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Action needed for schools offering a health FSA, HRAs, and/or paying for employees' health insurance coverage obtained elsewhere

Christopher G. Stevenson, Esq.

Recent joint guidance issued by the IRS and the DOL¹ (the "Joint Guidance") will require action by any school district that offers a health insurance flexible spending account ("Health FSA"), a health reimbursement account ("HRA") or that pays for an employee's health insurance that is obtained through the individual market and not through the school district's health plan.

The recent Joint Guidance has important new restrictions of which any school district offering, or considering to offer, a Health FSA, HRA and/or an Employer Payment Plan must be aware. If a school district fails to meet the new restrictions in the Joint Guidance on its Health FSA, HRA or Employer Payment Plan, the school district will be subject to a penalty of \$100 *per day, per individual* affected by the failure for the period of time during which the failure occurred.² This article will discuss these new restrictions and the steps school districts offering any of these plans must take in order to avoid these penalties.

Background

By way of background, a Health FSA is an optional component of a section 125 cafeteria plan which allows a participant to set-aside up to \$2,500 of wages each year, free from income and employment taxes, to pay for the uninsured medical costs (health insurance co-pays, orthodontia, etc.) of the participant, his/her spouse, and/or dependents. HRAs are funded solely by employers and amounts paid into HRAs are used to reimburse employees, their spouses and dependents for their eligible medical costs. In addition to offering Health FSAs and HRAs, some school districts have paid for health insurance coverage for certain employees who obtain coverage outside of the school's health plan on the individual market. The Joint Guidance refers to such an arrangement as an "Employer Payment Plan." More recently, some school districts have asked whether they can utilize an Employer Payment Plan to reimburse employees for health insurance coverage purchased on the new Health Insurance Exchange.

New restrictions on paying employees' health insurance obtained outside of the school district

Occasionally, school districts agree to pay for health insurance coverage for certain employees who obtain coverage outside of the school district. For example, under a long-standing IRS Revenue Ruling, school districts may reimburse employees on a tax-free basis for their cost of a health insurance policy purchased on the individual market (e.g. not under the district's group health plan).³ Recently, some school districts have asked whether they can utilize this technique to reimburse employees tax-free for the cost of individual health insurance policies obtained on the new Health Insurance Exchange.

Under the Joint Guidance school districts can no longer reimburse employees on a tax-free basis for health insurance obtained by an employee on the individual market, nor can they pay the health insurance issuer directly for such coverage on a tax-free basis. This prohibition applies to health insurance coverage obtained on the Health Insurance Exchange unless the school district is a qualifying small employer that is eligible to use, and is using, the Health Insurance Exchange coverage as the employer's group health plan.⁴ Thus, under the Joint Guidance, if an employee obtains health insurance coverage on the Health Insurance Exchange with his own funds, notwithstanding that the school had its own health plan, and submits the cost to the school district for reimbursement, the school district could not reimburse the employee on a tax-free basis for the cost. If the school district paid the reimbursement to the employee on a tax-free basis, the reimbursement would violate the new restrictions in the Joint Guidance and the school district would be subject to a penalty of \$100 per day for the period that the reimbursement arrangement remained in effect. The penalty would apply to any tax-free reimbursement from the school district to the employee for his/her cost of obtaining coverage under any individual policy (whether on the Health Insurance Exchange or in the private market).

It is important to note that the Joint Guidance only prohibits school districts' ability to pay for employee's coverage under individual health insurance as a tax-free benefit. Under the Joint Guidance it is still possible for a school district to pay for an employee's health insurance coverage under an individual health insurance policy, with after-tax dollars. However, it would probably not be practical to do so. For example, if a school district wanted to pay for coverage to an employee under a health insurance policy obtained in the individual market and the cost of the policy was \$6,000 for one year, the school district would have to effectively pay the employee a taxable bonus sufficient to cover the amount of the policy (the bonus would probably have to be about \$9,000 so that the employee has \$6,000 remaining after tax to pay for the policy). However, the Joint Guidance makes clear that if the employee purchased the \$6,000 policy out of his own funds, the school district could not reimburse the employee with tax-free dollars for the cost of the policy.

New eligibility restrictions and employer contribution restrictions on health FSAs

Under the Joint Guidance, effective January 1, 2014, an employee is only eligible to participate in a Health FSA through the school district if: (1) the employee is eligible to obtain health insurance coverage through the school district (the "Eligibility Restriction") and (2) the maximum benefit paid under the Health FSA to any participant for the year cannot exceed two times the amount of salary the employee elects to contribute to the Health FSA for the year or, if greater, the amount of the employee's salary contribution for the year, plus \$500 (the "Employer Contribution Restriction").

