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440 West Jubal Early Drive, Suite 130 Winchester, VA 22601  
540-535-0103 ♦ 800-323-9473 ♦ Fax: 540-535-0533  
www.ECFA.org ♦ Email: information@ECFA.org

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## Reimbursing Medical Expenses

by John Butler and Dan Busby

### Major Changes since Last Revision

The following changes have occurred since this article was last published:

- ✓ Non-discrimination regulations have been issued for cafeteria plans that affect FSAs and HSAs that are part of a cafeteria plan.
- ✓ Medicines, including over-the-counter medicines can not be reimbursed under an FSA, HRA or HSA, unless they have been prescribed by a doctor. The cost of insulin (only listed exception) may be reimbursed, however, whether or not it has been prescribed by a doctor.
- ✓ Non-discrimination requirements apply to most health plans.
- ✓ Most health plans are required to have additional provisions for: internal and external appeals.

Because of the increased requirements, we no longer provide document templates.

**Note:**

The health care reform legislation adopted in March, 2010 made extensive changes to health plan requirements. The following materials address requirements that as of the date of this article (November, 2010) applied for 2011-2012.

Securing adequate medical insurance is a high priority for employees—and their families. And following closely is the importance of having any medical expenses not covered by insurance reimbursed by the employer.

Paying medical insurance premiums to protect against catastrophic medical expenses is a commonly accepted practice. But even the best medical insurance policies generally do not pay all of the insured's medical expenses. These unpaid medical expenses are usually in the form of noncovered items or expenses subject to a deductible or coinsurance (or copayment) clause in a health insurance policy.

Medical expenses that are not eligible for reimbursement under a health insurance plan are deductible on Schedule A as itemized deductions. Conversely, medical expenses that are reimbursed under a health insurance plan cannot be deducted as medical expenses on an individual's tax return.

But for many employees, receiving an itemized deduction benefit from unreimbursed medical expenses is more a dream than a reality. There are two major barriers to deducting medical expenses. First, many employees use the standard deduction instead of itemized deductions (Schedule A). This is especially true for most employees who live in ministry-provided housing. Second, even for those employees who itemize their deductions, there is a 7.5% of adjusted gross income limitation.

**Example:** If adjusted gross income is \$30,000 and unreimbursed medical expenses are \$2,000, none of these expenses are beneficial in calculating itemized deductions on Schedule A because the 7.5% adjusted gross income limitation is \$2,150 (7.5% x \$30,000).

Reimbursing medical expenses seems so simple. But, it is significantly more complex than it appears. Here are the key options available to a ministry to reimburse employee medical expenses:

- ✓ **Cafeteria plans.** The “cafeteria” (IRS Code Section 125) approach provides a flexible benefits and services program. A specific dollar value is given to each benefit that an employee may choose from a menu of different items, and a maximum dollar value is established for an employee's total benefits. Health care reimbursements may be one of the items on the menu.
- ✓ **Premium Only Plan (POP).** A POP (also Section 125) only allows an employee to pay their portion of insurance premiums tax free. The employer determines the portion of the premium the employee will pay (e.g., employer pays 60% and employee pays 40%) and if the employee wants to participate in the employer's health insurance plan, the employee elects under a POP to have the employee's portion paid pre-tax.
- ✓ **Healthcare flexible spending accounts (FSAs).** An FSA (also Section 125) is a vehicle for a church to pre-fund dependent care or medical and dental expenses in pre-tax dollars. If an FSA only covers medical expenses, it is commonly referred to as a Healthcare FSA.
- ✓ **Health reimbursement arrangements (HRAs).** Under an HRA (Section 105), an organization may reimburse medical expenses up to a maximum dollar amount for the coverage period. HRAs do not provide a salary reduction election.
- ✓ **Health savings accounts (HSAs).** HSAs are individual portable, tax-free, interest-bearing accounts (typically held by a bank or insurance company) through which individuals with high-deductible health insurance save for medical

expenses. The purpose of an HSA is to pay what basic coverage would ordinarily pay.

Within limits, HSA contributions made by employers are excludable from income tax and social security wages. HSA contributions may be funded through salary reduction. Earnings on amounts in an HSA are not currently taxable and HSA distributions used to pay for medical expenses are not taxable.

