BenefitAdvisor

MARSH & McLENNAN AGENCY

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REIMBURSEMENT ACCOUNTS

Under Section 125, employers may offer employees medical or dependent care reimbursement accounts. These accounts allow employees to set aside some of their own money pre-tax at the beginning of the year for unreimbursed medical expenses or for dependent day care expenses.

The IRS rules for these accounts differ depending on the type of account. In addition, employers need to establish a Section 125 plan to allow for pre-tax contributions to these accounts. This *Benefit Advisor* reviews the following details:

- Section 125 plan general requirements
- Health care reimbursement accounts (HCRAs)
- Dependent care reimbursement accounts (DCRAs)
- Debit card rules

HCRA and DCRA accounts are mutually exclusive. Funds set aside in the HCRA can be used only for eligible health care expenses. Funds set aside in the DCRA can be used only for eligible dependent care expenses.

Because most employers offer reimbursement accounts, they need to understand clearly all the rules involved.

SECTION 125 PLAN GENERAL REQUIREMENTS

A Section 125 plan is the exclusive means for employers to offer a choice between cash or benefits. In many cases, it's simply the choice of taking a full salary or having that salary reduced to pay pre-tax for a variety of benefits, such as medical, dental, vision and others. Section 125 also includes rules for employers' HCRAs, DCRAs and even opt-out bonuses.

Section 125 plans require a plan document that includes all the following:

- A specific description of the benefits allowed under the plan and the coverage periods.
- Plan eligibility and participation rules – only employees can participate in the plan.

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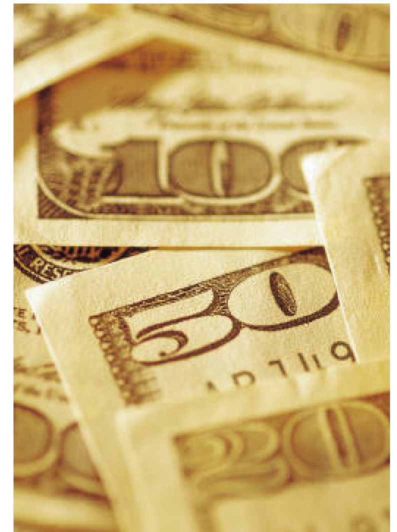

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- Rules that govern the plan elections; elections must be for the entire plan year unless the employee experiences an event that allows a mid-year plan change.
- Employer and employee contribution options, such as salary reductions, credit-based flex plans and so on.
- Any additional details the plan offers, such as an opt-out bonus, a vacation buy/sell plan, HCRAs, DCRAs, and so on.
- The document must include the plan year. A defined plan year can never be more than 12 months. Employers can, however, offer a shorter plan year for a valid business reason. In that case, they must notify plan participants before the start of the plan year.

Both employers and employees receive the Section 125 tax benefits. These plans cannot discriminate. In fact, employers must conduct tests as of the last day of the plan year to prove the plan does not discriminate.

HEALTH CARE REIMBURSEMENT ACCOUNTS (HCRAs)

HCRAs allow employees to set aside funds to pay for predictable unreimbursed medical expenses. Employers can offer a full-scope HCRA, which would reimburse all Section 213(d) medical expenses. Employers could also offer a limited-scope HCRA which would reimburse dental and vision expenses and can also reimburse expenses once the minimum deductible for qualifying high deductible health plans is met. Employees covered by a full-scope HCRA cannot contribute to an HSA, even if they are covered by an HDHP. Those covered by a limited-scope HCRA can contribute to an HSA if they are covered by an HDHP and meet all the HSA eligibility requirements.

