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Health Reimbursement Arrangements (HRA) As a Tax Free Employee Benefit

Internal Revenue Service
Department of the U.S. Department of Treasury
Publication 969 – Household Employees
Publication 502 – Qualified Medical Expenses
Publication 15-B – Qualified Plans, Expenses and Requirements

Health Reimbursement Arrangements (HRAs)

A health reimbursement arrangement (HRA) must be funded solely by an employer. The contribution cannot be paid through a voluntary salary reduction agreement on the part of an employee. Employees are reimbursed tax free for qualified medical expenses up to a maximum dollar amount for a coverage period. An HRA may be offered with other health plans, including FSAs.

Note. Unlike HSAs or Archer MSAs which must be reported on Form 1040 or Form 1040NR, there are no reporting requirements for HRAs on your income tax return.

For information on the interaction between an HRA and an HSA, see *Other employee health plans* under *Qualifying for an HSA,* earlier.

What are the benefits of an HRA? You may enjoy several benefits from having an HRA.

- Contributions made by your employer can be excluded from your gross income.
- Reimbursements may be tax free if you pay qualified medical expenses. See *Qualified medical expenses*, later.
- Any unused amounts in the HRA can be carried forward for reimbursements in later years.

Qualifying for an HRA

HRAs are employer-established benefit plans. These may be offered in conjunction with other employer-provided health benefits. Employers have complete flexibility to offer various combinations of benefits in designing their plan. You do not have to be covered under any other health care plan to participate.

Self-employed persons are not eligible for an HRA.

CAUTION *Certain limitations may apply if you are a highly compensated participant.*

Contributions to an HRA

HRAs are funded solely through employer contributions and may not be funded through employee salary deferrals under a cafeteria plan. These contributions are not included in the employee's income. You do not pay federal income taxes or employment taxes on amounts your employer contributes to the HRA.

Amount of Contribution

There is no limit on the amount of money your employer can contribute to the accounts. Additionally, the maximum reimbursement amount credited under the HRA in the future may be increased or decreased by amounts not previously used. See Balance in an HRA, later.

Distributions From an HRA

Generally, distributions from an HRA must be paid to reimburse you for qualified medical expenses you have incurred. The expense must have been incurred on or after the date you are enrolled in the HRA.

Debit cards, credit cards, and stored value cards given to you by your employer can be used to reimburse participants in an HRA. If the use of these cards meets certain substantiation methods, you may not have to provide additional information to the HRA. For information on these methods, see Revenue Ruling 2003-43 on page 935 of Internal Revenue Bulletin (IRB) 2003-21 at *www.irs.gov/pub/irs-irbs/irb03-21.pdf*, Notice 2006-69, 2006-31 I.R.B. 107 available at *www.irs.gov/irb/2006-31_IRB/ar10.html*, and Notice 2007-2, 2007-2 I.R.B. 254 available at *www.irs.gov/irb/2007-2_IRB/ar09.html*.

If any distribution is, or can be, made for other than the reimbursement of qualified medical expenses, any distribution (including reimbursement of qualified medical expenses) made in the current tax year is included in gross income. For example, if an unused reimbursement is payable to you in cash at the end of the year, or upon termination of your employment, any distribution from the HRA is included in your income. This also applies if any unused amount upon your death is payable in cash to your beneficiary or estate, or if the HRA provides an option for you to transfer any unused reimbursement at the end of the year to a retirement plan. However, see Qualified HSA distribution, later.

If the plan permits amounts to be paid as medical benefits to a designated beneficiary (other than the employee's spouse or dependents), any distribution from the HRA is included in income.

Reimbursements under an HRA can be made to the following persons.

1. Current and former employees.
2. Spouses and dependents of those employees.
3. Any person you could have claimed as a dependent on your return except that:
   a. The person filed a joint return,
   b. The person had gross income of $3,800 or more, or
   c. You, or your spouse if filing jointly, could be claimed as a dependent on someone else's 2012 return.
4. Your child under age 27 at the end of your tax year.
5. Spouses and dependents of deceased employees.

TIP *For this purpose, a child of parents that are divorced, separated, or living apart for the last 6 months of the calendar year is treated as the dependent of both parents whether or not the custodial parent releases the claim to the child's exemption.*

Qualified medical expenses. Qualified medical expenses are those specified in the plan that would generally qualify for the medical and dental expenses deduction. These are explained in Publication 502, Medical and Dental Expenses.

Also, non-prescription medicines (other than insulin) are not considered qualified medical expenses for HRA purposes. A medicine or drug will be a qualified medical expense for HRA purposes only if the medicine or drug:

1. Requires a prescription,
2. Is available without a prescription (an over-the-counter medicine or drug) and you get a prescription for it, or
3. Is insulin.

Qualified medical expenses from your HRA include the following.

- Amounts paid for health insurance premiums.
- Amounts paid for long-term care coverage.
- Amounts that are not covered under another health plan.

If you are covered under both an HRA and a health FSA, see Notice 2002-45, Part V, which is on page 93 of IRB 2002-28 at *www.irs.gov/pub/irs-irbs/irb02-28.pdf*.

