

**NEW HEALTH PLAN OPTION TO CONTROL COSTS –
FAVORABLE IRS GUIDANCE ON THE
“HEALTH REIMBURSEMENT ARRANGEMENT”**

The Internal Revenue Service has given wholesaler-distributors a valuable new tool to attack the high cost of employee health insurance. The IRS recently issued guidance that clarifies the favorable tax treatment of a “health reimbursement arrangement” (HRA), which is funded by the employer and reimburses an employee for out-of-pocket medical expenses up to a specified dollar amount per year.

What is an HRA?

An HRA is an arrangement that:

- is paid for solely by the employer and not funded in whole or in part by the employee through salary reduction,
- reimburses the employee only for qualified medical care expenses incurred by the employee or his or her dependents,
- provides reimbursements to an employee up to a maximum annual benefit amount for a coverage period (usually a calendar year), and
- any unused employee HRA account balance may be carried over to subsequent years, thereby increasing the maximum reimbursement amount available to the employee in future years.

An employee’s HRA account balance and any reimbursement received by the employee are not taxable income for the employee. An HRA may not discriminate in favor of highly compensated employees as to participation or the maximum annual benefit. Since an HRA is a group health plan it is subject to the COBRA continuation coverage requirements.

How do HRA’s benefit the Wholesaler-Distributor?

HRA’s are generally used in conjunction with a high-deductible group health insurance policy. The employer realizes a cost savings by paying a lower premium for the higher deductible policy that more than offsets the employer’s cost to fund the HRA for its employees. The employer’s annual contribution

to the HRA is often set at about one-half of the higher deductible (see the illustration which follows), so the employee has some limited exposure for medical expenses that will not be covered by insurance or the HRA. It is this limited exposure - - an out of pocket cost to the employee - - that will make the employee a more careful consumer of medical services.

Illustration

The following example of an employer's use of a tax qualified HRA was adopted from IRS Revenue Ruling 2002-41.

ABC Wholesaler-Distributor sponsors a major medical plan for all employees that provides coverage under a group health insurance policy. The major medical plan has a \$2,000 annual deductible for employee-only coverage and a \$4,000 annual deductible for family coverage. The major medical plan is paid for in part pursuant to salary reduction elections under ABC's cafeteria plan. The election form provides that salary reduction elections are used only to pay for the major medical plan. To participate in the major medical plan, an employee must make a \$1,000 annual salary reduction election for employee-only coverage or a \$3,500 annual salary reduction election for family coverage

In addition to the major medical plan, ABC also sponsors an HRA that reimburses the medical care expenses of all participating employees and their spouses and dependents up to an annual maximum reimbursement amount that is fixed on January 1 of each year. The HRA is available only to employees who participate in the major medical plan.

The HRA is paid for by ABC and employees do not make any salary reduction election to pay for the HRA. The HRA operates on a calendar year basis. Employees have no right to receive cash or any benefit from the HRA other than reimbursement for medical care expenses.

The expenses reimbursable under the HRA are any medical care expenses that would be covered by the major medical plan but for the major medical plan's deductible, limitation to expenses that are "usual, customary and reasonable," or any other similar dollar limitation imposed by the major medical plan. Only expenses that are substantiated are reimbursed.

The maximum reimbursement amount for the first year in which an employee participates in the HRA is \$1,000 for an employee who has employee-only coverage under the major medical plan and \$2,000 for an employee who has family coverage under the major medical plan. Unused reimbursement amounts from one year are carried forward for use in later years. Therefore, in each year after the first year, the maximum reimbursement amount under the HRA equals \$1,000 for an employee who has employee-only coverage and \$2,000 for an employee who has family coverage, increased by that employee's amount from the previous year. If an employee retires or otherwise terminates employment, any unused reimbursement amount remaining in the HRA is unavailable thereafter; or alternatively the HRA may allow former employees, including retirees, continued access to unused reimbursements.

Under the terms of the plans, a qualified beneficiary who chooses to elect COBRA continuation coverage may only elect the HRA in conjunction with the major medical plan. However, a qualified beneficiary may choose to elect COBRA continuation coverage for only the major medical plan.

The IRS concluded that the HRA in this example was entitled to favorable tax treatment and the amounts contributed to an employee's HRA were not considered taxable income to the employee.

Conclusion

The HRA is widely viewed as an important component to an employer's group health plan offering in the future due to its cost savings potential and tax benefits to the employees. Additional information on HRA's may be found in IRS Revenue Ruling 2002-41 and IRS Notice 2002-45 which may be accessed at www.ustreas.gov/press/releases/po3204.htm

To learn more about the NAW HRA plans, visit www.naw.flexiblebenefit.com or call toll free 1-888-345-7990.

HRA'S SAVE THE HEALTHCARE DAY FOR EMPLOYERS

December 3, 2002

Will health premiums for your business continue to rise? The likely answer is yes, even after two years of double-digit increases.