The following rules apply to **medical HCRAs**:

- These accounts must comply with the uniform coverage rule. This rule requires the full annual amount be available at the beginning of the plan year if the employee or a dependent incurs an eligible expense. For example, let's say an employee elects to put $2,600 into an HCRA. The employee has Lasik eye surgery in January costing $2,500. The employee could submit a claim and be reimbursed for the full $2,500, even though the account had only one month's contributions. The employee can reimburse the account throughout the year. However, if the employee then leaves the company during the year, employers will lose the money they paid in advance on the claim since the employee is no longer contributing to the account. The employer can't require the former employee to repay the outstanding balance.
- Employees must use the funds in the account by the end of the plan year. The "use it or lose it" rule requires them to forfeit any funds remaining after the end of the year. Employers can offer a grace period for eligible claims or even a rollover option to mitigate the impact of the "use it or lose it" rule.
- Employees must prove and the plan must substantiate that each claim is for an eligible expense.
- The plan must distribute experience gains properly. An experience gain is when the plan has forfeitures under the use it or lose it rule. Employers can use experience gains to offset experience losses or administrative expenses. Forfeitures under the HCRA should not be donated to charity as that may be a violation of ERISA rules.
- The Affordable Care Act (ACA) added an annually indexed limit for contributions to HCRAs. The 2019 limit is $2,700 per employee. The employer can set the account maximum at any amount below that limit.
- The plan must comply with Section 125 as outlined in the first section of this *Advisor*.

Section 125 has been modified over the years to lessen the impact of the "use it or lose it" rule since many employees would not participate in an HCRA for fear of losing any unused funds at the

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end of the year. Employers can adopt **only one** of the following options:

- **Grace period** – Employers can add up to a 2.5-month grace period to HCRAs, thus effectively extending the plan year for 2.5 months. During that grace period, employees can incur eligible claims that can be reimbursed out of funds remaining in the account at the end of the previous plan year. For example, employers with a calendar year plan can add a 2.5-month grace period so that claims incurred up to March 15 can be paid using the amount remaining in the account at the end of the previous plan year.
- **Rollover or carry over** – Employers can allow up to $500 remaining in an HCRA at the end of the plan year to rollover or carry over into the next plan year. The rollover funds can then be used for claims in the next plan year.

Neither of these options will offset the annual statutory maximum, and both can affect whether an employee can contribute to a health savings account (HSA). Employers planning to launch a high deductible health plan with an HSA need to be aware of the potential impact. There are options that can minimize the effect on whether an employee can contribute to an HSA.

HCRAs are considered self-funded medical plans. As such, these accounts also need to comply with other federal laws, including COBRA. However, COBRA applies only in certain circumstances. Employers must offer COBRA when employees lose coverage because of a qualifying event. When it comes to HCRAs, the account benefits available must exceed the COBRA premiums required to continue the account until the end the plan year. The date used to determine the account standing is the qualifying event date. Only paid claims are considered in the calculation. Unpaid pending claims are not counted. The employer must offer COBRA if the annual election minus claims paid before the qualifying event date is greater than the COBRA premium to continue to the end of the plan year. The employer does not need to offer COBRA if the COBRA premium to continue to the end of the plan year is greater than the funds available in the HCRA.

Health care reform also made another key change to Section 125. Since health care reform applies to group health plans, it should apply to HCRAs. However, it does not apply when an HCRA is considered “excepted.” To be considered excepted, an HCRA must meet both of the following requirements:

- HCRA eligible individuals must be eligible for other medical coverage through the employer
- The maximum benefit payable to any participant **cannot exceed**:
  - twice the participant's salary reduction election for the year
  - if it is greater, it cannot exceed $500 plus the amount of the participant's salary reduction election

Health care reform rules do not permit non-excepted HCRAs. Employers that cover any employees not eligible for other medical coverage through the employer likely are offering a non-excepted HCRA. Also, it could be an issue if the waiting period for your HCRA plan is shorter than the waiting period for your medical plan.

DEPENDENT CARE REIMBURSEMENT ACCOUNTS (DCRAs)

DCRAs allow employees to set aside tax-favored funds to pay for childcare for dependent children or elder care for dependent parents. Employees can use a DCRA or apply for a dependent care tax credit. Your employee should decide which is best. Encourage employees with questions to review the IRS Publication 503 to help them make an informed decision.

