Resource on Flexible Spending Arrangements (FSA), Health Reimbursement Arrangements (HRA), and Health Savings Accounts (HSA)

INTRODUCTION:

There are a number of tax-favored accounts that are utilized in the design of employer-sponsored health plans. These accounts allow employers to design programs that achieve their benefits program goals on a tax-favored basis to both the employer and the employee, including payroll tax savings for both; and employee income tax savings for both employer and employee contributions. This overview includes the three types of accounts most often encountered in group health plan design by governmental entities: Flexible Spending Arrangements (FSA), Health Reimbursement Arrangements (HRA), and Health Savings Accounts (HSA). It should be noted that additional types of accounts such as Retiree Health Savings Accounts (RHSA), Archer Medical Savings Accounts (Archer MSA), Voluntary Employee Beneficiary Association (VEBA), and Individual Coverage Health Reimbursement Arrangement (ICHRA), are available but less frequently used so not covered in this document.

ACCOUNT TYPES AND OVERVIEWS:

(Health) Flexible Spending Arrangements (FSA)

A Health Flexible Spending Arrangement (FSA) allows employees to be reimbursed for qualified eligible medical expenses from employers, and (sometimes) employer funds. There are two types of FSAs most often sponsored by employers. The first type of FSA is a Health FSA that reimburses for all eligible non-covered medical expenses allowable under IRS section 213(d) and outlined in IRS publication 502, such as deductibles, copays, qualified medical costs, and in some years over-the-counter medications. The second type of FSA is a limited-purpose FSA, which reimburses generally for non-covered dental and vision only expenses.

Common characteristics of an FSA Plan are:

- An FSA plan is a cafeteria plan under IRS Section 125 and requires a Section 125 (Cafeteria) Plan Document. Plan documents should utilize broad language to allow for frequent IRS updates to the details (such as limits and allowable expenses) by not inserting values but rather referring to the latest IRS limits and Section 83(d) expenses in effect for each calendar year.
- FSAs are usually funded through an employee's voluntary salary reduction agreement that employees enter with an employer; although employers may also contribute to employee FSA Accounts.

- An employee makes an annual election to have withholding from their pay into their FSA Account. The total election amount is funded on a per-pay pro-rata basis. For example, the total amount of the employee election could be $1,200. An employee being paid biweekly for 24 pay periods per year would have a per pay deduction of $50 per pay period.
- Although the funds are deducted per pay period, they are available in full beginning on the first day of the year in which the election is made.
- While Employee FSA contributions are funded throughout the year, employer FSA contributions do not need to be pre-funded to an employee's account. They can be paid as qualified employee expenses are incurred and submitted. An example is wellness rewards that are paid out quarterly.
- An employer-funded FSA amount must be included in the reported amount for each employee on Form W-2 Box 14, DD.
- To get reimbursed for an expense from an FSA, an employee must provide the health FSA (or its administrator) a written independent 3rd party statement (e.g. a receipt from a doctor or pharmacy, or an Explanation of Benefits, or EOB) stating that the medical expense has been incurred, and the amount. The employee is required to provide a written statement that the expense hasn't been paid or reimbursed under any other health plan coverage. Debit cards, credit cards, and stored value cards provided by or on behalf of the employer can be used to reimburse participants in a health FSA. Using these cards that meet certain substantiation methods may exempt the FSA participant from having to provide additional information to substantiate the expense.
- There is an annual maximum contribution to an employee FSA that is updated generally by the IRS Notice of Inflation Adjustments for the Tax Year in or around October of each year (sample here). It is important to update any employee correspondence, as applicable. An employer decides the annual maximum amount an employee can contribute to an FSA, up to the annual maximum allowed. Employers do not have to offer the employee the annual maximum allowed by the IRS.
- Under the FSA use-or-lose provision, participating employees normally must incur eligible expenses by the end of the plan year or forfeit any unspent amounts. However, employers can, if they choose to, offer an option for participating employees to have more time to use FSA money.
    - Under the *carryover option*, an employee can carry over up to the IRS limit for their plan of unused funds to the following plan year.
    - Under the *grace period option*, an employee has until two and a half months after the end of the plan year to incur eligible expenses. For example, March 5 for a plan year ending on December 31.
    - Employers can offer either option (not both) or no option.
    - NOTE: The IRS allowed employers to offer a special carryover provision for 2020 and 2021 due to the pandemic. It is important to verify if any current legislative rules pertaining to limits, eligible expenses, and carryover or grace period provisions are in effect.