Nationwide health insurers charged businesses 12.7 percent more this year – about eight times higher than the overall inflation rate – according to a 2002 survey of employer health benefits by the Kaiser Family Foundation. And even higher increases are expected in 2003, according to Jon Gabel, vice president of health systems studies for the Health Research and Educational Trust, which conducted the study with Kaiser.

The impact of rising health benefit costs on wholesaler-distributors has been severe, particularly for smaller businesses. For Furbay Electric in Canton and Mansfield, Ohio, the increases were “astronomic,” according to president Tim Furbay. With 49 employees, Furbay said, “It was the biggest thing we were dealing with in employee benefits, and it just got to be prohibitive to keep paying these huge increases.”

Rising premiums are not the only reason distributors are looking for solutions other than cutting benefits or dropping coverage altogether. Jeffrey Meltzer, president of Universal Hardwood Flooring in Los Angeles, said he was “completely dissatisfied with the level of treatment offered through the local health maintenance organization.”

American Craftlines president Ruth Sewart said it was a matter of the insurer dropping coverage after her husband had heart surgery and broke his ankle.

All three distributor executives, fortunately, discovered that there is an alternative to having no control over health insurance costs.

The ray of sun for them has been new defined-contribution, Health Reimbursement Arrangement (HRA) plans that restrain premiums by giving employers and employees more choice about the structure of benefits offered through plans available from the National Association of Wholesaler-Distributors (NAW) and the Flexible Benefit Service Corporation (FBSC). FBSC is the exclusive administrator to the NAW's HRA Program.

EMPOWERING EMPLOYEE CHOICE

Because the existing system periodically has made health benefit costs unpredictable, distributors like Furbay Electric, Universal Hardwood and American Craftlines look for ways to preserve benefits while containing costs. HRAs provide one solution by offering incentives that make employees more price conscious. In addition, they give employers and employees a real choice in how they spend their “first dollar” or deductible portion of benefits.

Here's how it works: Under a HRA defined-contribution plan, the employer puts a fixed amount annually in each worker's account. The annual contribution – which may range from a few hundred to a few

thousand dollars, depending on the structure of the plan – is there for employees to spend as they choose on a wide range of approved health services and products.

An additional bonus for employees is now available, thanks to a U.S. Internal Revenue Service ruling in June of 2002. Any unused money from the defined contribution may be rolled over to the next year tax free, subject to a cap that the employer sets. This counters the incentive for the employee to spend the whole account if part of it is not needed in a particular year. Such tax-free rollovers have not been allowed by the IRS in the case of so-called cafeteria benefit plans that offer a menu of services.

Once employees meet a fixed deductible, the insurer pays 100 percent of medical expenses, thus protecting workers against the big-dollar costs of hospitalization, diagnosis and other types of care. An incentive in the HRA plan for employees to be cost conscious is that they face spending their own money if they exhaust their HRA contribution account.

Although the defined-contribution plans have only taken off since the IRS ruling, distributors who have signed up say they already see their advantages.

“If an employee wants a full-body cat scan, he or she can use their account to buy it,” says Meltzer. The same is true, he says, if they want to go for chiropractic or homeopathic treatment. “One of our employees used the account to go to a podiatrist, and he liked being able to get treatment without the insurance company being between him and the doctor. The doctor likes it, too, because he gets immediate payment instead of waiting four months for reimbursement on an \$80 charge, with all the tracking and billing involved.”

And the way the plans are structured means that employees not only have more flexibility but also are more selective in their health care spending.

“When people see that that they can keep the money they don’t spend, they become more frugal consumers,” said FBSC CEO Allen Wishner. “When a doctor prescribes a drug, they’ll call a pharmacy and ask how much it costs. Or they may call a nurse instead of going to the emergency room right away. Under traditional plans, the employees are not engaged as consumers.”

EMPOWERING EMPLOYER CHOICE AND REDUCING COSTS

Many questions have emerged about the risks in defined-contribution plans. In fact, the plans give employers more control over the design and costs of their health benefit.

“I like it from a business standpoint,” Furbay said. “It allows you to do things that you want to do in terms of coverage. For example, you can choose whether to include eyeglasses every year or every two years or a routine physical.”

In addition, he said, “You are aware of what’s coming through the accounts and you can educate and advise people” on the choices they make in spending their accounts.

Although the plan has been in effect only since July this year, Furbay said that the projected savings, depending on whether employees spend 100 or only 50 percent of their accounts, are estimated between about \$32,000 and \$60,000 annually.

“We’re actually already seeing a potential reduction in medical costs,” said Meltzer, who signed up in March for the MSA plan. “The savings come when we see money not spent, that the employee gets to

keep, and invest the excess, that's where possible savings come in. We weren't looking for savings but stability in our medical costs."

