



B.O.P. Memo #11

Health Reimbursement Arrangements

This memo is written as a help guide for the Church of God

Paying medical insurance premiums to protect against catastrophic medical expenses is a commonly accepted practice. But even the best medical insurance policies generally do not pay all of the insured's medical expenses. These unpaid medical expenses are usually in the form of noncovered items or expenses subject to a deductible or coinsurance (or co-payment) clause in the health insurance policy. So...

Getting braces for you or your children is no fun. But the real sting often comes after the dental procedures are done – when you find out how much of the bill your health insurance *won't* cover. Or, it may be the appendectomy which, after applying the 70/30 percent co-payment provision, left you with a sizeable “patient responsibility.”

You may try to comfort yourself with the memory that medical expenses that are not eligible for reimbursement under a health insurance plan are deductible on Schedule A as itemized deductions for federal income tax purposes. Beware of the next sting...

For most taxpayers, receiving an itemized deduction benefit from unreimbursed medical expenses is more a dream than a reality. There are two major barriers to deducting medical expenses. First, many ministers and other church employees use the standard deduction instead of itemizing deductions on Schedule A. This may be especially true for ministers who live in church-provided housing. Second, even for those taxpayers who do itemize their deductions, there is a limitation of 7.5 percent of adjusted gross income.

Example: If adjusted gross income is \$30,000 and unreimbursed medical expenses are \$2,000, none of these expenses are beneficial in calculating itemized deductions on Schedule A, because the limitation of 7.5 percent of adjusted gross income is \$2,150 (7.5 percent x \$30,000).

For many years, some larger churches have tried to help their employees cope with the above “painful” financial realities by providing Flexible Spending Accounts (FSAs). However, FSAs have some limitations. Maintained through pre-tax employee salary-reduction contributions to cover that portion of medical expenses not covered by medical insurance, FSAs require employee contributions and impose an annual “use it or lose it” rule. Another alternative is a Health Reimbursement Arrangement (HRA).

The Benefits of an HRA

First of all, direct financial help is offered to the employees by the local church which establishes an HRA since the plan is funded entirely by the church.

Furthermore, a reimbursement from an HRA is like getting a tax-free raise. HRA payments to a church employee under Section 105(b) of the Internal Revenue Code escape federal (usually 15 percent or 27 percent) and state (often 5 percent or so) income tax and social security tax (15.3 percent for ministers and 7.65 percent for non-minister employees). The tax savings can run 40 percent or more of medical expenses covered under such a plan.

Example: The church has established an HRA with an annual limit of \$2,500 per employee. The minister's daughter gets braces costing \$2,400 and the minister submits the unpaid bills to the church (or the minister pays the portion not covered by the insurance carrier and submits the documentation for the minister's share to the church). The church pays the \$2,400. If the employee

is in the 27 percent federal income tax bracket, the 5 percent state income tax bracket and is liable for the 15.3 percent self-employment Social Security tax, the net savings is 47.3 percent times \$2,400 or \$1,135. Additionally, the minister could submit documentation for medical expenses up to another \$100 since the annual limit is \$2,500 for this plan. The claim for the last \$100 could even be made in a future year.

The Key Elements of an HRA

The establishment of a plan. The starting point for an HRA is the preparation of a formal plan document. (A sample plan document is shown below. It may be helpful to obtain professional assistance in adapting this sample document to the specific needs of your church.) Although tax regulations do not require a written plan, it is highly preferable to use a written plan to eliminate any doubt regarding the existence of a plan or the date it was instituted.

IRS policy (IRP 80,600) states that employer reimbursements made prior to the adoption of a plan are not excludable from gross income by the employee. In order for there to be a plan, the employer “must be committed to certain rules and regulations governing payments. These rules must be made known to employees as a definite policy and must be determinable before the employee’s medical expenses are incurred.”

Additional guidance for establishing an HRA was issued by the Internal Revenue Service in Notice 2002-45 and Revenue Ruling 2002-45.