Payments to an employee under a cafeteria plan, FSA, HRA, or HSA are not subject to federal tax (usually 10%, 15%, or 25%) or state income tax (often 5% or so) or social security tax (15.3% for ministers and 7.65% for nonminister-employees). The tax savings can easily run 40% or more of medical expenses reimbursed under these plans.

## Healthcare Flexible Spending Accounts (FSAs)

A health care flexible spending account (FSA) provides a method for an employee to pay for medical, vision and dental expenses with pre-tax dollars.

Through payroll deductions, an employee may contribute to a separate FSA account before any withholding for federal income tax, FICA (Social Security tax), and, in most areas, state and local income tax.

As eligible expenses are incurred and claims are submitted, the employee is reimbursed from the FSA account. FSA funds do not have to be in a separate checking account.

- ✓ **The establishment of a plan.** The starting point for an FSA is the preparation of a formal plan document. Generally, this will require professional assistance.
- ✓ **Availability of maximum reimbursement.** The maximum amount of reimbursement elected by each participant must be available to the participant throughout the coverage period, subject to reduction for prior claims paid. The amount of the available reimbursement cannot be based on the amount of premiums paid by the individual at the time the claim is made, nor can an employer accelerate the premium payment schedule based upon claims.
- ✓ **“Use it or lose it” concept.** The IRS requires flexible benefit plans to contain an element of risk. Thus, amounts selected but not used by the end of a plan year must be forfeited by the employee. (Documentation of medical expenses may be submitted to the employer subsequent to year end if the date the health care was incurred is on or before year end.) This is known as the “use it or lose it” concept.

Under this concept, an employee may receive, subject to a dollar limit, reimbursement for covered expenses but does not have the right to receive any of the amounts remaining unused at the end of the year.

**Example:** Employee Connie Barton opts to fund a healthcare flexible spending account by allocating \$600 of her salary (\$50 per month) to the account at the beginning of a calendar year. During the year, Connie’s out-of-pocket expenses for health care are reimbursed to her. The reimbursements are treated as “employer-provided health benefits,” which make the benefits tax-free income to Connie. As a result, Connie’s taxable income is reduced by the \$600 of pretax withholding for the FSA. Her employer keeps any portion of the \$600 that is not reimbursed to Connie for claims filed with the employer for the year. (Note: Claims may be filed for the year subsequent to year-end, if this is permitted by the employer’s plan.)

- ✓ **Non-discrimination in eligibility.** A plan satisfies the eligibility requirement if:
  - It is available to a reasonable classification of employees, such as specified job categories, nature of compensation (i.e., salaried and hourly), geographic location and similar bona fide business criteria.
  - No employee is required to work more than three years before being eligible.
  - The length of time before eligibility is the same for all employees.
- ✓ **Non-discrimination in contributions and benefits.** This requirement applies to both benefit availability and benefit utilization.
  - A plan meets the benefit availability requirement if each similarly situated participant has a uniform opportunity to elect qualified benefits.
  - A plan meets the benefit utilization requirement if qualified benefits are not disproportionately elected by highly compensated participants. “Highly compensated” for this purpose means (a) an officer (regardless of compensation), (b) a person with compensation in excess of \$110,000 (2011, adjusted for inflation), or (c) spouse or dependent of any of these.

The test for disproportionate benefits must be performed annually. The test is performed by comparing (a) the ratio of non-taxable benefits received to compensation of the highly compensated participants to (b) the ratio of non-taxable benefits received to compensation of the non-highly compensated participants. The ratio of highly compensated participants cannot exceed the ratio of non-highly compensated participants.

**Example:** Two highly compensated participants in a cafeteria plan (officers with compensation of \$50,000 & \$70,000; aggregate compensation of \$130,000) elect qualified benefits (\$4,000 & \$2,500; aggregate \$6,500) equaling 5% of aggregate compensation. Ten non-highly compensated participants (aggregate compensation of \$250,000) elect aggregate qualified benefits (aggregate of \$25,000) equaling 10% of aggregate compensation. The employer's cafeteria plan passes the contribution and benefits test.

- ✓ **Non-discriminatory concentration.** Not more than 25% of the benefits of a cafeteria plan can be provided to “key employees.” For a tax exempt organization the only relevant definition of a key employee is an officer paid more than \$160,000 (2011, adjusted for inflation).
- ✓ **Maximum election.** Beginning in 2013, the maximum election under a healthcare FSA is limited to \$2,500.

