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Funding HRAs With Vacation And Sick Leave

In 2005, the IRS gave health reimbursement arrangements (HRAs) a green light to draw on unused vacation and sick leave in order to boost funds at retirement through Revenue Ruling 2005-24.

There are two lessons in this ruling. First, that cash can never be offered to participants from an HRA, and second, that employers can now draft an HRA to include this type of subsidy for retiree health care.

What Is an HRA?

HRAs are employer-financed accounts that pay employees for eligible medical expenses. HRA plans do not have to physically set aside money for participant claims, but must pay eligible claims as they are presented. And employees cannot contribute to HRAs.

Sometimes HRAs are coupled with a higher-deductible health insurance product. The HRA pays for some or all of the deductible expenses formerly paid by insurance. This adds up to lower premiums, the same out-of-pocket costs for employees and, hopefully, health cost savings for everyone.

Flexible is an HRA's middle name. An HRA can offer the full annual limit amount on the first day of the plan year like a health flexible spending account (FSA) or make funds available only on a periodic basis. Eligible medical expenses can stretch from covering a single type, such as dental or vision, to the entire list of eligible expenses allowed by the IRS including prescribed over-the-counter drugs and medications. At the end of the year, unused funds may be forfeited back to the plan like a health FSA or rolled forward for an employee to use the following year.

Even with all this flexibility, employers have tried new twists with their HRA plans. One popular twist involves attempting to get some of the HRA money to current participants or retirees in cash. The heart of Revenue Ruling 2005-24 deals with this issue by addressing HRA plans that do not stick to IRS rules and the harsh reality of non-compliance.

Revenue Ruling 2005-24

This ruling makes clear that HRA funds earmarked for health care can never be available in cash. The revenue ruling reiterates this by restating much of the same information previously handed down from the IRS—but with one new spin.

Typical of these types of revenue rulings, facts are spelled out through a variety of scenarios with reported findings on their legality.

Three scenarios deal with HRA plans that included cash options. One scenario considers a plan that provides cash payment from the HRA at the end of the plan year or upon termination of employment.

The second situation suggests a plan

that would pay out all or a portion of the HRA to a beneficiary upon the death of the employee.

The last circumstance examines an "option plan" whereby, each year, employees have a choice of transferring all or a portion of their remaining funds to one of several retirement plans or to receive the amount as cash.

Verdict: The IRS ruled in every case that funds paid to an employee under an HRA reimbursement plan that provides the payment of unused amounts in cash are not excludable from gross income under Section 105(b).

Not only do those funds become taxable, but all medical expenses paid from the HRA plan become taxable. If one individual receives cash, then every employee participating in the plan—regardless if they chose cash or were paid for eligible medical expenses—would be taxed on all plan funds.

However, Revenue Ruling 2005-24 held an interesting slant for plans that provide retiree health care.

Retiree Health

With soaring health care costs, it's no wonder that employers are trying to save health dollars wherever they can. Employers with existing retiree health plans also are trying to find ways to cut their retiree health care tab.

Some have tried dropping their retiree plans or reducing health coverage to retirees. In fact, the Equal Employment Opportunity Commission (EEOC) advocated allowing employers to reduce or eliminate retiree health benefits for those with Medicare coverage. The proposal was slapped down by a federal judge with a bolster from the AARP. The AARP claimed that providing different benefits to younger and older retirees was age discrimination.

So, how can employers cut their costs for retiree health benefits without cutting benefits? Revenue Ruling 2005-24 may hold the key to this dilemma for employers who offer an HRA and bankable vacation and sick leave.

Plan Design for Retirees

The IRS presented a scenario that contemplated an HRA plan design in which an employee's accumulated vacation and sick time was incorporated into the employer's HRA.

In this scenario, when an employee retires, the employer automatically and on a mandatory basis contributes an amount to the HRA equal to the value of all or a portion of the retired employee's accumulated unused vacation and sick leave. The funds are carried forward for the retiree to use for future HRA-eligible expenses. Under no circumstances may the retired employee, the retired employee's spouse or dependents receive any of the designated amounts in cash.

Forgo Sick Leave or Vacation?

A novel approach to retirement planning may end up costing employees their vacation and sick time throughout their career. With a big carrot of retiree health coverage dangling at the end of a long stick, more employees could skip the beach time while working in order to relax after retirement. Hopefully, the hoarding of vacation and sick time will not become a retirement planning staple.

Here's the Lesson

Even with the nugget of a new retiree funding mechanism, Revenue Ruling 2005-24 was about one thing. Regardless of the intent of an employer's HRA, when cash is an option, every dollar in the HRA is taxable. This includes all those unreimbursed medical expenses that could have been paid in a non-taxable form.

No matter how hard an employer may try to circumvent the "no cash from HRAs" rule, the IRS has made clear that the rule stands. If an employee is offered a choice of cash or benefits outside those eligible for HRA medical expenses, the tax benefits are lost. And all employees suffer by experiencing a taxable event.

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