Eligible participants. An HRA may only reimburse employees, former employees (including retirees) or their tax dependents for qualified medical care expenses.

Limitation on annual coverage. An HRA must provide a maximum dollar amount of coverage for the employee or for the family (including the employee). For example, a plan could provide that all full-time employees will have benefits up to a maximum of \$2,000 per year and that any employees with dependents (family coverage) will have benefits up to a maximum of \$4,000 per year. (The \$2,000 and \$4,000 in this example are simply illustrations. The plan may set the amounts as high or as low as they wish. Of course, the ceiling probably will be subject to the church’s financial ability to pay the benefit.)

Funding source. An HRA is funded solely with employer contributions and not salary-reduction elections.

The relationship of the plan to the compensation package. The salary level of the employee and the amount of medical expenses that potentially may be reimbursed under an HRA are two entirely separate issues. The church establishes an employee’s compensation separately from the church’s establishment of the maximum reimbursement under an HRA. The law does not permit a church to establish a combined salary and HRA amount with the portion of the HRA amount that is not spent for medical expenses to be reflected as compensation on an employee’s Form W-2.

Determination of church funding level for an HRA. A church should commit to the amount it will fund an HRA (for each employee) prior to the beginning of the plan year. If the amount of church funding is not the same for each employee, the church should first review the nondiscrimination rules (see later paragraph).

Money left in the plan at year end. Any money left in an employee’s HRA account on December 31 of each year (or the end of the plan’s year) may be carried forward to increase the maximum reimbursement dollar amount in subsequent periods in the following situations (Revenue Ruling 2002-41):

1. Retirees or those otherwise terminating employment. An HRA may include a provision that reimburses a former employee for medical care expenses up to an amount equal to the unused reimbursement amount remaining at retirement or other termination of employment. For example, an individual who retired or otherwise terminated employment and had a balance of \$500 in an HRA account could submit medical expense documentation to the employer for the plan year for up to \$500 or could submit the documentation for a year following the plan year.

If an HRA plan does not provide for payments to be made after the retirement or termination of an employee, a retirement or severance “bonus” related to an employee’s maximum reimbursement amount remaining in an HRA at that time is not allowed. If done, it will disqualify the HRA.

2. Continuing employment. Account balances may be carried forward to increase the maximum reimbursement amount in subsequent coverage periods. For example, an individual who has not retired or otherwise terminated employment has a balance of \$500 in an HRA account at the end of a plan year. The maximum annual reimbursement available to the employee is \$2,000. The individual is eligible to carry forward the unused \$500 from the previous plan year and submit documentation for medical expenses for reimbursement up to \$2,500 for the new plan year.

Qualified medical expenses are submitted to the church for reimbursement. When an employee is billed for a qualifying health care expense that isn’t covered by the employee’s health insurance plan, the employee submits the receipt to the church. The church writes a check to reimburse the employee or pay the expense directly to the health care provider.

Annual reporting is required in certain situations. An HRA constitutes a welfare benefit plan subject to ERISA and its reporting requirements. However, there is an exemption from filing a Form 5500 (5500-C or 5500-R) if the plan is unfunded (e.g., benefits are paid from the employer’s general assets) and has fewer than 100 participants at the beginning of a particular plan year. Most HRAs established by churches would be unfunded and therefore qualify for this Form 5500 reporting exemption. There is also a Form 5500 filing exemption for a welfare benefit plan that is unfunded and is provided for a select group of staff or highly compensated employees which meets certain requirements.

Application of the nondiscrimination rules. When churches pay health care costs from church funds, nondiscrimination rules apply. Generally, these rules require that the plan not discriminate in favor of highly compensated individuals with regard to either the eligibility to participate or the amount of benefits. Specifically, the nondiscrimination rules applicable to HRAs defines a highly compensated individual as any individual among the highest paid 25 percent of all employees (with certain exclusions). Therefore, it is difficult to avoid the impact of the nondiscrimination rules if some employees in a class are provided greater benefits than other employees in the same class. However, a distinction in eligibility to participate and amount of benefits may be made between classes of employees, such as between full-time and part-time employees.