## Health Reimbursement Arrangements (HRAs)

Similar to an FSA, HRA payments to an employee under Section 105(b) of the Internal Revenue Code escape federal and state income tax and social security tax.

**Example:** A ministry has established an HRA with an annual limit of \$2,500 per employee. The employee's daughter gets braces costing \$2,400 and the employee submits the unpaid bills to the ministry (or the employee pays the portion not covered by the insurance carrier and submits the documentation for the employee's share to the employer). The ministry pays the \$2,400. If the employee is in the 27% federal income tax bracket, the 5% state income tax bracket and is liable for the 15.3% self-employment social security tax, the net savings is 47.3% times \$2,400 or \$1,135. Additionally, the employee could submit documentation for medical expenses up to another \$100 since the annual limit is \$2,500 for this plan. The claim for the last \$100 could even be made in a future year.

**The basic elements.** Here are the key elements of an HRA:

- ✓ **The establishment of a plan.** The starting point for an HRA is the preparation of a formal plan document. Generally, this will require professional assistance.

A written plan must be used to avoid taxation of benefits to highly compensated employees (defined below). IRS policy (IRP 80,600) states that employer reimbursements made prior to the adoption of a plan are not excludable from gross income by the employee. In order for there to be a plan, the employer "must be committed to certain rules and regulations governing payments. These rules must be made known to employees as a definite policy and must be determinable before the employee's medical expenses are incurred."

Additional guidance for establishing an HRA was issued by the Internal Revenue Service in Notice 2002-45 and Revenue Ruling 2002-41.

- ✓ **Eligible participants.** An HRA may only reimburse employees, former employees (including retirees) or their tax dependents for qualified medical care expenses.
- ✓ **Limitation on annual coverage.** An HRA must provide a maximum dollar amount of coverage for the employee or for the family (including the employee). For example, a plan could provide that all full-time employees will have benefits up to \$2,000 per year and that any employees with dependents (family coverage) will have benefits up to \$4,000 per year. (The \$2,000 and \$4,000 amounts in this example are simply illustrative.) There is no minimum or maximum. However, the ceiling may be subject to the organization's financial ability to pay the benefit.

- ✓ **Funding source.** An HRA is funded solely with employer contributions and not by salary reduction election or other similar election under a cafeteria plan.
- ✓ **The relationship of the plan to the compensation package.** The salary level of the employee and the amount of medical expenses that may potentially be reimbursed under an HRA are two separate issues. An employee's compensation of, for example, \$25,000 can be set and the maximum reimbursable under an HRA of \$3,000, for example, can be established. It is not permissible for a ministry to establish a combined salary and HRA for \$25,000 with the portion of this amount that is not spent for medical expenses to be reflected as compensation on an employee's Form W-2.
- ✓ **Determination of ministry funding level for an HRA.** A ministry should commit to the amount it will fund an HRA (for each employee) prior to the beginning of the plan year. If the amount of church funding is not the same for each employee, the employer should first review the nondiscrimination rules (see pages 14-15).
- ✓ **Money left in the plan at year end.** Any money left in an employee's HRA account on December 31 of each year (or the end of the plan year) may be carried forward to increase the maximum reimbursement dollar amount in subsequent periods, if the employer includes this option in their plan. This may be useful in the following situations (Revenue Ruling 2002-41):

1. **Retirees or those otherwise terminating employment.** For example, an individual who retired or otherwise terminated employment and had a balance of \$500 in an HRA account could submit medical expense documentation to the employer for the plan year for up to \$500 or could submit the documentation for a year subsequent to the plan year.

If an HRA plan does not provide for payments to be made after the retirement or termination of an employee, a retirement or severance "bonus" related to an employee's maximum reimbursement amount remaining in an HRA at that time will disqualify the HRA. However, an HRA may include a provision that reimburses a former employee for medical care expenses up to the unused reimbursement amount remaining at retirement or other termination of employment.

2. **Continuing employment.** Account balances may be carried forward to increase the maximum reimbursement amount in subsequent coverage periods.