CAUTION *You cannot deduct qualified medical expenses as an itemized deduction on Schedule A (Form 1040) that are equal to the distribution from the HRA.*

Qualified HSA distribution. This is a distribution made before January 1, 2012, from your HRA that is transferred to your HSA, discussed earlier.

For more information, see Notice 2007-22, 2007-10 I.R.B. 670 available at *www.irs.gov/irb/2007-10_IRB/ar10.html*.

If you do not remain an eligible individual for HSA purposes during the testing period, the distribution is included in your income and is subject to a 10% additional tax. See Qualified HSA distribution under *Health Savings Accounts (HSAs)*, earlier.

Balance in an HRA

Amounts that remain at the end of the year can generally be carried over to the next year. Your employer is not permitted to refund any part of the balance to you. These amounts may never be used for anything but reimbursements for qualified medical expenses. See Qualified HSA distribution, earlier.

Employer Participation

For an HRA to maintain tax-qualified status, employers must comply with certain requirements that apply to other accident and health plans. Chapters 1 and 2 of Publication 15-B, Employer's Tax Guide to Fringe Benefits, explain these requirements.

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Free help with your tax return. Free help in preparing your return is available nationwide from IRS-certified volunteers. The Volunteer Income Tax Assistance (VITA) program is designed to help low-moderate income, elderly, disabled, and limited English proficient taxpayers. The Tax Counseling for the Elderly (TCE) program is designed to assist taxpayers age 60 and older with their tax returns. Most VITA and TCE sites offer free electronic filing and all volunteers will let you know about credits and deductions you may be entitled to claim. Some VITA and TCE sites provide taxpayers the opportunity to prepare their return with the assistance of an IRS-certified volunteer. To find the nearest VITA or TCE site, visit IRS.gov or call 1-800-906-9887 or 1-800-829-1040.

As part of the TCE program, AARP offers the Tax-Aide counseling program. To find the nearest AARP Tax-Aide site, visit AARP's website at *www.aarp.org/money/taxaide* or call 1-888-227-7669.

For more information on these programs, go to IRS.gov and enter "VITA" in the search box.

Internet. You can access the IRS website at IRS.gov 24 hours a day, 7 days a week to:

- *E-file* your return. Find out about commercial tax preparation and *e-file* services available free to eligible taxpayers.
- Check the status of your 2012 refund. Go to IRS.gov and click on *Where's My Refund.* Information about your return will generally be available within 24 hours after the IRS receives your e-filed return, or 4 weeks after you mail your paper return. If you filed Form 8379 with your return, wait 14 weeks (11 weeks if you filed electronically). Have your 2012 tax return handy so you can provide your social security number, your filing status, and the exact whole dollar amount of your refund.
- *Where's My Refund?* has a new look this year! The tool will include a tracker that displays progress through three stages: (1) return received, (2) refund approved, and (3) refund sent. *Where's My Refund?* will provide an actual personalized refund date as soon as the IRS processes your tax return and approves your refund. So in a change from previous filing seasons, you won't get an estimated refund date right away. *Where's My Refund?* includes information for the most recent return filed in the current year and does not include information about amended returns.
- You can obtain a free transcript online at IRS.gov by clicking on *Order a Return or Account Transcript* under "Tools." For a transcript by phone, call

IRS Publication 502 – excerpt
Qualified Medical Expenses

Insurance Premiums

You can include in medical expenses insurance premiums you pay for policies that cover medical care. Policies can provide payment for:

- Hospitalization, surgical fees, X-rays, etc.,
- Prescription drugs,
- Dental Care,
- Replacement of lost or damaged contact lenses,
- Membership in an association that gives cooperative or so-called "free-choice" medical service, or group Hospitalization and clinical care, or,
- Qualified long-term care insurance contracts (subject to additional limitations). See *Qualified Long-Term Care*, later.

IRS Publication 15-B – excerpt
Special Rules for Various Types of Fringe Benefits

Type of Fringe Benefit	Income Tax Withholding	SSI & Medicare	FUTA
Accident and Health Benefits	Exempt	Exempt	Exempt

Accident or health plan. This is an arrangement that provides benefits for your employees, their spouses, and their dependents in the event of personal injury or sickness. **The plan may be insured or noninsured and does not need to be in writing**.

Employee. For this exclusion, treat the following individual as employees.

- A current common-law employee.
- A former employee you maintain coverage for based on the employment relationship.

HOUSEHOLD EMPLOYER DEDUCTIBILITY OF HEALTH INSURANCE PREMIUMS PAID ON BEHALF OF, OR REIMBURSED TO, HOUSEHOLD EMPLOYEES

CCH (Commerce Clearinghouse) Payroll Guide Section 631, Benefit Plan Contributions

EMPLOYER CONTRIBUTIONS TO QAULIFIED PLANS ARE GENERALLY NOT TAXABLE

Employer contributions to fund employee benefit plans (retirement and pension plans, group term life insurance up to $50,000, disability insurance, health and medical insurance, income replacement programs, death and dismemberment insurance, and workers' compensation) are not subject to employment taxes. The plans must be qualified and non-discriminatory as defined in the Internal Revenue Code (.15).