For purposes of determining the Employer Contribution Restriction, the maximum benefit includes the employee's salary deferral, plus any optional employer contributions. This means that as long as the school district does not make employer contributions to the Health FSA (most school districts offering Health FSAs do not make such employer contributions), the maximum benefit requirement will be met. If a school district does make an employer contribution to an employee's Health FSA, the maximum benefit requirement will be met as long as the employer contribution does not exceed the employee's salary reduction contribution to the Health FSA. For example, a school district could comply with the Employer Contribution Restriction by offering a 1:1 match whereby the employer contributes \$1 to an employee's Health FSA for every \$1 of salary contributed by the employee. However, school districts should be particularly careful if their Health FSA provides for a mandatory, lump-sum employer contribution to the employee's Health FSA, regardless of how much the employee elects to contribute in salary.

The Eligibility Restriction means that any school district offering a Health FSA must review the terms of the Health FSA document and verify that, for example, the Health FSA is not offered to any employee who is not eligible to obtain health insurance coverage through the school district's health plan (e.g. part-time employees). However, it is important to note that the Joint Guidance only requires that the employee electing to participate in the Health FSA be *eligible* to obtain health insurance through the school district. In other

words, under the Joint Guidance a school district is permitted to allow a full-time employee who is offered coverage through the school district but declines it, to still elect to participate in the school district's Health FSA.

New restrictions on HRAs

It is worth mentioning that the Joint Guidance also placed new restrictions on HRAs. Unlike the Health FSA, which can be funded with both employer and employee contributions, HRAs are funded solely by employers. Amounts paid into HRAs are used to reimburse employees, their spouses and dependents for their eligible medical costs. One difference between a Health FSA and an HRA is that an HRA can be used to reimburse employees tax-free for the cost of their health insurance premiums. Also, unlike Health FSAs, which have historically been subject to the "use it or lose it rule" discussed below, amounts remaining in HRAs at the end of the year can generally roll over and are available in later years. However, because HRAs can be funded solely with employer contributions, most school districts do not offer HRAs to employees. With that said, any school district that does offer an HRA will have to review the Joint Guidance to ensure that their HRA meets the new restrictions. One notable new restriction on HRAs in the Joint Guidance is that an HRA can no longer be used to reimburse the employee tax-free for the cost of health insurance coverage obtained by the employee on the individual market, including coverage obtained on the Health Insurance Exchange. Also, HRAs must now generally be "integrated" with another group health plan. This means that in order for an employee to participate in a school district's HRA, the employee must be *enrolled* in other group health plan coverage (e.g. health insurance coverage through the school district or coverage through the employee's spouse's employer but not coverage obtained under individual policies). There are several other new restrictions in the Joint Guidance on HRAs. Any school district sponsoring an HRA should review the Joint Guidance in close detail.

Modification of the "use it or lose it rule" for health FSAs

In separate guidance, the IRS recently announced that employers can amend their Health FSAs to allow up to \$500 of a participant's Health FSA balance at year-end to be carried forward to reimburse the participant's uninsured medical costs in the upcoming year.⁵ An often-cited draw-back of the Health FSA is the so called "use-it-or-lose-it" rule which, up until now, provided that amounts contributed to a Health FSA can only be used to pay for qualifying medical costs incurred by the employee, the employee's spouse or dependents during the particular plan year (or during the plan year plus an optional grace period of up to 2 ½ months after year-end). Under the "use-it-or lose-it rule," to the extent that the employee did not incur sufficient medical costs during the year, the employee would forfeit the unexpended balance to the school district. The school district could use the forfeited amounts to pay for future plan administration fees, such as TPA fees, or to offset any shortfalls in employees' FSA accounts upon their severance from employment.

Under the recent IRS announcement, a school district has the option to amend its Health FSA to allow an employee to carry forward up to \$500 of his/her unused Health FSA balance to the following year. The draw-back is that if a school district amends its Health FSA to allow for the \$500 carryover, the Health FSA cannot also contain the optional grace period of up to 2 ½ months for utilizing unexpended balances following year end. School districts that wish to include the \$500 carry forward provision for the current school year should notify Health FSA participants immediately of the change and should amend their cafeteria plan document to reflect the new \$500 carry forward feature by the end of the school year. If the Health FSA now contains an optional 2 ½ month grace period, the school district would also have to amend its cafeteria plan to remove that grace period.

The rules relating to employer-sponsored health benefits continue to rapidly evolve. We will continue to monitor all developments in this area and keep districts informed of all relevant changes. ■

Endnotes

1. Department of Labor Technical Release 2013-03 available at <http://www.dol.gov/ebsa/newsroom/tr13-03.html> and IRS Notice 2013-54 available at <http://www.irs.gov/pub/irs-drop/n-13-54.pdf>.
2. 26 U.S.C. §4980D.
3. IRS Rev. Rul. 61-146.
4. 26 U.S.C. §125(f)(3)(B).
5. IRS Notice 2013-71.