**Example:** An individual who has not retired or otherwise terminated employment has a balance of \$500 in an HRA account at the end of a plan year. The maximum annual reimbursement available to the employee is \$2,000. The individual is eligible to carry forward the unused \$500 from the previous plan year and submit documentation for medical expenses for reimbursement up to \$2,500 for the

subsequent plan year.

- ✓ **Qualified medical expenses are submitted to the organization for reimbursement.** When an employee is billed for a qualifying health care expense that isn't covered by the employee's health insurance plan, the employee generally submits the claim to the insurance company, receives an Explanation of Benefits (EOB) form, and submits the EOB form to the employer. The employer writes a check to reimburse the employee or pays the expense directly to the health care provider.
- ✓ **Non-Discrimination Requirements.** An HRA cannot discriminate in favor of highly compensated employees, as to either eligibility or benefits.
  - The highest paid 25% of all employees (other than certain excluded employees described below who are not participants) and the five highest paid officers are considered highly compensated.
  - Employee eligibility must cover at least 70% of all employees, or meet one of the alternative eligibility requirements.
  - In testing eligibility and benefit discrimination, some employees can be excluded from the test, provided the plan does not cover them. For most churches, the primary groups of excludable employees are:
    1. Employees who have not completed three years of service;
    2. Employees who have not attained age 25; and
    3. Part-time (less than 35 hours a week) or seasonal (less than seven months a year) employees.

## Health Savings Accounts (HSAs)

HSAs allow deductible contributions to be set aside to cover medical expenses that are not covered by a high-deductible medical plan in which the employee participates. HSAs offer a tax-favored vehicle that allows not only a deduction for contributions and tax-free accumulation, but also eventual tax-free distributions.

High-deductible medical insurance has had little appeal in the past and for good reason. Most people simply haven't wanted to risk a number of large claims in one year—all falling below the high deductible amount. The addition of the Health Savings Account, with tax deductible contributions and tax excludable withdrawals has made high deductible health insurance more attractive.

An employee gets a deduction for contributions going into the HSA, and then the employee is allowed to withdraw the funds tax-free in the same year or in a future year to cover unreimbursed medical expenses. Contributions that are not used in any tax year may be rolled over, instead of being subject to the "use it or lose it" rule applies to flexible spending accounts. Upon reaching age 65, accumulated funds in an HSA can be withdrawn tax-free to cover medical expenses, or they can be withdrawn penalty-free (although not tax-free) for any purpose whatsoever.

- ✓ **The HSA basics.** HSAs are non-forfeitable individual accounts held in trust or a custodial account and funded either with pre-tax employer contributions, above-the-line deductible contributions directly from individuals or through roll-over funds for individuals who are covered under a high-deductible health plan. Management will usually be handled by a bank or insurance company. An HSA may invest in stocks, bonds, mutual funds, etc.

In addition to coverage under a high-deductible health plan, an eligible individual is one who:

- is not also covered by any other health plan that is not a high deductible health plan
- is not entitled to benefits under Medicare, and
- may not be claimed as a dependent on another person's tax return.

Deposits are made on a pre-tax basis. Any portion contributed by an employer is not income to the employee.

HSAs can be funded up to \$3,050 each year for individuals and \$6,150 for families to cover health care costs (these 2011 figures will be indexed annually for inflation).

In addition to the maximum contribution amount, catch-up contributions may be made by or on behalf of individuals age 55 or older and younger than 65. Individuals who have reached age 55 by the end of the tax year are allowed to increase their annual contribution limit by \$1,000 for 2009 and thereafter. HSA contributions may not be made after an employee retires.

All payments made by or on behalf of the eligible individual are added together for purposes of the contribution limitations. This includes employer HSA contributions for the individual, as well as those made by the employee.

**Covered expenses.** A qualified medical expense is generally defined as one incurred to diagnose, cure, treat or prevent disease. Qualified medical expenses also include certain health insurance premiums, such as Medicare Part A and Part B, Medicare HMO and the employee's share of premiums for employer-sponsored health insurance. Medigap policy premiums are not covered.

Distributions not made for medical expenses are taxed as ordinary income. However, nonmedical distributions avoid the 10 percent penalty for withdrawals if made after death, disability or reaching Medicare eligibility.

