

Square Pegs: Applying COBRA to Health Reimbursement Arrangements

Executive Summary

Almost all health reimbursement arrangements (HRAs) must offer COBRA coverage to those who lose HRA coverage due to a qualifying event. But offering COBRA under an HRA presents several issues. Four of those issues are addressed in detail in this *Alert*. Here is a summary.

- A plan consisting of high-deductible health coverage plus an HRA may be designed so that qualified beneficiaries who want COBRA coverage must elect both the HRA and the high-deductible health coverage. Plans generally can avoid being required to offer the option of COBRA coverage under the high-deductible health coverage alone or the HRA alone. Plan document provisions are key in arranging this.
- A plan that includes an HRA must provide that a qualified beneficiary who elects COBRA will have the same amount of coverage under the HRA as the qualified beneficiary had on the day before the qualifying event. When family coverage is in effect on the day before a qualifying event and the qualifying event (e.g., a divorce) splits the family into two or more coverage units, it becomes unclear how to apply this rule. COBRA regulations essentially require that the plan multiply the HRA balance, creating financial exposure for the employer.
- When a qualified beneficiary has COBRA coverage under an HRA, the employer is required to add to the HRA balance at the same time and in the same increments as it does so for similarly situated active employees. Employers may wish to provide that HRA balances will accrue monthly or quarterly, rather than annually, in order to limit their financial risk.
- COBRA premiums can't exceed 102% of the cost to the plan for providing coverage to a similarly situated employee. For HRAs that allow carryovers, it can be difficult to calculate that cost. In most cases, the rate will not vary based on an individual's HRA balance. A single, actuarially determined, rate will apply to all similarly situated qualified beneficiaries.

Background

Most employers that have adopted a consumer-driven health plan have chosen a plan consisting of high-deductible health coverage coupled with an HRA.

What Is an HRA? An HRA is an employer-sponsored medical reimbursement account. An employer can offer an HRA as a stand-alone benefit, but most often HRAs are paired with high-deductible health coverage as part of a consumer-driven health plan. HRAs have several advantages over other types of medical reimbursement accounts (e.g., health flexible spending accounts (FSAs)). Those advantages make them a valuable part of a consumer-driven health plan.

- HRAs can allow unused balances to roll over from one coverage period to the next (rather than being forfeited at the end of each coverage period).
- HRAs can have coverage periods shorter than a year (rather than having all contributions made in annual increments).
- HRAs can limit the benefits payable to a participant to the amount of the participant's account balance (rather than making the entire amount to be added to the HRA for a coverage period available from the first day of the coverage period).

HRAs can't have these features, however, if employees make any pre-tax contributions to them. (Employees may, however, make pre-tax contributions toward the cost of any companion high-deductible health coverage.) Therefore, except for COBRA premiums, the employer generally makes all contributions to the HRA and pays all HRA claims from its general assets. See Willis EB *Alert* #39 for a comparison of HRAs, HSAs, and health FSAs.

Because HRAs reimburse health care expenses, they generally are subject to COBRA. In addition, most HRAs do not qualify for the limited COBRA obligations that apply to most cafeteria plan health FSAs.

What Are the Limited COBRA Obligations? A health FSA that qualifies for the limited COBRA obligations gains two advantages. First, the health FSA need not offer COBRA coverage to any individual who is overspent at the time of the qualifying event. (That is, the individual has already received reimbursements that exceed the individual's contributions.) Second, the health FSA can terminate COBRA coverage under the health FSA at the end of the plan year in which the qualifying event occurred. This prevents individuals from making a new health FSA election for the following year.

Why Don't the Limited COBRA Obligations Apply to HRAs? Most HRAs can't qualify because employee pre-tax contributions are not allowed. Therefore, HRAs generally can't meet one of the tests for the limited COBRA obligations to apply. Under that test, the maximum benefit available for a year cannot exceed the greater of two times the employee's pre-tax contribution (\$0 in the case of an HRA) or the employee's pre-tax contribution plus \$500. In other words, an HRA cannot qualify for the limited COBRA obligations unless additions and carryovers are limited so that no participant can have a balance greater than \$500.

Unfortunately, several sticky issues arise when applying COBRA to HRAs. This *Alert* addresses four of those issues.

