Health Reimbursement Arrangement Can be Used to Convert Unused Vacation and Other Leave into Nontaxable Welfare Benefits

By Jeff Chang

In the employee benefits arena, employers and advisors are often looking for ways to convert taxable wages or benefits into nontaxable benefits. One method that the IRS recognizes involves an employer's adoption of a "health reimbursement arrangement" and then "converting" what would otherwise be taxable vacation and other types of leave into nontaxable welfare benefits. From a tax standpoint, it's almost like turning water into wine!

What is an HRA and How Does It Work?

An HRA is an arrangement under which an employer establishes separate bookkeeping accounts for employees to pay for certain medical insurance coverage and welfare benefits. To the extent that an HRA is an employer-provided accident or health plan, coverage and reimbursements under the HRA of medical care expenses for an employee and his or her spouse and dependents are generally excludable from the employee's gross income. The income tax benefits of HRAs recognized by the IRS in Notice 2002-45 and subsequent guidance are available only if the following requirements are met:

- The HRA's benefits must be paid for solely by the employer and not provided pursuant to a salary reduction contribution or otherwise under a Code section 125 cafeteria plan.
- The HRA account must be used to pay for premiums for medical insurance (including COBRA premiums) covering the participant, the participant's spouse (or surviving spouse in the event of the death of the participant), and the participant's dependents, or medical care expenses (as defined in Code section 213(d)) of the participant, the participant's spouse (or surviving spouse in the event of the death of the participant), and the participant's dependents.
- Reimbursements must be limited to a maximum dollar amount for a coverage period and any unused portion of the maximum dollar amount at the end of the coverage period must be carried forward to increase the maximum reimbursement amount in subsequent coverage periods.
- Reimbursements are made on a tax-free basis only to the extent permitted by the Code's nondiscrimination rules that apply to HRAs. If medical expenses other than medical insurance premiums are reimbursed under the HRA, then the nondiscrimination rules applicable to self-insured medical reimbursement plans under Code section 105(h) will apply to the HRA. In many cases, the employer will limit reimbursements under the HRA to medical insurance premiums to avoid the testing and nondiscrimination rules of Code section 105(h).

Once a participant's bookkeeping account under an HRA is reduced to $0, further benefits can be paid by the HRA to or for the benefit of the participant. If the participant, his or her spouse and all dependents die before the participant's account under the HRA is reduced to $0, no death benefit is payable to any person from the participant's HRA account.

What Does Revenue Ruling 2005-24 Say?

In Revenue Ruling 2005-24, the IRS considered whether an employee's accumulated vacation and sick leave, which would otherwise be paid to the employee upon his or her termination of employment and taxed as compensation income, could be contributed to a separate account under an HRA to provide tax-free reimbursements of medical care expenses.

The IRS analyzed four different situations. In the first, when an employee retired, the employer automatically and on a mandatory basis (as determined under the plan) contributed an amount to the employee's separate account equal to all or a portion of the retired employee's accumulated vacation and sick leave. Under no circumstances could the retired employee or his or her spouse or dependents receive any of the designated amount in cash or other benefits.

In this first situation, the IRS concluded, in essence, that the contribution was made by the employer (even though, but for the plan's mandatory contribution provision, the employee would have received the contributed amount in cash), and that the arrangement would thus qualify as an HRA because it was provided by the employer and payments were limited solely to reimbursements of previously substantiated medical care expenses incurred by current and former employees and their spouses and dependents.

In each of the second, third and fourth situations, the IRS concluded that the arrangement was not an HRA and would not meet the requirements for tax-favored treatment because the plans provided for amounts to be paid irrespective of whether medical care expenses had been incurred. In the second situation, the plan provided for a cash payment to the employee equal to all or a portion of the unused reimbursement amount available to the employee under the arrangement. In the third situation, all or a portion of the unused reimbursement amount was paid in cash to the participant's beneficiary or to the participant's estate upon the death of the participant. In the fourth situation, the employer established a separate "option plan," under which each participant could elect to participate and have unused reimbursement amounts that were "forfeited" under the plan at the end of each plan year either contributed to one of several retirement plans or paid to the participant in cash. If a participant did not elect to participate in the option plan, unused reimbursement amounts would be carried forward to future plan years.