- ✓ **Eligibility.** People who are covered by individually purchased or employer-sponsored health insurance with a deductible of at least \$2,400 for family coverage or \$1,200 for individual coverage (2011 limits) are authorized to establish an HSA. Deposits may be made into HSAs by employers or by employees on a salary reduction basis.
- ✓ **Tax treatment.** Employee deposits are excluded from the personal income tax base, the employee payroll tax for lay employees and the self-employment social security tax for ministers. Here is an example of healthcare costs that can be saved using HSAs.

**Example:** A single 60-year-old male makes a \$2,500 contribution to an HSA for a \$2,500 tax deduction.

Taxable income:	\$65,000
Federal tax rate	28%
State tax rate	3%
Gross health insurance policy cost	\$1,795 per year (\$2,500 deductible)
Annual tax savings	\$775 [(28% + 3%) x \$2,500]
Net health insurance cost	\$1,020 (\$1,795 - \$775)

Accumulations are tax-sheltered and all withdrawals are excluded from taxable income if used to pay for covered expenses. Money can be withdrawn for any purpose without penalty after becoming eligible for Medicare, but you will have to pay income tax if the expenses are not health related. Before becoming eligible for

Medicare, if withdrawals are used for other than covered expenses, they are included in income subject to the personal income tax and an additional 10 percent penalty tax.

- ✓ **Maximum deposits.** The maximum deposit is \$6,150 when family coverage applies and \$3,050 when individual coverage applies (2010 limits) if the account owner is under 55. If the account owner is at least 55, the deposit limit is increased by \$1,000 in 2010 and subsequent years.
- ✓ **Account balances.** Balances in HSAs are unlimited. Surviving spouses may inherit HSAs without tax. HSA bequests to others are included in the terminal income tax return of the decedent but are not subject to the penalty tax.
- ✓ **The medical insurance side.** Only employees who are enrolled in qualifying high-deductible plans may participate in an HSA. A high-deductible health insurance plan has at least a \$1,200 annual deductible for self-only coverage and a \$2,400 deductible for family coverage (2011 rates). Additionally, annual out-of-pocket expenses for HSAs must be limited to \$5,950 for self-covered and \$11,900 for families (the 2010). To compare high deductible policies, check Insure.com and www.ehealthinsurance.com.

**Example #1:** A plan provides coverage for A and his family. The plan provides for the payment of covered medical expenses of any member of A's family if the member has incurred covered medical expenses during the year in excess of \$1,000 even if the family has not incurred covered medical expenses in excess of \$2,400 (2011 rate). If A incurred covered medical expenses of \$1,500 in a year, the plan would pay \$500. Thus, benefits are potentially available under the plan even if the family's covered medical expenses do not exceed \$2,400. Because the plan provides family coverage with an annual deductible of less than \$2,400, the plan is not a high deductible health plan.

**Example #2:** Same facts as in example #1, except that the plan has a \$5,000 family deductible and provides payment for covered medical expenses if any member of A's family has incurred covered medical expenses during the year in excess of \$2,400. The plan satisfies the requirements for a high deductible health plan with respect to the deductibles.

On the first day of any month, not only must an individual be covered by a high deductible health plan, but he or she also must not be covered under a non-high-deductible plan. This requirement does not apply to coverage for accidents, disability, dental, vision or long-term care. It also does not limit the medical plan options available to an employee, but only applies to that plan in which the employee elects to participate.

- ✓ **Planning strategies.** The HSA high-deductible coverage is especially well-suited to younger employees, since, as a group, they generally do not incur significant medical expenses and will be able to keep contributions in their HSAs for tax-free

accumulation over a longer period. Older workers, however, will generally suffer as a group, since they tend to need more medical care, and cost of traditional insurance presumably will rise as younger workers leave that risk pool.

An individual that has an HSA can still contribute to a 401(k), 403(b), and a healthcare FSA.

- ✓ **Non-Discrimination Requirement.** If an employer makes HSA contributions, the employer must make available comparable contributions on behalf of all “comparable participating employees” (i.e., eligible employees with comparable coverage) during the same period. Contributions are considered comparable if they are either the same amount or same percentage of the deductible under a high deductible health plan.

## Contrasting the Elements of FSAs, HRAs, and HSAs

**Expenses eligible for reimbursement.** Any out-of-pocket medical expenses can be reimbursed under an FSA, HRA, or HSA. These expenses may relate to your medical plan's deductible, co-insurance or noncovered items.