If a self-insured plan is discriminatory, then the church is generally required to report some or all of the church’s reimbursements to highly compensated individuals as taxable income.

If your church is providing HRA benefits for some but not all of the church employees, professional assistance may be helpful to gain a full understanding of the application of the nondiscrimination rules.

Expenses eligible for reimbursement. Any out-of-pocket medical expenses can be reimbursed under an HRA. These expenses may relate to your medical plan’s deductible, coinsurance or noncovered items.

Health insurance premiums are eligible for reimbursement under an HRA. However, health insurance premiums may be paid or reimbursed to employees on a tax-free basis without utilizing an HRA.

Any medical expense that is allowable as a medical expense deduction on Schedule A of your income tax return (Section 213 of the Internal Revenue Code) may be covered under an HRA. The IRS defines medical expense as amounts you paid for “diagnosis, cure, mitigation, treatment, or prevention of diseases.”

You are eligible to include money paid to doctors, dentists, hospitals, nursing homes or other medical providers, and prescription drugs in an HRA to the extent you weren’t reimbursed by a health insurer. You may even include payments to a chiropractor, as well as the cost of prescription eyeglasses, hearing aids, crutches, and ambulance service.

Certain non-insurance arrangements, often called “newsletter” plans, are modeled on the old assessment-type insurance arrangements that were popular at the turn of the 20th century. Since such plans typically make strong claims about *not* being insurance (in order to escape regulation by State Insurance Commissioners), the payments by a church to these plans (or to reimburse a church employee’s payments to these plans) is a fully taxable benefit reportable on the employee’s Form W-2. Such expenses may not be paid under the HRA plan.

Since newsletter plans do not constitute health insurance, payments that you have received from a newsletter-type plan are not considered medical reimbursements. Therefore, medical expenses that are not reimbursed under a health insurance plan are eligible for deduction as medical expenses on Schedule A or for reimbursement under an HRA, even though you have received payments from a newsletter plan related to these expenses.

Type of expenses eligible for HRA reimbursement include:

- Transportation costs. Transportation expenses to and from medical appointments are includible – even in the town where you live. If you drive directly without running other errands, you’re allowed a standard medical mileage rate announced by the IRS annually.
- If you or your spouse travel out-of-town for medical care, you may deduct up to a set amount per night for lodging (cf. IRS rules). If the ailing spouse can’t travel alone, you may each deduct up to the set amount per night.
- Dependent’s medical expenses.
- Co-payments for doctor visits and prescriptions.
- Prescription eyeglasses, eye exams, and contact lenses.
- Extra cost of a private hospital room.
- Laser correction eye surgery.
- Chiropractic expenses beyond active treatment of injury.
- Dental care and orthodontia.
- Hearing devices and batteries, and special equipment for the deaf.
- Weight-loss programs. If a physician diagnoses a patient as obese, then the patient’s participation in a weight-loss program as treatment for obesity is reimbursable under an HRA. Additionally, if a patient is directed by a physician to lose weight as treatment for another condition, such as hypertension, the treatment is also eligible for reimbursement under an HRA. If participation in a weight-loss program is merely to improve general health and appearance, then the fees are not amounts that may be reimbursed under an HRA. The cost of purchasing reduced-calorie diet foods, because the food is merely a substitute for the food an individual would normally consume, is not eligible for reimbursement.
- Insurance. Reimbursement for insurance (“newsletter” plans do not constitute insurance) covering medical care expenses are allowable HRA reimbursements, including amounts paid for premiums for accident or health coverage.