Finally, the IRS stated that the ruling would apply to arrangements covering any combination of active employees or retirees. Thus, for example, an employer could establish an HRA with a mandatory conversion feature to cover retirees only.

Which Employers Can Adopt an HRA With a Conversion Feature?

Before an employer can adopt an HRA with a mandatory conversion feature, such an arrangement must first be evaluated under applicable state law. In many states, terminating employees are generally entitled to receive, in cash, the value of any unused vacation, sick and other types of leave, which right the employer cannot violate unilaterally by contributing some portion or all of such amounts on a mandatory basis to an HRA. In California, for example, Labor Code section 202 generally requires an employer to pay to a terminated employee, in cash, all of such individual's wages, including amounts representing unused or accumulated vacation, sick and other leave, either on the date of termination or within 72 hours thereafter. Since willful violations of this requirement may be subject to criminal prosecution, it is quite likely that the California Labor Code, and similar laws in other states, would not be preempted by ERISA, nor would they be overridden by the Internal Revenue Code.

There are, however, certain exceptions to these requirements. For example, section 220 of the California Labor Code provides that section 202 is inapplicable to the payment of wages to any person who is directly employed by any county, incorporated city, or town or other municipal corporation. Therefore, unlike private employers, which must satisfy the requirements of section 202, local governmental entities can adopt an HRA and provide for mandatory conversion of some portion or all of employees' accumulated leave without violating state law.

Because of these state law requirements, an HRA with a mandatory conversion feature is likely to be most attractive to eligible public entities. For example, this type of arrangement can be very useful for public employers in California and other states that wish to participate in the state's medical program, such as CalPERS, but are nervous about the escalating cost of the general requirement to provide equivalent coverage to both active employees and retirees for life. With careful planning, a city or county could provide up to full coverage at the employer's expense for active employees and a minimum of coverage at the employer's expense for retirees. A retiree's money in the form of accumulated leave could be used on a tax-favored basis to pay for some or all of the retiree's portion of the cost of medical premiums

and reimbursements of other medical expenses. Such an approach would convert what would otherwise be taxable compensation for the retirees into tax-free medical coverage and reimbursements that will also save money for the employer. How's that for a "win-win" proposition?!

Before adopting such an arrangement, the employer must also consider the terms of any employment contract, collective bargaining agreement or memorandum of understanding.

How Does an Employer Adopt an HRA With a Conversion Feature?

Once an employer decides to adopt an HRA, with or without a conversion feature, the process of documenting the arrangement is fairly straightforward. Besides the preparation of a plan document that contains all of the terms of the arrangement, the employer will also want to distribute appropriate communications materials to all affected employees and retirees.

We are aware of several vendors that market packaged documents to establish HRAs to cities, counties and other municipalities. While, in general, such packages will adequately document the HRA, we have also found that many of these programs are unnecessarily complex, for example, by requiring that all contributions be made to a Code section 501(c)(9) trust (also known as a VEBA). Because a VEBA generally serves no useful purpose in this context, we believe that employers can often enjoy significant cost savings, increased flexibility in design and administration of their HRA arrangements if they obtain expert advice to evaluate the pros and cons of these offerings.

What Type of HRA is Right?

As most employers know, the use of HRAs was affected by the passage and implementation of the Affordable Care Act (ACA). Because the ACA treats HRAs for active employees as being subject to several of the limitations on employer group health plans (see IRS Notices 2015-17 and 2015-87), the number of HRAs covering active employees has decreased dramatically in recent years. However, these limitations are not applicable to retiree-only HRAs (RHRAs). As a result, many of the advantages and techniques mentioned above can be used with RHRAs.

What to do?

Employers that would like to convert taxable compensation into nontaxable benefits should consider the opportunity presented by the IRS in Revenue Ruling 2005-24. Due to potential conflicts with state labor law rules, this planning opportunity may not be available to every employer. However, depending on the state labor law rules in your jurisdiction, or your status as a public employer, you just might be able to accomplish this conversion for the benefit of your employees.

Please contact Jeff Chang if you'd like more detail on this issue.

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