

## Health Reimbursement Arrangement (HRA)

On June 26, 2002, the IRS announced a new revenue ruling (2002-41), which allows employers to establish a special fund for an employee that can be used to pay for health care expenses, incurred by an employee. The employee has had to qualify for employee benefits and the incurred expense has to be incurred after the special fund has been established. Only the employer can contribute to the fund, called an HRA, and the employee must have exhausted his FSA (Financial Spending Arrangement) before using the HRA funds. There is no dollar limit listed in the announcement and, importantly, any unused funds automatically accumulate into the following year. The employer can change the new annual amount contributed each year, up or down. The same rules apply as to what is acceptable as a health care deduction (section 213). There is no requirement that the funds be in any trust but it can be assumed the funds are truly a committed obligation on the part of the employer. If the employee terminates employment for any reason, the unused funds are available to the employee to pay health care expenses only and cannot be used to fund any other kinds of employee benefits or pay. If the employee should die, the employee's dependents have access to the HRA funds for health care expenses until the funds are exhausted. The employee cannot contribute to the fund or redirect the funds to be used for any other purpose.

Most TaxSaver clients have set up Salary Reductions for their spouses and other employees as FSA's. The FSA has a "use it or lose it" factor, meaning that the employee loses whatever funds are left over (unused) after the Plan Year. It could be that the employee (as the spouse of the employer) has set up a fat FSA because any unused money is given back to the employer and so the employer's family has not lost a cent. An employer and employee cannot set up an FSA after the health care incident has occurred because that would violate the basic principle of insurance which calls for the insurance event to occur only after the insurance plan has been established. However, the HRA can be set up as a fund to cover added health expenses beyond the usual (almost known) expenses for dental and medical services or products; and then an HRA fund can be built (at least started) to cover some crushing expense. Perhaps \$1,000 in the first year could start the HRA plan, continue for perhaps five years, and then stop or only replace the unexpected expense money used. The fund exists on paper even if the business shuts down, because the employer is going to pay the expense anyway but has the capability to pay the expense as a business expense instead of a personal expense in his 1040 tax return. The business expense ultimately gets to the 1040 as a business loss without any further manipulation in reducing the deductibility of the health expense. There appears to be no reason why you cannot start an HRA fund right now! It just needs to be formally documented.

A consideration is that the employer has to be prudent in funding benefits for family members who are employees. Is the employee for whom an HRA is being set up really worth the money being committed? There are numerous court cases where the employer could not prove that the spouse actually worked in the business adequately to justify the expense of salary and benefits, resulting in disallowance of deductions as well as added investigation into other aspects of the tax return.

If the HRA is established for a spouse, it may be that the same benefit must be available to other employees of equal business stature. IF this is a problem, it is suggested that the spouse stick with the voluntary approach of setting up an FSA only which is funded by reducing spouse's salary. Other employees can get equal treatment by reducing their salaries also to set up an FSA to the degree each sees fit, resulting in no discrimination.

Please write or call with your questions. There will, no doubt, be added word on HRA's.