Although dependent care account rules and health reimbursement account rules are similar, they are not identical:

- The uniform coverage rule **does not** apply. Employees can withdraw only the funds that they have already deposited. There is

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no employer risk for these accounts.

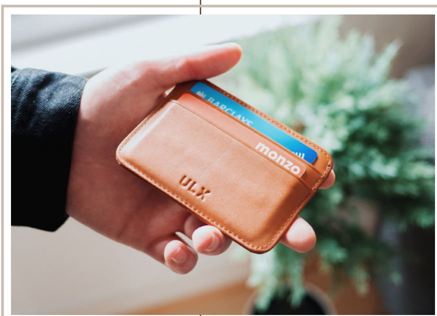
- The "use it or lose it" rule applies to these accounts. The IRS does allow the employer to include a "spend down rule." In other words, former employees can use any remaining funds to pay eligible expenses they incurred before the plan year ended.
- The employee must prove each claim is for an eligible expense.
- The IRS limits these accounts to $5,000 for married couples filing jointly. Claims must occur within the plan year or within the grace period (if the employer adds a grace period).
- The plan must distribute experience gains properly. Gains associated with the dependent care account have the same options as the health care account, but employers may also contribute dependent care account forfeitures to charity.
- The plan must comply with Section 125 as outlined in the first section of this *Advisor*.
- The employee and the spouse need to pay for daycare or elder care so that they can work.
- Most child care centers will be considered eligible providers. In-home day care providers can also be eligible, but the provider must provide a social security number. Back-up day care providers must meet certain requirements.
- The child care expenses must be only for the care and wellbeing of the child. Expenses for education, such as kindergarten fees, would not qualify for dependent care reimbursements.

Dependent care accounts must pass a separate nondiscrimination test under Section 129.

DEBIT CARD RULES

To encourage their employees to use spending accounts, some employers allow them to use debit cards for eligible expenses. Because paying with a debit card is immediate, these accounts are more practical for employees who live paycheck to paycheck.

Employees can use debit cards for both HCRA eligible expenses and DCRA eligible expenses. However, most employers allow them to use debit cards only for HCRAs. An issue arises with dependent care expenses because they are generally paid in advance and account rules do not allow reimbursing an expense until it is incurred. This gap between the payment and the care provided complicates using the debit card for dependent care expenses.



The IRS sets rules for paying with a debit card. Although HCRA vendors handle most of the work involved with these debit cards, employers need to be aware of the rules. In addition, your employees need to understand their responsibilities when they use debit cards. Some of the rules include:

- Participants must agree in writing to use the card only for eligible medical expenses that cannot be reimbursed under any other plan.
- The card must be limited to the annual HCRA election amount, less any claims paid to date.
- The card must be canceled when the employee terminates.
- Employees can use debit cards only at merchants with health care merchant codes and certain pharmacies that use IIAS inventory systems.
- Employees must prove any debit card paid expenses are HCRA eligible expenses. In certain circumstances, claims can be auto-substantiated if they meet IRS rules.
- If a claim is paid improperly (employee used a debit card for an ineligible expense or cannot prove the expense was eligible), the plan must follow IRS requirements:
  - The debit card must be turned off.
  - The employee must repay the account using an IRS approved method.

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The IRS requires employers offering debit cards to ensure employees comply with the following restrictions:

1. Participants agree to use the card only for eligible health care expenses and they must substantiate each claim. The debit card must state this requirement.
2. Card value is limited to the funds available in the account. Each year the card will be loaded with the annual election amount. When the plan pays a claim, that amount is reduced.

3. The card must be cancelled when participation in the HCRA ends. It is a best practice not to allow COBRA participants to have access to the card if they elect COBRA on the HCRA account.
4. Cards are valid only if providers have health care merchant codes and if pharmacies have IIAS inventory systems.
5. Every single claim the card pays must be substantiated. Employees must, therefore, submit the claim detail after they use the debit card. Most vendors allow them to submit claim details electronically, so it is fairly easy to substantiate a claim.