CCH Payroll Guide Section 690, Insurance (Health and Medical)

EMPLOYER CONTRIBUTIONS FOR MEDICAL INSURANCE PLANS ARE NOT SUBJECT TO EMPLOYMENT TAXES

Payments made to or for the benefit of an employee under a self-insured medical expense reimbursement plan are not subject to FICA, FUTA or Federal Income Tax withholding (.01). A medical reimbursement plan, underwritten by an insurance policy issued by a licensed insurance company, or a qualified prepaid health care plan that does not involve the shifting of risk, is "self-insured."

CCH Perk Tax Guide Section 4378

WHAT IS THE TAX EFFECT ON THE EMPLOYEE WHEN PREMIUMS ARE PAID

An employer's contribution to a health and accident plan that provides sickness, injury, or preventative health benefits, including diagnostic medica surveillance benefits for its employees, their spouses, or their dependents is not taxable to the employees.

CCH Perk Tax Guide Section 4364

WHAT ARE THE ADVANTAGES FOR THE EMPLOYEE?

Health insurance may be provided to employees on a tax-free basis. No amount is required to be included in the employee's income or wages at the time the employer makes contributions to the plan or pays premiums to the insurance company, and no amount is required to be included when benefits are paid to the employee to the extent that the benefits do not exceed the employee's medical care expenses

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Are there any tax breaks if I offer health insurance?

see: IRS Publication 969

Yes. And they can be significant for both you and your employee.

When a household employer contributes toward health insurance premiums, these dollars are not considered taxable income. Neither employer nor employee is required to pay taxes on these dollars. A family may choose to pay the healthcare premium directly to the health insurance company or give these dollars directly to their employee. (In the latter case, the family must keep a copy of a current health insurance card on file for proof of a current insurance policy)

The nanny I'm about to hire would like to have Health Insurance as part of her compensation package. How does that work?

Health insurance premiums are a non-taxable form of compensation, meaning neither you nor your nanny would have any taxes on that portion of her compensation. Therefore, there is a significant financial advantage to both of you if part of your compensation to her goes toward a health insurance premium.

Here's how the tax math works. Let's say you pay your employee $2,000 per month in "straight" (taxable) wages. Her "take-home pay" after taxes would be roughly $1,700 per month (it may be a few dollars higher or lower depending on her personal tax situation). If she then buys a health insurance policy and pays $300 per month, her after-tax "disposable" income is $1,400 per month.

Alternatively, if you pay the same $2,000 per month, but it includes the health insurance contribution (i.e. $1,700 in taxable wages plus $300 in health insurance contributions), her after-tax disposable income is $1,475 per month.

So, in this illustration, your nanny sees a real gain of $75 per month (or $900 per year) and your employer taxes are reduced by about $25 per month (or $300 per year) – simply by having healthcare contributions managed through the payroll process. It's a win-win situation.

Why can't my nanny just pay for her own health insurance policy and then deduct the premium expense on her itemized tax return?

The nanny would not receive $900 per year in a tax refund if she paid for health insurance premiums with after-tax dollars. This option does not exist. She is only $900 richer if the health insurance premiums are separated from her taxable wages and she is taxed on a smaller amount of wages. She does not have the option of paying for health insurance premiums with after tax dollars (as shown in the first part of the example) and then taking a refund equal to the amount of tax on the dollars used for health insurance premiums. The law (as of 2007) states that health insurance premiums paid by an individual must be paid with after-tax dollars.

Only an employer can contribute tax-free.

If a nanny pays for health insurance on her own without assistance from her employer, she must have her entire monthly salary taxed and then pay for health insurance as an after-tax expense. She will not receive a refund or write-off on her health insurance premiums. Therefore, **the only way to generate savings on health insurance premiums is by having the employer provide the dollars for this expense**. Employers can contribute to health insurance premiums tax-free. This can be done by providing money for premiums over and above the salary, which is a significant financial benefit.

In our example, the employer is not increasing their cost by providing health insurance, but they are saving their nanny $900 per year by reducing her salary by the amount of the health insurance premiums. If the nanny was going to pay $300 per month for health insurance in any event, she might as well pay for it with pre-tax dollars provided by her employer rather than after-tax dollars on her own. The $900 savings is generated by taxing a lower monthly gross income ($1700 vs. $2000). The nanny increases her net pay by $75 per month in receiving $300 from her employer tax-free to use toward health insurance premiums.

This is the only way to receive a tax savings on health insurance premiums. When she is taxed on the full $2000, she pays taxes on the $300 used for health insurance premiums. Uncle Sam is not holding a tax refund - she owes the $900 in taxes as she has higher taxable wages ($2000 vs. $1700).

If you have any questions about health insurance or how to set it up so you can take advantage of these tax breaks, call Breedlove & Associates. Breedlove is happy to provide a complimentary phone consultation and guide you through all the financial and legal aspects of being a household employer.