- Other items. If you have allergies, you may be able to include the cost of an air conditioner in a window – but probably not for installing central air conditioning throughout your home. Your doctor may suggest that you join a health club, take swimming lessons, or take vitamins, but such expenses are not allowed by the IRS. The IRS definition of medical expenses generally doesn't include expenses for "solely cosmetic reasons" or for procedures that "are merely beneficial to one's general health."
- Free list. For a free list of allowable health care deductions, check IRS Publication 502, "Medical and Dental Expenses" (available from the IRS by calling 1-800-TAX-FORM or on the web at <http://www.irs.gov/formspubs/index.html>).
- Right to receive cash. If any person has the right to receive cash or other benefit under the HRA other than the reimbursement of medical care expenses, currently or in a future year, the entire HRA is disqualified.

Summary of Differences Between Fringe Benefit Plans

Section 125 cafeteria plan. A Section 125 plan may include benefits that are excludable from an employee's gross income as follows:

- Group-term life insurance (up to \$50,000 coverage)
- Qualified group legal services
- Dependent-care assistance (\$5,000 limit per year)
- Accident or health plan
- Long-term disability benefits

Additionally, a Section 125 cafeteria plan can offer certain after-tax (taxable) benefits, such as: group-term life insurance in excess of \$50,000 face amount; dependent life insurance; benefits under group legal services; car insurance; or other personal insurance programs on a group basis.

Section 125 health flexible spending accounts (FSAs). Health flexible spending accounts, also called FSAs, may include benefits that are excludable from an employee's gross income as follows:

- Health care expenses (but not health care insurance premiums)

The following features apply to Section 125 FSAs:

- The employee decides how much goes into a health FSA and the amount directly reduces the employee's taxable compensation.
- Unused elective contributions or plan benefits cannot be carried from one plan year to another plan year.
- The maximum amount of reimbursement must be available at all times during the coverage period.
- There is a mandatory 12-month period of coverage.
- Medical expenses must generally be incurred during the period of coverage.

Health reimbursement arrangements (HRAs). An HRA may include benefits that are excludable from an employee's gross income as follows:

- Health care expenses
- Health care insurance premiums (long-term care insurance premiums are not eligible for reimbursement)

HRAs are established under the following guidelines:

- The employer decides how much will be available for each employee in an HRA. This amount is generally the same for all eligible employees because of the nondiscrimination rules.
- Employees must not have a right to receive cash or any other benefit other than reimbursement for medical care expenses.
- 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.
- An HRA may specify a coverage period for a reimbursement amount that is less than a 12-month period.
- Although claims incurred during one coverage period may be reimbursed at a later coverage period, an unreimbursed claim may be reimbursed at a later coverage period only to an individual who was covered under the HRA when the claim was incurred.
- 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.

Sample Health Reimbursement Arrangement (HRA)

Whereas, _____ Church of God desires to provide medical care benefits relating to expenses not covered under a medical policy;

Resolved, The church establishes a Health Reimbursement Arrangement (HRA) effective _____, 201__ for the benefit of all full-time employees (working at least 30 hours or more per week) and their dependents (employee's spouse and minor children) under Section 105(b), (e) of the Internal Revenue Code.

Resolved, Health reimbursement accounts shall be maintained for each full-time employee from which covered expenses (as defined in Section 213 of the Internal Revenue Code) for the employee or their dependents shall be reimbursed. Church-funded reimbursements to an employee shall not exceed \$_____ during one calendar year. Church-funded reimbursements to an employee with dependents shall not exceed \$_____ during one calendar year.

Resolved, The submission of medical expenses must be in a form and in sufficient detail to meet the requirements of the church. Expenses may be submitted until March 31 for the previous calendar year.

Resolved, The plan shall be administered in a nondiscriminatory manner (as defined in Section 150(h) of the Internal Revenue Code) and shall remain in effect until modified or terminated by a later resolution.

Resolved, The plan shall reimburse former employees for medical care expenses up to an amount equal to the unused reimbursement amount remaining at retirement or other termination of employment.

Note: The definition of a full-time employee (30 hours or more a week) and the March 31 deadline for submitting expenses are shown only for illustrative purposes.

Disclaimer

The information contained in this MEMO series is of a general nature. It is not offered as specific legal or tax "advice." Each person and local church board should evaluate their own unique situation in consultation with their local legal and tax advisors.

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