- Must a plan consisting of high-deductible health coverage plus an HRA offer qualified beneficiaries the option to elect COBRA coverage under the high-deductible health coverage alone, or under the HRA alone?
- What amount of coverage does a qualified beneficiary have under the HRA?
- When does the employer have to add to a qualified beneficiary's HRA balance?
- How much can the employer charge for COBRA coverage under an HRA?

What Coverage Must Be Offered to Qualified Beneficiaries?

In most cases, when an HRA is part of a consumer-driven health plan, only those employees who elect employer-sponsored high-deductible health coverage receive HRA coverage. That is, an active employee typically cannot choose to have the high-deductible health coverage alone or the HRA alone. Nonetheless, individuals considering whether to elect COBRA sometimes will ask whether they can lower their cost for COBRA coverage by electing the high-deductible health coverage alone or the HRA alone.

COBRA doesn't require employers to allow qualified beneficiaries to elect HRA and high-deductible health coverage separately. It also doesn't prohibit separate elections. Instead, IRS COBRA regulations require that a separate election be offered under each "plan" in which a qualified beneficiary participates on the day before the qualifying event. The rules then allow the employer to define which health benefit components are part of a single plan by specifying its intention in the plan documents.

Example. Epsilon Enterprises offers its employees an HRA/high-deductible health coverage combination for 2006. The high-deductible health coverage is provided under an insurance policy. The insurer administers claims under the HRA, which is a self-funded program with a separate document. When Epsilon offers COBRA coverage under the HRA/high-deductible health coverage combination, a qualified beneficiary contends that he is entitled to reduce his COBRA premium by electing high-deductible health coverage only. If the HRA and the high-

deductible health coverage are two separate plans, the qualified beneficiary will be entitled to elect the high-deductible health coverage alone. If they are one plan, Epsilon doesn't have to offer that option (the qualified beneficiary can be forced to choose between taking both or having no COBRA coverage). Under the COBRA rules, the two components will be a single plan unless it is clear from the documents that the employer intends to maintain the benefits as separate plans. In this case, the qualified beneficiary might prevail by arguing that the HRA's separate document means that it is a separate plan from the high-deductible health coverage.

To ensure that qualified beneficiaries have only the options that Epsilon wants to offer, Epsilon should specify in its plan documents whether it considers the HRA/high-deductible health coverage combination to be two plans or one plan. Note, however, that if Epsilon allows active employees to elect the HRA separately from the high-deductible health coverage, Epsilon probably can't deny that choice to qualified beneficiaries.

What amount of coverage does a qualified beneficiary have under the HRA?

In most cases, an HRA provides that a specific dollar amount will be added to a participant's balance each year. In addition, most allow carryover of some or all amounts that are unused at the end of a coverage period.

Example. Epsilon Enterprises' consumer-driven health plan provides high-deductible health coverage that has an annual deductible of \$800 for individual coverage and \$1,600 for family coverage. A companion HRA provides that \$600 will be added to a participant's balance each year if the participant has individual coverage and \$1,200 will be added if the participant has family coverage. Amounts that are used to reimburse medical expenses are deducted from a participant's balance; any amounts that aren't used are carried over for use in the future.

When an individual elects COBRA coverage, the general rule is that the level of coverage that was in effect at the time of the qualifying event continues. This rule is straightforward when a single employee that has individual coverage is the only qualified beneficiary.

Example. Edgar elected individual coverage under Epsilon's plan (described above) starting on January 1, 2005. He received the \$600 addition for 2005 and spent only \$200 of it during 2005. In 2006, Edgar didn't submit any claims under the HRA. Therefore, after the \$600 addition for 2006, Edgar's balance is \$1,000. When Edgar terminates employment on December 31, 2006, he will be entitled to continue his \$1,000 of HRA coverage under COBRA. In addition, as discussed later in this *Alert*, Edgar will be entitled to the same additions to his balance as are provided to an active employee with individual coverage.