Some claims can be auto-adjudicated. This means swiping the card substantiates the claim in the following situations:

- **Certain transactions that involve dollar amounts that match copayment amounts under the employer-sponsored health plan (or multiples of that amount).** Examples of this would include a payment at a doctor's office that matches the $25 copay under the plan or a $20 payment at pharmacy that matches two times the generic copay of $10 under the plan.
- **Certain previously approved recurring expenses.** An example of this may be a $90 payment at medical facility for physical therapy or an appointment every two weeks after the initial $90 claim for the first visit was substantiated.
- **Claims that are substantiated at the point of service.** An example of this may be a card swipe used to pay for Lasik eye surgery where the eye doctor verifies the expense with the vendor at the point of payment.
- **Claims verified through IIAS codes at the pharmacy.**

For the most part, however, employees do need to substantiate claims when they pay with a debit card. If an employee does not provide documentation, the plan must consider the payment an improperly paid claim.

The IRS requires the plan take the following steps to correct for improper payments:

1. Turn off the debit card – the card must be turned off until the employee pays back the amount of the improper claim. Some employers choose to turn off the card for the remainder of the plan year as a punitive action for not following the claims substantiation rules.
2. Require repayment – the plan must demand repayment of the improper claim. This can include:
   a. Withholding the amount from the employee's pay. Note this must be allowable under any state or local laws.
   b. Offset valid future claims. For example, let's say the employee submitted a $400 invalid debit card claim. The same employee later submits a valid claim for $700. The plan can reimburse $300 of the expense and consider the remaining $400 as repayment for the improper claim.
   c. Treat the expense as a business debt and pursue it accordingly.

The IRS requires you to follow this process for improper claim payments made with the debit card.

Employees must be aware of the additional responsibilities they take on when they pay HRCA

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claims with a debit card. Communication is critical so they understand they must substantiate claims and the steps the plan will take if there is an improper payment. In addition, it is important to inform employees that the following basic problems can occur:

- They can use the card only at swipe machines with pharmacy and health care provider Merchant Category Codes (MCC). Sometimes, however, providers buy used swipe machines and do not correct the MCCs. The card is then declined but that will not be apparent because the employee is at a health care provider and the swipe machine may be coded otherwise.
- Employees need to be aware of the amount remaining on the card. The amount starts at the annual election and decreases as claims are paid under the HCRA. If expenses swiped exceed the amount remaining in the account, the card will be declined.
- If their debit cards are turned off because they did not substantiate a claim, employees can still access their funds, but they need to file a claim to get reimbursements.

Debit cards are a very convenient way to pay for medical expenses and allow employees immediate access to their funds in an HCRA. However, employers must follow several IRS rules when they decide to offer debit cards. Although HCRA vendors handle most of the work involved, employers must understand the repayment options, because they are required, not optional.

CONCLUDING THOUGHTS

Nearly every employer offers reimbursement accounts. They are a great way to save tax dollars on predictable medical and dependent care expenses.

The IRS loses tax dollars on these accounts. As a result, the Section 125 rules have built-in employer risk for offering these accounts and employee risk for using them.

The employer risk is limited to HCRAs. The uniform coverage rules require employers to make the full annual election available to the employee as of the first day of the plan year. If the employee has eligible expenses, the plan must pay benefits even if the account isn't funded yet. If the employee then leaves the organization midyear with claims that exceed account funding, the employer funds the loss.

The employee risk is the "use it or lose it" rule. Employees lose any funds remaining in the account at yearend if they have not incurred eligible expenses. The "use it or lose it" rule deters employees from using these accounts because of the fear of losing money. Over the years, the IRS added both the grace period rules and the carryover option to mitigate the "use it or lose it" implications.

These accounts are a great benefit but it is important that organizations follow the IRS rules under Section 125 and Section 129 (DCRAs).

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