



How IRS Rules Impact HRAs

HRAs Deliver Substantial Tax Benefits

Making Health Reimbursement Arrangements (HRAs) the foundation of your health benefit plan gives you control of your plan, the flexibility you need to recruit and retain employees, and the ability to save money on healthcare expenses. Additionally, HRAs provide very attractive tax savings for your company and its employees, reducing federal, state, and local income taxes, along with payroll and unemployment taxes.

Although HRAs were created in 2002, some companies and their financial advisors may be unfamiliar with IRS Regulations regarding HRAs. Because HRA tax benefits are valuable, companies and their advisors should understand HRA regulations to ensure they capture these benefits.

Overview of HRA Tax Treatment

HRAs are governed by Section 105 of the Internal Revenue Code. Only employers may contribute to HRAs. All reimbursements are excluded from an employee's gross income and wages subject to FICA (7.65%). Similarly, employers deduct reimbursements as a business expense and exclude them from wages subject to FUTA (0.8%) and the employer portion of FICA (7.65%).

Only employees and former employees of a company are eligible to participate in an HRA. Self-employed individuals (e.g. sole proprietors), partners, and S-Corp shareholders who hold more than two percent of their company's stock are not considered employees for tax purposes and not eligible to participate. However, these "Business Owners" can receive nearly all the tax benefits that other employees receive.¹

Special Rules for Highly Compensated Individuals

As mentioned above, HRA reimbursements are tax-free to employees. However, each class within an HRA must comply with certain rules for "highly compensated individuals" (HCIs) within the class in order to enjoy all tax savings. HCIs include the highest paid five company officers, shareholders with more than 10 percent of the employer's stock, and/or the highest paid 25 percent of employees. However, they exclude the Business Owners described above. The Section 105 rules each HRA class must meet are as follows:

1. **Eligibility.** An HRA class must not be set up in a way that not disproportionately benefits, or "discriminates" in favor of, HCIs.²

¹ See "HRA Tax Savings For Business Owners", published by Zane Benefits.

² §105(c)(2) allows certain employees to be excluded in these tests. Consult your tax advisor for more information.

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2. **Discrimination.** Benefits offered within an HRA class must not discriminate in favor of “highly-compensated individuals” (HCIs) within that class.

The IRS considers “all facts and circumstances” in determining whether an HRA or class within an HRA complies with these rules. Employers are responsible to make sure classes meet these requirements. To the extent employers adhere to the following three guidelines, they are more likely to meet these tests and ensure tax-free reimbursement for all employees in the HRA.

1. **Create classes based on objective business criteria.** These may include job categories, geographic location, part-time or full-time status, date of hire, etc.
2. **Ensure classes do not consist primarily of HCIs.** An HRA class with only a nominal number of employees who are not HCIs may be considered discriminatory.
3. **Explicitly specify the basis on which discrimination testing will occur in the plan document.**

The consequences for violating Section 105 eligibility and discrimination rules are *not significant*. If, upon audit, an HRA class is found to violate these rules, the HCIs who received HRA reimbursements must pay income taxes on the “excess” portion of the reimbursements they actually received. HCIs do not pay income taxes on the allowances they do not use *or* on their entire reimbursement. Moreover, their HRA reimbursements are still exempt from FICA and FUTA taxes and are fully deductible by the employer.

Violating the eligibility and discrimination tests described above *does not mean* other employees are entitled to the higher level of benefits received by HCIs or other classes. Similarly, a violation does not cancel or otherwise invalidate the HRA or jeopardize the company's ability to deduct all HRA reimbursements.

How Zane Benefits Enables Compliance with IRS Rules

Using Zane Benefits to create your HRA lets you to make the most of employee classes while complying with Federal Income Tax regulations. Specifically, Zane Benefits:

1. Helps you creates employee classes and provides advice about how to structure these classes to meet IRS requirements
2. Enables you to customize the benefits for each class
3. Substantiates claims in accordance with IRS rules and retains a seven-year record of all substantiated expenses for audit purposes.
4. Provides reports that show how each class benefits from the HRA
5. Generates plan documents that meet the IRS requirements

Start Enjoying HRA Tax Benefits Today

Your company and your people deserve the benefits that HRAs offer – including tax savings. With Zane Benefits’ help, you’ll create a health benefit plan that delivers these benefits.

Talk to your Zane Benefits Health Benefits Specialist today to get started.

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