Any medical expense that is allowable as a medical expense deduction on Schedule A (Section 213 of the Internal Revenue Code) of your income tax return may be covered under an FSA, HRA, or HSA. The IRS defines medical expense as amounts you paid for "diagnosis, cure, mitigation, treatment, or prevention of diseases."

You are eligible to include money paid to doctors, dentists, hospitals, nursing homes or other medical providers, and prescription drugs in an FSA or HRA to the extent you weren't reimbursed by a health insurer. You may even include payments to a chiropractor, as well as the cost of prescription eyeglasses, hearing aids, crutches, and ambulance service.

- ✓ **Newsletter plans.** Certain non-insurance arrangements, often called "newsletter" plans, are modeled on the old assessment-type insurance arrangements that were popular at the turn of the 20th century. Since such plans typically make strong claims about *not* being insurance (in order to escape regulation by State Insurance Commissioners), the payments by a church to these plans (or to reimburse a church employee's payments to these plans) is a fully taxable benefit reportable on the employee's Form W-2.

Since newsletter plans do not constitute health insurance, payments that you have received from a newsletter-type plan are not considered medical reimbursements. Therefore, medical expenses that are not reimbursed under a health insurance plan are eligible for deduction as medical expenses on Schedule A or for reimbursement under an FSA, HRA, or HSA, even though you have received payments from a newsletter plan related to these expenses.

- ✓ **Eligible expenses.** Expenses eligible for reimbursement include:
  - Transportation costs. Transportation expenses to and from medical appointments are includible even in the town where you live. If you drive directly without running other errands, you're allowed 16.5 cents a mile (2010 rate, which may be adjusted from time to time by the IRS).
  - If you or your spouse travel out-of-town for medical care, you may deduct up to \$50 a night for lodging. If the ailing spouse can't travel alone, you may each deduct up to \$50 a night.

- Dependent's medical expenses.
- Copayments for doctor visits and prescriptions.
- Prescription eyeglasses, eye exams, and contact lenses.
- Extra cost of a private hospital room.
- Laser correction eye surgery.
- Chiropractic expenses beyond active treatment of injury.
- Dental care and orthodontia.
- Hearing devices and batteries, and special equipment for the deaf.
- Weight-loss programs. If a physician diagnoses a patient as obese, then the patient's participation in a weight-loss program as treatment for obesity is reimbursable under an FSA, HRA, or HSA. Additionally, if a patient is directed by a physician to lose weight as treatment for another condition, such as hypertension, the treatment is also eligible for reimbursement. If participation in a weight-loss program is merely to improve general health and appearance, then the fees are not amounts that may be reimbursed. The cost of purchasing reduced-calorie diet foods, because the food is merely a substitute for the food an individual would normally consume, is not eligible for reimbursement.
- Insurance. Reimbursement for insurance ("newsletter" plans do not constitute insurance) covering medical care expenses are allowable for FSA, HRA, or HSA reimbursement, including amounts paid for premiums for accident or health coverage.
- Other items. If you have allergies, you may be able to include the cost of an air conditioner in a window—but probably not for installing central air conditioning throughout your home. Your doctor may suggest that you join a health club, take swimming lessons, or take vitamins, but such expenses don't make the IRS cut. The IRS definition of medical expenses generally doesn't include expenses for "solely cosmetic reasons" or for procedures that "are merely beneficial to one's general health."
- Free list. For a free list of allowable health care deductions, check IRS Publication 502, *Medical and Dental Expenses*, by calling 800-829-3676. This publication is also available on the Web at [www.irs.gov/forms\\_pubs/pubs](http://www.irs.gov/forms_pubs/pubs). Also see page 20 for OTC medical items eligible for reimbursement.

- ✓ **Right to receive cash.** If any person has the right to receive cash or other benefit under an FSA, HRA, or HSA, other than the reimbursement of medical care expenses, currently or in a future year, the entire FSA, HRA, or HSA is disqualified.
  
- ✓ **Substantiating claims.** An FSA or HRA can reimburse a participant only for properly substantiated claims for medical expenses. What constitutes a “properly substantiated” claim? As with insurance coverage generally, a written statement from an independent third party describing the medical expense and indicating the amount of the expense is necessary. HSA participants are not required to document medical expenses before being reimbursed for them. However, you should maintain evidence of medical expenses in case of a tax audit.