

FOR IMMEDIATE RELEASE

## **IRS Deals Serious Blow to Plans Offering Elective Features**

### **IRS Confirms Individual, Irrevocable Elections to an HRA Are Taxable**

IRS Private Letter Ruling 200704005 confirms that individual, irrevocable elections to an HRA are taxable. This new ruling was released on January 26, 2007 and applies to:

1. Individually elected salary reductions; and
2. Individually elected contributions of accrued leave.

Such contributions are not excludable from employees' gross income under section 106 of the Internal Revenue Code (the Code).

### **Consistent With Previous Guidance**

The new ruling is consistent with previous guidance from the IRS (Notice 2002-45 and Revenue Ruling 2005-24) which defines an HRA, in part, as a plan that

“...is not provided pursuant to salary reduction election or otherwise...”

If a plan allows individual elections, irrevocable or otherwise, it does not meet the qualifications of an HRA and cannot enjoy the tax-favored treatment of a properly designed HRA.

In other words, employees cannot individually designate a portion of their salary or leave cash out to an HRA and still receive tax exempt treatment of such contributions. Rather, contributions are includable in employees' gross income under section 61 of the Code.

### **IRS Looking For Violators**

The July 2006 newsletter produced by the IRS Office of Federal, State and Local Governments (FSLG) indicated the IRS has commenced examinations of governmental employers with established plans that appear to not meet the qualifications of an HRA.

This is not good news for employers sponsoring plans with elective features.

### **Consequences Not Yet Known**

It is not yet known what penalties the IRS may impose upon plan sponsors operating plans in violation of the ruling, nor what the impact will be upon affected employees. Employers offering elective features could be at risk and should contact their legal counsel.

[Private Letter Ruling 200704005](#)