation, an HRA subject to COBRA must still comply with the COBRA continuation coverage requirements. If a qualified beneficiary elects COBRA continuation coverage in addition to the continued reimbursement amount already available, an HRA complies with the COBRA requirements by increasing the maximum reimbursement amount at the same time and by the same increment that it is increased for similarly situated non-COBRA beneficiaries (and by decreasing it for claims reimbursed).

VIII. Other Matters

Accident or health plans that meet the definition of an HRA are subject to a variety of statutory rules and provisions, many of which are not addressed in this notice. Among the statutory provisions not addressed in this notice are:

- The deduction limitations under §§ 419 and 419A (for employer contributions to welfare benefit funds) and under § 404 (for amounts paid or accrued under plans providing for deferred benefits that are not provided through a welfare benefit fund).
- The application of the nondiscrimination requirements under the Health

Insurance Portability and Accountability Act of 1996 (HIPAA), including the extent to which underwritten individual health insurance policies purchased and reimbursed by an HRA are treated as health insurance coverage offered under a group health plan.

- Other requirements under HIPAA, including the requirement that a group health plan provide certificates of creditable coverage.
- The requirements for welfare benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA).

The proposed regulations relating to health FSAs under § 125 state that certain requirements apply whether or not the health FSA is part of a cafeteria plan. Future guidance will modify the proposed regulation under § 125 to clarify that while those rules continue to apply to health FSAs provided pursuant to salary reduction election under a § 125 cafeteria plan, they do not apply to HRAs.

COMMENTS REQUESTED

Comments are requested about the rules set forth in this notice. Send comments to : CC:DOM:CORP:R (Notice 2002–45), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand-delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (Notice 2002–45), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, D.C. Alternatively, taxpayers may submit comments electronically at: Notice.Comments@irs.counsel.treas.gov (a Service comments e-mail address).

DRAFTING INFORMATION

The principal author of this notice is Lorianne D. Masano of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Lorianne D. Masano at (202) 622–6080 (not a toll-free call).

Request for Comments Containing Suggestions for Future Proposed Regulations Concerning Permitted Elimination of Optional Forms of Benefit From Defined Benefit Plans

Notice 2002–46

The Internal Revenue Service and the Treasury Department request comments on regulations that are expected to be proposed under § 411(d)(6) of the Internal Revenue Code concerning the elimination of optional forms of benefit from defined benefit plans, including the types of situations in which the retention of particular optional forms of benefit under a defined benefit plan results in significant burdens and complexities for sponsors of retirement plans and for participants and the conditions under which these optional forms of benefit are of *de minimis* value to participants.

BACKGROUND

Section 411(d)(6) generally provides that a plan is treated as not satisfying the requirements of § 411 if the accrued benefit of a participant is decreased by a plan amendment.¹ Under § 411(d)(6)(B), a plan amendment that eliminates or reduces an early retirement benefit, a retirement-type subsidy, or an optional form of benefit is treated as reducing accrued benefits to the extent that the amendment applies to benefits accrued as of the later of the adoption date or the effective date of the amendment. However, § 411(d)(6)(B) permits the Secretary of Treasury to issue regulations that permit the elimination of optional forms of benefit. Pursuant to this authority, regulatory exceptions to the application of § 411(d)(6) to optional forms of benefit

have been developed in the past to address certain specific practical problems and to permit elimination of most optional forms of benefit in many defined contribution plans. See A–2 and A–10 of § 1.411(d)–4 of the Income Tax Regulations.

Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), 115 Stat. 38 (2001), the authority to permit elimination of an optional form of benefit did not apply if the optional form constituted an early retirement benefit or retirement-type subsidy. EGTRRA amended § 411(d)(6)(B) to provide for the Secretary of Treasury to issue regulations under which § 411(d)(6)(B) would not apply to any plan amendment which reduces or eliminates benefits or subsidies that create significant burdens or complexities for the plan and plan participants, unless such amendment adversely affects the rights of any participant in a more than *de minimis* manner. Under section 645(b)(3) of EGTRRA, these regulations are to be issued by December 31, 2003 and are to apply to plan years beginning after December 31, 2003 or an earlier date.

COMMENTS REQUESTED

The Service and Treasury intend to issue proposed regulations under § 411(d)(6) of the Code with respect to optional forms of benefit under defined benefit plans. Consequently, comments are requested on which optional forms of benefit (including early retirement benefits and retirement-type subsidies) should be permitted to be eliminated and the circumstances under which they should be permitted to be eliminated, consistent with § 411(d)(6)(B) as amended by EGTRRA. In particular, comments are requested on when particular optional forms of benefit (whether or not subsidized) result in significant burdens and complexities for sponsors of

¹ Section 204(g)(2) of the Employee Retirement Income Security Act of 1974 (ERISA), Public Law 93–406, (88 Stat. 829), provides a parallel rule to § 411(d)(6)(B) of the Internal Revenue Code that applies under Title I of ERISA, and authorizes the Secretary of the Treasury to provide exceptions to this parallel ERISA requirement. Thus, Treasury regulations issued under § 411(d)(6)(B) of the Internal Revenue Code apply as well for purposes of § 204(g)(2) of ERISA.