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Health reimbursement arrangements for small employers

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The IRS recently issued Notice 2017-67 to provide guidance on "qualified small employer health reimbursement arrangements" (qualified small employer HRAs) under Sec. 9831(d). Qualified small employer HRAs enable an eligible employer to reimburse employees for medical expenses, such as health insurance premiums, as defined under Sec. 213(d). Qualified small employer HRAs are solely employer-funded; employees cannot contribute to them. Payments from a qualified small employer HRA to an employee are not includible in the employee's income, as long as the employee has obtained qualifying health insurance. An employer can establish a qualified small employer HRA for tax years beginning after Dec. 31, 2016. The guidance within Notice 2017-67 is effective for arrangement plan years beginning on or after Nov. 20, 2017.

Qualified small employer HRAs are an exception to the otherwise applicable requirement of the Patient Protection and Affordable Care Act of 2010 (PPACA), P.L. 111-148, that an HRA may not be maintained by an employer that does not also maintain a group health plan for its employees. Violations can result in the imposition of an excise tax under Sec. 4980D of $100 per day ($36,500 per year) per employee. The qualified small employer HRA legislation came about to provide relief from these penalties, but as discussed below, this relief is only for small employers. It should be noted, however, that under Notice 2015-17, an HRA maintained by an S corporation for its 2% shareholder-employees does not subject the S corporation employer to the Sec. 4980D tax until the IRS issues further guidance.

To be eligible to provide a qualified small employer HRA, an employer must not be an "applicable large employer" (ALE), defined by Sec. 4980H(c)(2) as an employer "who employed an average of at least 50 full-time employees on business days during the preceding calendar year." A full-time employee is defined as an employee who works on average 30 or more hours per week. Sec. 4980H(c)(2)(E) requires full-time-equivalent (FTE) employees also to be taken into account in determining whether an employer is an ALE.

The number of FTE employees is determined for each calendar month by dividing the total number of hours worked during the month by non-full-time employees by 120. Regs. Sec. 54.4980H-2(b) provides that the average number of full-time employees for the preceding calendar year is the sum of full-time and FTE employees for each calendar month in the preceding calendar year divided by 12, rounded down to the nearest whole number. If the result is less than 50, the employer is eligible to provide a qualified small employer HRA.

In addition, to be eligible to provide a qualified small employer HRA, an employer must not offer a group health plan to any of its employees. Examples of group health plans that would disqualify an employer include an HRA other than a qualified small employer HRA, and a health flexible spending arrangement. However,

employer contributions to an employee's health savings account (HSA) do not constitute a group health plan. As noted above, for reimbursements from a qualified small employer HRA to be nontaxable to an employee, the employee must have qualifying health insurance, generally, minimum essential coverage as defined in Sec. 5000A(f). However, an employer who maintains a qualified small employer HRA cannot offer health insurance to employees. Thus, employees must obtain the health insurance through another source, such as a health insurance exchange established under PPACA.

A qualified small employer HRA must be provided to all an employer's employees, with a few exceptions. It may exclude employees who have not completed 90 days of service with the employer; employees who have not attained age 25 before the beginning of the plan year; part-time and seasonal employees; employees covered by a collective bargaining agreement, if health benefits were the subject of good-faith bargaining; and employees who are nonresident aliens with no earned income from sources within the United States. Notice 2017-67 provides guidance on the definitions of part-time and seasonal employees.

Qualified small employer HRAs must be provided to all eligible employees under the same terms, which generally prohibits the employer from providing differing benefits to its employees. However, it is permissible for the benefit to vary based on variations in the price of insurance attributable to the age of the employee and family members, or the number of an eligible employee's family members covered by the arrangement. Notice 2017-67 provides detailed guidance on the same-terms requirement.

The maximum permitted benefit an employer may provide to each employee for 2018 is $5,050 for self-only coverage and $10,250 for family coverage. For employees not covered for an entire year, these limits are prorated on a monthly basis, with an employee treated as having coverage for the entire month if he or she is eligible for the arrangement on any day of that month.

Employers are required to provide written notice of qualified small employer HRA coverage to eligible employees at least 90 days before the beginning of each plan year, as described in detail in Notice 2017-67. In the case of a newly eligible employee, the notice must be provided on or before the first day the employee first becomes eligible to participate. Under a special transition rule, employers providing qualified small employer HRAs in 2017 and 2018 must furnish the initial written notice to eligible employees by the later of Feb. 19, 2018, or 90 days before the first day of the plan year.

To receive reimbursement from a qualified small employer HRA, an eligible employee must provide proof of health insurance coverage. In addition, the employee must substantiate any medical expense for which payment from the arrangement is made. Notice 2017-67 provides details of what constitutes proof of coverage and substantiation of a medical expense. If a qualified small employer HRA mistakenly makes a payment to an employee when he or she does not have insurance coverage, the payment is taxable to the employee. If the arrangement mistakenly makes payments to an employee who failed to satisfy the substantiation requirements, the consequences are severe. All payments to all employees made on or after the date of the mistaken payment become taxable, regardless of whether the employee substantiates the payments. Fortunately, the notice provides for a correction period before these consequences are triggered.

Other potentially severe consequences are related to qualified small employer HRAs. Specifically, if an arrangement fails to satisfy all of the requirements for treatment as a qualified small employer HRA, it will be treated as a regular HRA, which will trigger the Sec. 4980D excise tax of up to $36,500 per year per employee (i.e., $100 per day per employee) for violating PPACA requirements, as discussed above.

The notice provides additional guidance that is beyond the scope of this discussion, including how qualified small employer HRAs are reported on Forms W-2, *Wage and Tax Statement*, and the impact of a qualified small employer HRA on an employee's premium tax credit and eligibility for an HSA.

In summary, qualified small employer HRAs provide a valuable benefit and favorable tax treatment for employees of small employers. However, employers must exercise diligence in maintaining these plans, as there are hefty negative tax consequences for violating the requirements. Employers who currently maintain a qualified small employer HRA and those who are considering adopting one should carefully review Notice 2017-67 to ensure their arrangement complies with the Code and IRS guidance.

EditorNotes

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