Health Reimbursement Arrangements (HRA)

A Health Reimbursement Arrangement (HRA) allows employees to be reimbursed for qualified eligible medical expenses from employer provided funds only. Under an HRA, 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. HRAs can reimburse for eligible non-covered medical expenses allowable under IRS section 213(d) and outlined in IRS publication 502, such as deductibles, copays, and non-covered qualified medical costs.

Common characteristics of an HRA Plan are:

- HRAs are often paired with a "High Deductible Health Plan" to offset the employee's deductible or maximum out-of-pocket expense.
- As HRAs are a reimbursement type plan whereby the expense must be incurred to be reimbursed, they generally cost the employer less funding than an HSA program, as they do not generally incur the full maximum potential funding for all employees.
- An employer elects whether an unused HRA balance at the end of the year is eligible for carryover. This should be clearly identified in any plan document and clearly communicated to employees. The ability of an employer to not allow a carryover of the unused potential balance may limit an employer's OPEB liability.
- An HRA account is not part of a Section 125 cafeteria plan, as HRA rules explicitly state that an HRA cannot be subject to a salary reduction agreement (a Section 125 cafeteria plan) to be eligible to be a tax-free benefit to the employee.
- There is no limit on the amount that can be contributed to an HRA account.
- HRA funds can be used by an employee to pay for Section 213 eligible expenses, eligible over-the-counter medical products (which may be updated from year to year based on legislation), long-term care coverage, and health insurance premiums. The latter makes HRAs a popular vehicle for Retiree Health Reimbursement Accounts.
- When set up as an employee retires, retiree HRAs may carry additional requirements such as contribution and election requirements by class, and IRS documentation should be reviewed and or benefits counsel consulted when considering establishing a program and plan document).
- When an employee is offered both an FSA and an HRA, the HRA funds for the same eligible expenses must be exhausted before reimbursement may be made from the FSA. Educating and communicating with employees on this is important.
- An HRA is a self-insured medical plan. It has IRS and potentially other agency reporting requirements that must be reviewed with an advisor (Example: PCORI fee).
- To receive a reimbursement distribution from an HRA for qualified medical expenses incurred, the expense must have been incurred after the date the employee enrolled in the HRA. NOTE: Debit cards, credit cards, and stored value cards provided by or on behalf of the employer can be used to reimburse participants in an HRA. Using these cards that meet certain substantiation methods may exempt the HRA participant from having to provide additional information to substantiate the expense.
- Reporting of HRA contributions on Form W-2 is optional but should be verified each year as requirements can be updated.

Health Savings Account (HSA)

A Health Savings Account is a tax favored way to allow employers and employees to contribute to tax-exempt trust or custodial accounts established for each employee, through a qualified HSA trustee (such as a bank, insurance company, or investment firm). With an HSA, the employee owns the funds once deposited and can use the funds to pay for or reimburse certain medical expenses in the current year or in future years. The funds can be invested and grow tax free year to year. To be eligible for an employee to make or receive HSA contributions on their behalf, the individual (account holder) must be eligible which includes the following:

- ✓ Covered under a high deductible health plan (HDHP) on the first day of the month.
- ✓ Have no other health coverage except what is permitted by the IRS under Other health coverage (work comp, specified illness, specified dollar coverage).
- ✓ Not be enrolled in Medicare.
- ✓ Not be claimed as a dependent on someone else's tax return.

