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Recent Private Letter Ruling Provides Valuable IRS Perspective

IRS Allows Employer to Give Employees a Choice between HRA and Profit-Sharing Plan Benefits without Creating a Cash or Deferred Arrangement or Causing Taxable Health Reimbursements.

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As a benefits executive, have you ever wondered whether your employees would choose more welfare benefits over more retirement benefits? The total benefit cost spread between the two types of benefits would essentially be the same, but by giving employees the ability to choose would give them more control and would arguably result in more satisfaction with their benefits overall—a win-win situation. Well, the Internal Revenue Service (IRS) recently ruled [Private Letter Ruling 202023001] that an employer can allow its employees to choose between employer contributions to their profit-sharing plan or to their health reimbursement arrangement (HRA) without (1) causing the profit-sharing plan to be treated as offering a cash or deferred arrangement (CODA), or (2) causing taxable income to employees, retired employees, their spouses, and dependents through HRA reimbursements. However, we note, that an IRS private letter ruling (PLR) is directed only to the taxpayer who requested it and may not be used or cited as precedent.

Background

To properly administer a plan, employers and plan administrators must understand whether their retirement plan contains a CODA or not. Generally, a CODA allows an employee to make an election (direct or indirect) to either receive cash or another taxable benefit, or to contribute that amount into a qualified retirement plan, deferring taxable compensation. An employer's inclusion of a CODA typically is purposeful because the CODA must satisfy multiple requirements of Internal Revenue Code (Code) Section 401(k), [*See* Treas. Reg. § 1.402(a)-1(d)] including but not limited to the annual dollar limit on elective deferrals, the special non-discrimination and vesting rules that apply, and the special distribution rules. When a CODA occurs unintentionally, adverse tax consequences may result. If a qualified plan contains a nonqualified CODA, the employer's contributions, which are deemed excess "elective deferrals," will be included in the employee's gross income in the year contributed. In addition, the plan may be disqualified, in which case all vested contributions would become taxable in the year made, the trust established pursuant to the plan would lose its tax exempt status, and distributions could not be rolled over into IRAs or other qualified plans. [Code Section 401(a)(30) requires elective deferrals for each participant under all plans of the same employer to be limited to amounts set forth in Code Section 402(g)—exceeding these limits subjects the plan to disqualification] As a result, voluntary correction with the Employee Plans Compliance Resolution System (EPCRS) may be needed to preserve the plan's tax-qualified status.

If the requirements of Code Sections 105(b) and 106 are met by an HRA, an employer's reimbursements of qualified medical expenses (as defined in Code Section 213(d)) of employees, retired employees, and their spouses and dependents are excludable from the individual's gross income. Generally, benefits under an HRA are excludable from the gross income of participating employees under Code Sections 106 and 105, if (1) the benefits are paid solely by the employer and not through salary reductions; (2) reimbursements are for medical care expenses incurred by participating employees and their spouses and dependents up to a maximum annual reimbursement amount, in compliance with Code Sections 213(d) and 152; (3) unused amounts from one coverage period are carried forward to subsequent coverage periods; (4) participating employees have no right to receive cash or any other benefit in lieu of medical expense reimbursements; and (5) the benefits are limited to current and former employees (including retired employees), their spouses and dependents, and the spouses and dependents of deceased employees. [*See* Rev. Rul. 2002-41 and Notice 2002-45] Failing to comply with Code Sections 105 or 106 would result in all benefits received from the HRA being taxable to the employee.

PLR Facts

Participating employers in certain collective bargaining agreements, were required to make scheduled contributions to the HRA and profit-sharing plan. The union proposed an amendment to the HRA and profit-sharing plan to base the amount of the employers' contributions to each plan on an irrevocable annual election made by covered employees before the beginning of each plan year. A set minimum amount of employer contributions would be contributed to the HRA Plan. And, with respect to the remaining portion of employers' contributions, employees would be allowed to elect to receive the additional contribution amounts to either the HRA or the profit-sharing plan (Discretionary Contribution). In the absence of an employee election, a default contribution will be allocated to each plan on behalf of the employee.

Rulings Requested

The following rulings were requested from the IRS:

1. The proposed amendment to the defined contribution plan will not cause a CODA pursuant to Code Section 401(k); and
2. The proposed amendment to the HRA Plan will not cause HRA reimbursements to be taxable under Code Sections 105(b) and 106.

First Ruling

While the annual irrevocable election would allow employees to decide an employer's contribution rate to either the HRA or profit-sharing plan, employees "are not permitted to elect to have the contributions paid in cash or some other taxable benefit." Consequently, the IRS held that the amendments to the HRA and profit-sharing plan would not cause a CODA.

Second Ruling

The IRS concluded that if HRA requirements are met (that is, the requirements of Rev. Rul. 2002-41 and Notice 2002-45) and an employee makes an irrevocable annual election to contribute a portion of the Discretionary Contribution to the HRA instead of the profit-sharing plan, the amounts would not be deemed to be pursuant to a salary reduction agreement. Further, since the amount of the Discretionary Contribution made to an employee's HRA would only be used to reimburse qualified eligible medical expenses (under Code Section 213(d)) and not used to provide for death benefits, bonuses, or separation pay, the IRS ruled that the HRA amounts will receive favorable tax treatment under Code Sections 105(b) and 106.

PLR Reflects IRS's Continued Flexibility in Progressive Plan Designs that Benefit Employees

This PLR was the second recent favorable ruling on progressive plan designs. Prior to issuing this PLR, the IRS also indicated a level of regulatory flexibility towards a progressive plan design intended to help employees repay their student loans in PLR 201833012. PLR 201833012 allows student loan payments made by employees to be "matched" by the employer through a contribution on behalf of that employee to the 401(k) plan that would simply be considered a nonelective employer contribution for the employee. When viewed together, these private letter rulings indicate the IRS's willingness to view favorably progressive plan designs that give employers additional flexibility in providing benefits to employees.

Conclusion

Although other taxpayers would need to request their own private letter ruling on progressive plan designs to receive the same protections of the IRS conclusions, this PLR does provide valuable IRS perspective on CODAs and HRA benefits. ■

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