This rule becomes much more difficult to apply when family coverage is in effect before the qualifying event and only some family members become entitled to — or elect — COBRA. For example, if a divorce splits a single family group into an active employee's coverage and a COBRA qualified beneficiary's coverage, is the HRA balance split between them? IRS COBRA regulations provide that each qualified beneficiary has a right to continue at least the amount of HRA coverage that was in effect for the entire family on the day before the qualifying event, so the plan ends up providing at least double the HRA coverage that was in effect before the qualifying event that split the family. This rule may create significant financial exposure for an employer that sponsors an HRA.

In addition, applicable COBRA rules direct that, when one family unit is split into two or more family units and at least one of those units elects COBRA coverage, only the expenses incurred prior to the qualifying event by individuals who are members of that family count against applicable plan limits. In the case of deductibles and out-of-pocket limits, this rule works to a plan's advantage because a single expense doesn't get counted toward two different families' deductibles and out-of-pocket limits. In the case of an overall limit on benefits available to a family under a plan, however, this rule works to a plan's disadvantage, as described in the previous paragraph, because HRA coverage is doubled, but expenses charged against that coverage are not. There is some disagreement about whether this rule should be applied when determining what the HRA coverage level is at the time of a qualifying event. The more cautious approach is to apply the rule to make that determination.

Example. Eloise elected family coverage under Epsilon's plan (described above) for herself and her husband Edward starting on January 1, 2005. Eloise received the \$1,200 addition for 2005 and spent \$200 of it on expenses that she incurred during 2005. Edward had no expenses reimbursed during 2005. In 2006, Eloise did not submit any claims for herself or Edward under the HRA. Therefore, after the \$1,200 addition for 2006, Eloise's balance was \$2,200. Eloise and Edward divorced on December 31, 2006, and Edward elected COBRA coverage. Because Edward is entitled to continue the coverage in effect at the time of the qualifying event, his balance will be at least \$2,200. At the same time, Eloise continues in active employment and retains her \$2,200 balance.

If Epsilon adopted the more cautious approach described above for determining HRA balances for qualified beneficiaries, Edward's HRA balance will be \$2,400 [the amount of the additions (\$2,400) less the expenses paid on Edward's behalf under the HRA (\$0)].

When does the employer have to add to a qualified beneficiary's HRA balance?

The rules governing HRAs require that a qualified beneficiary's balance be increased "at the same time and by the same increment" that similarly situated active employees' balances are increased. This rule is an important factor to consider when determining whether an HRA should provide for a coverage period shorter than a year or limit the amount of reimbursement available.

Example. As described above, Epsilon Enterprises adds \$600 each year to the HRA balance of an employee who elects individual coverage. In 2005, Epsilon credited that amount on January 1 and made it available throughout the year to participants. Eugene began participating in Epsilon's HRA/high-deductible health coverage combination on January 1, 2005 and had not submitted any claims when he terminated employment on March 1, 2005. Eugene elected COBRA coverage and his \$600 HRA balance continued. Eugene paid one month's COBRA premium and then terminated his COBRA coverage. During that month, however, Eugene incurred more than \$600 of reimbursable expenses and was entitled to \$600 from the HRA.

Epsilon amended its HRA effective January 1, 2006 to prevent this situation. Under the amendment, instead of \$600 being available to an employee who elects individual coverage starting on January 1, \$50 is available on January 1, and an additional \$50 of the annual amount becomes available on the first day of each month during 2006 that participation continues. In addition, the HRA provides that a participant's reimbursements will be limited to the participant's account balance. Everett participated in the HRA during 2005 and carried over an unused balance of \$100 from 2005 to 2006. When Everett terminates employment on January 14, 2006, his balance is \$150. Everett's \$150 HRA balance is all that would be available to him during January if he elected COBRA. An additional \$50 in HRA reimbursements would become available each month after he paid his COBRA premium.

How much can the employer charge for COBRA coverage under an HRA?

It is tempting to think that the COBRA premium for an HRA would be the amount of additions made for an individual each year divided by 12. Unfortunately, the carryover feature associated with most HRAs makes calculating the COBRA premium much trickier. This is because the maximum COBRA premium that can be charged for HRA coverage is 102% of the *cost to the plan* of providing such coverage to similarly-situated participants who have not had a qualifying event. Under an HRA, the only amounts that count toward the cost of coverage are actual claims payments made during a year and administrative expenses. Any amounts that are carried over don't get counted when determining the cost to provide HRA coverage for a year. Therefore, the cost to provide coverage to a similarly situated active employee is less than the additions made to the HRA each year.

