



Health Savings Accounts (HSAs) and Their Impact on Health Care Benefits

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By SHPS, Inc.
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Preface

This paper is intended to provide human resource and health care benefits executives a high level overview of Health Savings Accounts (HSAs) and their potential role within employee benefits programs. It will also provide a description of what HSAs are and will detail features that distinguish them from other health-related savings vehicles, as well as a matrix that organizes this comparative information as a tool for future use.

Topics addressed in this paper include:

Background

A Brief Description of the Medicare Prescription Drug, Improvement, and Modernization Act that provided for the creation of HSAs.

General Features of a Health Savings Account

Combined with a high deductible health plan, HSAs will allow eligible individuals to take greater control of their health care choices. With greater control for their own destiny, employees and their HSA will be subject to certain requirements and restrictions with the benefit. This paper will foreshadow eligibility requirements, tax implications and the rollover ability of HSA funds.

Comparison of HSAs, HRAs and FSAs

The challenge to benefits professionals will be wading through the similarities and differences found in HSAs, Health Reimbursement Arrangements (HRAs), and Flexible Spending Accounts (FSAs). Ultimately, the research and investigation done over the next 12 months will be vital in the decision-making process leading into 2005. This document provides a matrix for quick reference when comparing the three accounts.

Anticipated Revisions to Legislations

As with any new piece of legislation, questions and clarifications have already started to surface before it has been signed into law. Congress, as well as lawyers, tax and benefits experts, continue to search for possible corrections and improvements. This paper will attempt to bring some of those anticipated changes to light.

Conclusion: HSA Impact on Employers

Although HSAs are expected to change the face of benefits administration, they will not eliminate the use of HRAs and FSAs. If anything, the future may see employers taking the best of all three accounts to afford employees a single plan for all health-related events. This paper will anticipate future developments before HSAs emerge in the marketplace.

Background

On November 25, 2003, congress passed the Medicare Prescription Drug, Improvement, and Modernization Act. Of specific importance to benefits managers and employers, this highly publicized Act -- primarily concerned with the redesign of Medicare -- contained a provision in Title XII, Section 102 that amended the Internal Revenue Code to allow for Health Savings Accounts, or HSAs. HSAs are a type of Medical Savings Account targeted to eligible employees participating in high deductible health plans. In a somewhat unexpected event, the Act also was passed with a provision that allows for HSAs to be funded on a pre-tax basis through cafeteria plans. This provides yet another area of traction for consumer-driven health care.

Interestingly, an anticipated provision in the act to allow for a year-end rollover of up to \$500 in employee funds in Flexible Spending Accounts died in committee.

The Act was signed into law on December 8th, and becomes effective January 1st, 2004. The following is an overview of HSA information, how it will affect employers and the industry.

General Features of an HSA

The HSA is an individual spending account that permits saving for qualified medical and retiree health expenses on a tax-free basis. But the HSA has characteristics unique from traditional health FSAs and HRAs. Eligibility to participate in an HSA is contingent on participation in a high deductible health plan, or HDHP, and unlike traditional FSAs and HRAs, the health spending account is entirely portable—the employee retains rights to the funds at all times. Similar to an IRA account, funds are held in a trust or custodial account, and the HSA may be transferred without penalty if the employee changes jobs. Penalties for non-medical withdrawals are similar to those of a 401(k).

HSAs are a revamped form of the Archer medical savings accounts (MSA) that were originally offered only to small businesses and the self-employed. In fact, MSAs can now be rolled into an HSA. But unlike the MSA, the HSA is available to virtually anyone who has coverage under a qualifying high deductible health plan.

Participation: Participation in an HSA is limited to individuals who are participating in a statutorily defined high deductible health plan. That is a health plan that has an annual deductible of no less than \$1,000 for individual coverage and \$2,000 for family coverage, and no more than \$5,000 for individual coverage and \$10,000 for family coverage. Participants may also be covered by additional “permitted” insurance or coverage, as long as the addition plan(s) do not provide the same benefits as an HDHP. Individuals who are eligible for Medicare may not continue to have contributions made for them, nor can they make contributions themselves on a tax-deductible basis. However, HSA funds accrued prior to the person becoming eligible for Medicare may be used on a tax-free basis to pay for qualified medical expenses. Individuals who may be claimed as tax dependents of another individual are not eligible to participate in an HSA.

Ineligible Individuals: Individuals who fall within one of the following categories are not eligible to participate in an HSA:

- Individuals covered under a spouse's or dependent's employer health plan
- Individuals covered under a comprehensive major medical individual insurance policy
- Individuals covered under a Health FSA or HRA, unless coverage is limited to permitted or specific benefits not provided by the HDHP

Trust Requirement: HSA contributions must be deposited into the trust of a bank, an insurance company, or a third party administrator who demonstrates to the satisfaction of the Secretary of the Treasury that they will administer the trust consistent with HSA requirements. Further, no part of the trust can be invested in life insurance contracts, and the assets of the trust cannot be commingled with other property except in a common trust or investment fund.

