

Update

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Deciphering how COBRA affects account-based health benefits

Summary

Under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), employees, spouses and dependent children – so-called “qualified beneficiaries” – can elect continuation coverage upon losing their employer-sponsored group health plan benefits because of certain “qualifying events” (see sidebar on page 2). This *Update*, the fourth in a series designed to help employers understand COBRA, describes the law’s application to account-based health benefits, including health savings accounts (HSAs), Archer medical savings accounts (MSAs), health flexible spending arrangements (FSAs) and health reimbursement arrangements (HRAs).

What types of account-based health benefits are subject to COBRA?

To help employees pay medical expenses on a tax-favored basis, employers often offer one of several account-style benefits, sometimes referred to as defined contribution health plans, such as HSAs, Archer MSAs, health FSAs or HRAs (see sidebar on page 3 for brief descriptions of these plans). COBRA carries different consequences for each of these benefit offerings. As a general rule, savings accounts (HSAs and Archer MSAs) are exempt from COBRA, while FSAs and HRAs are subject to varying continuation coverage requirements.

How broad is the COBRA exemption for HSAs and MSAs?

The tax code exempts HSAs and Archer MSAs from COBRA. In addition, as long as the employer has limited involvement with these accounts, they generally are not considered ERISA plans, so ERISA’s COBRA requirements aren’t likely to apply. However, it remains unclear whether the Public Health Service Act’s COBRA provisions apply to HSAs and Archer MSAs offered by state and local government plans.

Qualified beneficiaries

- Employees, spouses and dependent children enrolled in an employer's group health plan on the day before a COBRA qualifying event
- Any child born to or placed for adoption with a current or former employee during a period of COBRA coverage
- Retirees and their family members losing health plan coverage due to an employer's bankruptcy

Qualifying events

- Employee loss of coverage due to:
 - Termination for reasons other than gross misconduct
 - Reduction in work hours
- Spouse or dependent loss of coverage because the covered employee:
 - Is terminated or has work hours reduced for reasons other than gross misconduct
 - Enrolls in Medicare
 - Divorces/separates from the spouse
 - Dies
- Dependent loss of coverage due to aging out or otherwise losing dependent status under the plan
- Retiree loss of coverage for self and/or family members due to employer's bankruptcy

Despite the exemption for HSAs and MSAs, COBRA still applies to any employer-sponsored high-deductible health plan (HDHP) offered in conjunction with these accounts. In addition, although HSA and MSA funds generally can't be used to purchase health coverage, an exception allows account holders to use HSA or MSA funds to pay COBRA premiums.

How does COBRA affect health FSAs?

COBRA generally applies to health FSAs, but continuation is limited for health FSAs exempt from the Health Insurance Portability and Accountability Act (HIPAA).

Exceptions for HIPAA-exempt FSAs. A health FSA is HIPAA-exempt if it meets both of these conditions:

- Its maximum annual benefit does not exceed two times the employee's annual FSA salary reduction election or, if greater, the employee's annual salary reduction election plus \$500.
- Employees have other health coverage available that isn't exempt from HIPAA.

If a health FSA is HIPAA-exempt, two special COBRA rules apply:

Special rule 1: Limited COBRA period. The COBRA period runs until the end of the plan year in which the qualifying event occurred. Employers aren't required to offer the full 18, 29 or 36 months of COBRA coverage.

Example: John has indemnity coverage under his employer's group health plan and annually contributes \$1,200 to a health FSA. When John terminates employment on April 30, he will be offered COBRA only through the end of the plan year, because the health FSA is HIPAA-exempt.

Special rule 2: No COBRA in "deficit" situation. If the COBRA premium for the remainder of the plan year is greater than the reimbursements available from the health FSA, then COBRA need not be offered. When making this calculation, employers can take into account any prior reimbursements made from the health FSA.

Example: John from the above example has to pay \$800 (plus 2 percent) for the remaining eight months in the calendar year for his health FSA COBRA benefit. But he is only eligible for \$500 of reimbursements because he was reimbursed \$700 before his qualifying event. In this case, John doesn't need to be offered COBRA. However, John would remain eligible to elect continuation coverage under the indemnity plan for the usual COBRA duration.