For Sewart and her husband, who are the employee/owners of the distributorship, coverage which had cost them as much as \$3,000 per month, are now about one third of what they were with the HRA plan. "We are happy with it," Sewart said.

Here are some key features that distributors can craft to control costs and levels of benefits:

- The amount of the defined contribution to the HRA.
- When to put funds into the HRAs.
- The amount in those accounts that can be accumulated through rollovers.
- The amount of the deductible.
- Whether to offer an incentive for "wellness" measures employees take, such as stopping smoking or submitting to an annual physical.
- Whether to extend the HRA plans to retirees under provisions of the Consolidated Omnibus Budget Reconciliation Act (COBRA) of 1985 that require most employers to offer continuing coverage temporarily to employees after they leave due to termination or layoff.

"Furthermore, instead of having to accept one-size-fits-all solutions, employers can tailor their plans to the wellness, age and risk profile of their workforce," said Wishner. "With double-digit inflation in premiums, you want to know you're never in over-insuring situations."

REDUCING COSTS

The driving force for adopting the HRA approach is the promise of reduced premiums. With a high deductible, for instance, plans for small groups offer premium savings of 30 percent to 40 percent or more. Here's an example of how a plan might be structured:

With a \$2,000 deductible, the HRA covers the first \$1,000 of an employee's health care expenses. The second \$1,000 is the employee's responsibility. Beyond this deductible, the insurer picks up 100 percent of the employee's claims.

National data show that about 60 percent of insured workers have claims totaling less than \$1,000 per year. That means most employees will have less out-of-pocket expenses under an HRA than under traditional plans with deductibles and co-payments.

For employers, this also means less cost. In one illustration, a Blue Cross and Blue Shield high-deductible plan that assumes covering a group of 103 employees consisting of a mixture of single, spousal and family beneficiaries, the annual cost to the employer would be about \$46,000 to \$113,000 less than the cost of a Preferred Provider Organization (PPO) plan with similar benefits. The greater savings occur if employees spend only 50 percent of their personal accounts, the lesser if they spend 100 percent.

"The major appeal of these plans is that they are going to significantly reduce premium rate increases, which are becoming unsustainable," said Wishner. "What they are really doing is re-engineering the first

dollar benefit by paying it with tax-deductible dollars. This can give relief to the employer and keep employees happier.”

ADVANTAGES OF HRAS OVER TRADITIONAL PLANS

A growing number of employers are considering the defined-contribution approach embracing HRAs for employees. The Kaiser survey reports nearly one-fifth of all are doing so, and the reason is clear. Against the background of rising costs of new diagnostics and procedures, an aging population, and consumer demand for better health services, small businesses are looking for ways to leverage their power in the health insurance market.

HRAs avoid many of the improper incentives of traditional plans in the past that contributed to premium increases. Employers facing higher premiums have sought to contain costs and preserve benefits by switching to managed-care plans, restricting benefits and – particularly among small businesses – dropping coverage.

In the 1980s, employers switched from fee-for-service plans offered by Preferred Provider Organizations (PPOs) to Health Management Organizations (HMOs), which promised to control costs while providing expanded benefits. “The latest round of health inflation has exposed the folly of those claims,” said one *USA Today* article from the Sept. 24 issue. While generally somewhat less expensive than PPOs, HMOs have not been the plan of choice (only about 26 percent of employees with health insurance provided by employers are covered by them).

In the 1990s employers turned increasingly to cutting benefits by requiring higher deductibles and co-payments by their workers. They also have been increasing the employee share of premiums.

With the recent downturn in business, many small firms have dropped coverage altogether. This trend is dramatically reflected in the latest Census Bureau Current Population Survey (released in September) on health insurance coverage. It reveals that another 1.4 million people were added in 2001 to the ranks of the uninsured. The Kaiser survey found that 45 percent of companies employing nine or fewer employees had dropped coverage. And the ranks of uninsured among all small businesses squeezed by rising premiums and the sluggish economy are likely to increase, *The New York Times* reported Sept. 6.

However, small companies have reached the point at which cutting benefits, increasing the employee share of premiums or canceling coverage raises some serious offsetting risks.

The Kaiser survey reported: “The less competitive labor market may make it easier for employers to pass along the cost of health insurance to employees, but doing so may have an adverse impact on a firm’s ability to attract and retain workers.”

Dropping coverage also has an indirect cost: the burden of the increasing pool of uninsured Americans on the rest of the health care system. With the number of uninsured Americans growing – now estimated at 41.2 million – who are not able to pay their share of the cost for health services, some of that shortfall is passed along in the form of higher premiums to employers and higher taxes to support government insurance programs.

Summing up the effects of the squeeze on health benefits facing companies, the *USA Today* editorial reported: “By simply requiring employees to pay more for the same types of benefits, employers risk

moving the health-insurance system further away from where it needs to go, toward one in which workers are given new incentives to be price-sensitive health-care consumers.”

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