Tax Treatment of Contributions: Individuals who participate in an HSA may take an above-the-line deduction - amounts may be used to determine the individual's adjusted gross income prior to considering standard or itemized deductions – for contributions made during the tax year. The deduction cannot exceed the sum of the monthly limitations defined as 1/12th of the following amounts:

- Amount of annual deductible up to a maximum of \$2,600 in 2004 for those with individual coverage
- Amount of annual deductible up to a maximum of \$5,150 in 2004 for those with family coverage

Contributions levels will be indexed annually for inflation. Employers may also make an excludable contribution to the HSA subject to the limits above.

For participants who are married, if either spouse has family coverage, both are treated as having only that family coverage and the lowest deductible is used for determining the monthly limitation. Therefore, non-HDHP family coverage -- such as an HMO or low deductible plan – on the part of either spouse would make both ineligible for the HSA.

The monthly limitation is currently increased by an additional contribution amount of \$500 for participating individuals who are age 55 and over. That amount will increase by \$100 each year up to \$1,000 beginning in tax year 2009. The monthly limitation will also be decreased by the sum of the following amounts:

- The aggregate amount paid to Archer MSAs by the HSA participant during the tax year
- The aggregate amount contributed by the participant's employer

Contributions made in excess of the limitations are not deductible and are, indeed, subject to a 6% excise tax unless the excess contribution and any net income attributable to them are returned to the participant before the end of the tax year. The returned funds are then included in the participant's gross income.

Tax Treatment of Distributions: Distributions from an HSA are excluded from income when they fall under the category of "qualified medical expenses" as defined in IRS Code Section 213(d), which includes certain over-the-counter medications (OTCs). This does not include payments for health insurance premiums except for the following:

- COBRA coverage
- Qualified long-term insurance contracts
- Any health plan retained while the individual is receiving unemployment
- Any health insurance, other than a Medicare supplemental policy, for those 65 and over

Distributions made from an HSA for expenses that are not qualified are included in the participant's gross income, and are generally subject to an additional 10% tax except in the following instances:

- Payments are made following the participant's death
- Payments are made after the participant becomes eligible for social security
- Payments are made after the participant becomes disabled
- Excess contributions are returned to the participant prior to the end of the tax year
- Contributions are rolled over within the statutory timeframes (discussed later in this document)

Finally, HSA's can be transferred under a divorce or separation instrument, and to the spouse upon the participant's death, without being subject to taxation. However, if upon death the account is transferred to someone other than the participant's spouse, the account ceases to be an HSA and an amount equal to the fair market value of the account assets as of the date of death are considered to be taxable income.

THE HSA ROLLOVER OPTION DISTINGUISHES IT FROM OTHER SAVINGS PRODUCTS

The entire unused balance of an HSA may be rolled over tax-free each year. Further, the amounts are allowed to accumulate over time without penalty, and can ultimately be used to supplement Medicare if available at the time of the participant's Medicare eligibility.

HSA distributions not used for qualified medical expenses are subject to income tax and a 10% penalty. However, non-medical distributions are exempt from taxes and penalties provided that the funds are rolled into another qualified HSA account within 60 days of distribution. The participant can invoke this option only once every 12 months. Archer MSAs may also be rolled tax free into a qualified HSA. Because the excise tax for non-medical withdrawals on an Archer MSA is 15%, it is advantageous for current participants in an Archer MSA to convert their plan to an HSA.

HSA's CAN ALSO BE INCLUDED IN EMPLOYER CAFETERIA PLANS

One of the fundamental requirements of the Code Section 125 cafeteria plan rules is that they may not include a benefit that defers receipt of compensation. This would seemingly exempt HSA's on the basis of the rollover option. However, the Medicare Prescription Drug, Improvement, and Modernization Act amends Section 125 to specifically allow HSA's to be offered under cafeteria plans.

Comparison of HSAs, HRAs and FSAs

Figure 1 below outlines a comparison of HSAs, HRAs, and FSAs to provide a better understanding of their features, benefits and use.

FIGURE 1

Criteria	Health Savings Account	Health Reimbursement Arrangement	Health Flexible Spending Account
Initial Legislation or Regulation	Medicare Prescription Drug, Improvement, and Modernization Act of 2003.	U.S. Department of the Treasury Revenue Ruling 2002-41.	Revenue Act of 1978.
Date effective	January 1, 2004.	June 26, 2002.	January 1, 1979.
Internal Revenue Code Reference	IRS opinion not yet issued.	Internal Revenue Code section 105 & 106(b).	Internal Revenue Code section 125.
Eligibility	All employees, but must be covered by high-deductible health plan.	All employees, no underlying plan required.	All employees except self-employed, no underlying plan required.
Plan Design Requirement	<p>Front-end deductible of \$1,000 or greater for single coverage and \$2,000 or greater for family coverage. (Amounts indexed for inflation.)</p> <p>Maximum out-of-pocket \$5,000 for single coverage and \$10,000 for family.</p> <p>Preventive care and accidents may be excluded from overall deductible.</p> <p>Overlapping coverage from other plans not permitted. Potential exists for separate policies that do not have overlapping medical coverage:</p> <ul style="list-style-type: none"> • Workers compensation • Hospital indemnity insurance • Insurance for a specified disease • Disability • Dental care • Vision care • Long term care <p>Regulations to clarify.</p>	None.	None.