Characteristics of an HSA Include:

- An HSA must be paired with a qualifying High Deductible Health Plan subject to minimum deductibles and out-of-pocket expenses, which is updated by the IRS annually (IRS Notice of Annual Inflation Adjusted Amounts example is here). The intent is that the deductible and out-of-pocket costs are higher than a normal health plan.
- The medical plan does not pay expenses for an HSA participant in a qualifying HDHP until the deductible is met (through in-network costs). An exception is that the insurance provider can pay for preventative costs and any other costs allowed per recent legislative action before the annual deductible is met. This limitation should be fully considered when an employer has an on-site or near-site employee health center.
- An employer's contribution to an employee's HSA must be comparable to all comparable participating employees (other employees covered by HDHP)
- An HSA cannot be paired with a medical FSA but can be paired with a limited purpose FSA or HRA (ex: dental and vision only) or retirement HRA.
- An HSA is portable – an employee takes the account balance with them when they leave employment.
- An employee must report HSA activity on their annual tax return utilizing Form 8889 – see instructions here.
- Employers fund HSA accounts anytime throughout the year and generally pro-rate for new employees.
- An employee may view their HSA account as a 401k account – a savings account for the future. Catch-up contributions are allowed for individuals over the age of 55. See the current catch-up amount here.
- An employee may change their employee HSA contribution amount at any time during the year.
- An employee is not eligible to contribute to an HSA starting 6 months prior to Medicare eligibility (Part A).
- Financial institutions holding an HSA Account will send account holders an annual statement for use in preparing Form 8889 on their annual tax return. Contributions to

the HSA account are reported by the trustee on Form 5498-SA – HSA, Archer MSA, or Medicare Advantage MSA information; and distributions for expenses paid from the account are reported on Form 1099-SA - HSA, Archer MSA, or Medicare Advantage MSA information.

- Employers report the amount of contributions to an employee's HSA on Form W-2 Box 12, Code W.

GENERAL INFORMATION:

Coordination with your organization's internal staff, including human resources, budget, and legal is highly recommended.

See Publication 15-B Table 2-1 for Special Rules for Various Types of Fringe Benefits to understand the tax benefits (including payroll).

Before proceeding with any of the above accounts or implementing or communicating changes based on the above – check with advisors on latest legislative updates regarding these arrangements and accounts.

IRS Documents are updated frequently. Please be sure to research the most recent document of this or a similar name.

RESOURCES:

IRS Publication 969: https://www.irs.gov/pub/irs-pdf/p969.pdf

IRS Publication 15-B: https://www.irs.gov/pub/irs-pdf/p15b.pdf

IRS Publication 502: https://www.irs.gov/publications/p502

Application of the Patient-Centered Outcomes Research Trust Fund Fee to Common Types of Health Coverage or Arrangements: https://www.irs.gov/newsroom/application-of-the-patient-centered-outcomes-research-trust-fund-fee-to-common-types-of-health-coverage-or-arrangements

Form W-2 Reporting of Employer-Sponsored Health Coverage: https://www.irs.gov/affordable-care-act/form-w-2-reporting-of-employer-sponsored-health-coverage

Form 8889: https://www.irs.gov/pub/irs-pdf/f8889.pdf

Form 8889 Instructions: https://www.irs.gov/pub/irs-pdf/i8889.pdf

IRS tax inflation adjustments for tax year 2023: https://www.irs.gov/newsroom/irs-provides-tax-inflation-adjustments-for-tax-year-2023

Eligible employees can use tax-free dollars for medical expenses: https://www.irs.gov/newsroom/irs-eligible-employees-can-use-tax-free-dollars-for-medical-expenses

IRS Publication HRA Part III – Administrative, Procedural, and Miscellaneous: https://www.irs.gov/pub/irs-drop/n-02-45.pdf