Health FSAs not exempt from HIPAA. When health FSAs don't qualify for an exception, qualified beneficiaries can elect to continue FSA coverage for the standard 18-, 29- or 36-month COBRA period.

Types of account-based health plans

All account-based plans allow money to be set aside on a tax-favored basis to pay for covered individuals' qualified medical expenses. Despite these similarities, the plans have some differences.

HSAs and MSAs are available only to people covered by qualifying HDHPs. Almost anyone with a qualifying HDHP can have an HSA, but only employees of certain small employers and self-employed individuals can have MSAs. The two also have differing HDHP definitions and contribution rules. Even if funded partly by an employer, an HSA or MSA is the individual's property to retain from year to year and even after job loss. Thus, these accounts generally are not employer group health plans subject to COBRA.

Health FSAs are only offered through employer-sponsored cafeteria plans. Both employer and employee pretax contributions can be made to these accounts. Plans may but aren't required to set annual limits on health FSA contributions. All employees with health FSAs must elect how much to contribute before a plan year begins and generally forfeit any leftover funds at the plan year's end (the "use it or lose it" rule). Health FSAs are employer group health plans subject to COBRA.

HRA funds come entirely from employer contributions; employee contributions are not allowed. Unlike FSAs, unused HRA amounts can carry over from one plan year to the next. As health benefits fully funded by employers, HRAs are employer group health plans subject to COBRA.

Allocating FSA benefits. While each qualified beneficiary in a family has an independent right to elect COBRA coverage, no official guidance explains how to allocate FSA amounts among qualified beneficiaries. For example, if employee Lori gets divorced on May 31, her FSA remains active, but her ex-husband could elect his own health FSA. If the health FSA had already paid \$300 in expenses before the divorce, would that amount limit Lori's husband to a \$2,100 FSA, or could he elect the full \$2,400 annual benefit? Similar questions about allocating benefits among qualified beneficiaries arise if an employee's death triggers COBRA. Employers facing these issues should consult a tax and benefits attorney before deciding how to handle them.

How does COBRA apply to HRAs?

HRAs are subject to COBRA, so qualified beneficiaries can elect continued HRA coverage for the usual 18-, 29- or 36-month period. While they must pay premiums to continue their HRAs, qualified beneficiaries remain eligible for any employer contributions or increases in HRA credits that occur during the COBRA period. There are two ways to offer COBRA under an HRA: by bundling continuation coverage for the HRA and the underlying health plan or by allowing HRA continuation on a stand-alone basis.

COBRA premiums for HRAs. IRS guidance says employers can charge the same COBRA premium to all qualified beneficiaries with the same HRA coverage and credits. It doesn't, however, rule out varying COBRA premiums for qualified beneficiaries with different HRA balances. For example, to avoid adverse selection and provide equitable treatment, employers may prefer to charge someone with a \$15,000 HRA balance a higher COBRA premium than someone with a \$1,500 HRA balance. Rather than calculate COBRA premiums for each different HRA, employers may want to set up a schedule of COBRA premiums for different coverage tiers – such as single versus family – and different ranges of account balances. In view of the limited guidance available, employers should discuss with counsel, the proper method of setting COBRA premiums for HRAs.

Determining and allocating HRA benefits. The amount of HRA coverage that should be made available to qualified beneficiaries – that is, the maximum benefit payable from the HRA – is not clearly addressed in COBRA guidance. If COBRA coverage is identical to the pre-COBRA coverage (such as employee-only or family coverage), it makes sense to give a qualified beneficiary the same HRA account balance that existed before the COBRA event. But, as with health FSAs, allocating this amount among multiple qualified beneficiaries can be tricky. For example, if multiple qualified beneficiaries elect to continue an HRA, should the employer split the HRA balance among all individuals as of the date of the qualifying event? Alternatively, should each qualified beneficiary have a separate right to the full balance, resulting in multiple HRAs and increasing an employer's liability?

Each approach presents certain financial or administrative burdens for employers, and it's unclear which approaches would hold up best to any legal challenge. As a result, employers should consult tax and benefits advisers before deciding how to proceed.

For additional information, please contact your Mercer consultant.

*This **Update** is for information only and does not constitute legal advice; consult with legal and tax advisers before applying this information to your situation.*

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