Example. Epsilon Enterprises' consumer-driven health plan (described above) adds \$600 to Emily's balance for 2006. (Emily began participating on January 1, 2006.) If Emily spends only \$400 of that amount, the plan's cost to provide HRA coverage to Emily for the year is \$400 plus administrative expenses. Assuming that other HRA participants are like Emily and will spend less than 100% of their annual addition so that they have amounts to carry over, the aggregate cost to the plan to provide HRA coverage to active employees will be less than the amount of the annual addition.

IRS guidance on HRAs indicates that the COBRA premium will not vary based on individual balances at the time of the qualifying event. Instead, the premium will be the same for all qualified beneficiaries receiving the same level of additions to their balances. The actuarial challenge in connection with COBRA coverage under an HRA is determining how much less than the annual addition amount represents the cost of providing HRA coverage to an active employee.

Example. Under Epsilon Enterprises' consumer-driven health plan (described above), the following employees had the following credits and claims payments.

Employee's Name/ Coverage Unit	2005 Additions	2005 Claims Paid	2006 Additions as of 8/31/06	2006 Claims Paid as of 8/31/06	Balance at 8/31/06
Emmet (Family)	\$1,200	\$1,000	\$ 800	\$ 700	\$ 300
Erin (Individual)	\$ 600	\$ 0	\$ 400	\$ 0	\$1,000
Eleanor (Family)	\$1,200	\$ 900	\$ 800	\$ 100	\$1,000
Emory (Individual)	\$ 600	\$ 550	\$ 400	\$ 400	\$ 50

Each of these employees terminated employment on August 31, 2006. Before the beginning of the 2006 plan year, Epsilon worked with an actuary who determined that the cost to provide HRA coverage was \$35 per month for those with individual coverage and \$75 per month for those with family coverage. Accordingly, Epsilon set its COBRA rates for HRA coverage for 2006 at \$35.70 and \$76.50 (reflecting the actuarially determined cost plus two percent).

Erin and Emory, who each had individual coverage at the time of the qualifying event, will continue their respective account balances (\$1,000 and \$50) and each will pay the same \$35.70 monthly rate for their COBRA coverage under the HRA. Each will continue to receive \$50 per month additions to their balances for each month that they have COBRA coverage in effect.

If Emmet and Eleanor, who each had family coverage, elect to continue that family coverage, each will have the same account balance as at the time of the qualifying event (\$300 and \$1,000, respectively) and each will pay the same \$76.50 monthly rate for their COBRA coverage under the HRA. They too will continue to receive additions to their balances at the same rate and in the same increments as active employees having family coverage.

If Emmet chose to elect COBRA coverage only for his daughter Elise instead of electing to continue coverage for the entire family, Elise would have a balance of at least \$300 (see the discussion above of the amount of HRA coverage that continues). And the monthly rate for Elise's COBRA coverage under the HRA would be \$35.70 because she has individual coverage in effect as the only member of her family electing COBRA. If Epsilon chose the more cautious interpretation of the rules on the amount of coverage (as described above), and none of the expenses reimbursed under the HRA during 2005 and 2006 were Elise's, then Elise's balance at the time of the qualifying event would be \$2,000. But the monthly rate for her COBRA coverage would still be \$37.50.

Conclusion

Employers that plan ahead for COBRA issues when adopting a high-deductible health coverage/HRA combination can take several steps to limit the employer's financial risks.

- They can prevent qualified beneficiaries from electing the high-deductible health coverage or HRA separate from the other component by providing in plan documents that the two components are considered one plan for COBRA purposes.
- They can adopt the more cautious approach to determining what level of coverage a qualified beneficiary is entitled to under an HRA.
- They can adopt a schedule of monthly additions to participants' HRA balances so that an entire year's addition is not available immediately when a qualified beneficiary elects COBRA.
- They can consult with an actuary to determine the maximum permissible COBRA premium for HRA coverage.

If you have questions about the relative advantages and disadvantages of consumer-driven health plans and the various vehicles for implementing them, please contact your local Willis office.

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