Criteria	Health Savings Account	Health Reimbursement Arrangement	Health Flexible Spending Account
Contribution Limits	Individual: Deductible, up to \$2600 for 2004. Family: Deductible, up to \$5150 in 2004. Contributions are subject to a monthly limit of 1/12 total per month. Contribution limits indexed to cost of living. Annual "catch up" provision for ages 55 and up - \$500 in 2004 to \$1000 in 2009+.	No statutory limit; limits may be set by employer. Contributions may be made in a lump sum.	No statutory limit; limits may be set by employer; \$5000 max is typical.
Uniform Coverage Requirement	Does not apply. Spending cannot exceed available funds.	Does not apply, but generally the full balance is available at the beginning of the policy year.	Applies. Maximum amount of coverage must be available throughout the coverage period.
Funded Balances	Yes.	Notional Accounts.	Yes.
Interest on Funds	Yes, tax free accumulations.	No.	No.
Contributor	Employee, employer, or both.	Employer only.	Employer, employee or both (usually employee only).
Balances Carried Over To Next Year	Yes.	Permitted, but not required.	Not permitted: Use it or lose it.
Qualified Expenses	Otherwise unreimbursed Code 213(d) medical expenses incurred while coverage in effect, but not expenses for insurance other than premiums for COBRA, a qualified long-term care contract, or for a health plan while the individual is either: i) receiving unemployment compensation; or ii) is over the age of 65 (other than a Medicare supplement policy).	Otherwise unreimbursed Code 213(d) medical expenses incurred while coverage in effect, including premiums for eligible health insurance and long-term care insurance. Cannot reimburse qualified long-term care services so long as the HRA is a health FSA. Further limitations may apply for employees with a qualified HSA – i.e. no duplicate coverage of benefits.	Otherwise unreimbursed Code 213(d) medical expenses incurred during the coverage period. Cannot reimburse insurance premiums. Cannot reimburse qualified long-term care services. Further limitations may apply for employees with a qualified HSA – i.e. no duplicate coverage of benefits.
Rollover	MSAs and HSAs may be rolled over to another qualified HSA plan without taxes or penalty. <ul style="list-style-type: none"> • Within 60 days of receipt of distribution. • No more than once every 12 months. 	No.	No.
Portability	Yes, funded individual account. Employee retains access to unused account balance even upon termination.	No. There is no individual HRA account for transferring balance. Available for COBRA premiums. Employer determination of continued access to unused balance if the employee is no longer working for the employer. Account remains under the control of the employer for continuation and vesting based upon contract rules. Year-to-year carryover at discretion of Employer.	None: must be used during periods of employment, and/or continuation under COBRA Cash-outs not permitted.

Criteria	Health Savings Account	Health Reimbursement Arrangement	Health Flexible Spending Account
Tax Treatment	<p>Pre-tax to employee up to contribution limits.</p> <p>Accumulations non-taxable provided they are used for qualified medical events.</p> <p>Employee contributions pre-tax to employer if part of a Section 125 plan.</p> <p>Withdrawals for non-medical purposes are subject to income tax and a 10% excise tax.</p> <p>The 10% excise tax is waived for:</p> <ul style="list-style-type: none"> • Account beneficiaries 65 and older • Disabled account beneficiaries as defined by Code Section 72 • Transfer of funds due to death or divorce <p>In case of death, funds transferred tax free to spouse, but subject to estate or income tax if beneficiary other than spouse.</p>	<p>Employer allocations of HRA balances are non-taxable.</p>	<p>Pre-tax.</p>
Reporting / Adjudication	<p>To be determined - statute does not address issue.</p> <p>Conference report indicates that HSAs receive the same treatment as MSAs, which require no adjudication.</p> <p>IRS has not yet issued an opinion.</p>	<p>Third Party, Section 213.</p> <p>100% substantiation for all debit card and OTC drug transactions.</p>	<p>Third Party, Section 213.</p> <p>100% substantiation for all debit card and OTC drug transactions.</p>
Fund Management	<p>Third Party Trustee.</p> <p>Funds can be managed in a pooled account, but employee retains all rights to funds. Funds cannot be invested in life insurance contracts.</p>	<p>Plan Sponsor or Third Party Trustee.</p>	<p>Plan Sponsor or Third Party Trustee.</p>
Offered As Part Of A Cafeteria Plan	<p>Separate account, or offered through section 125 cafeteria plan.</p> <p>Qualifying employees may open their own plans if not offered by their employer.</p>	<p>Separate Account.</p>	<p>Separate Account.</p>
Qualifying Test	<p>Code 4980G non-discrimination test: Equal contributions or % of deductible for all employees within the same coverage category.</p>	<p>Section 105(h) non-discrimination test.</p>	<p>Section 105(h) non-discrimination test.</p>

Criteria	Health Savings Account	Health Reimbursement Arrangement	Health Flexible Spending Account
Critical Advantages	<p>Funded tax-free with tax-free interest and non-taxed withdrawals for qualified medical expenses.</p> <p>Individual accounts under a trustee.</p> <p>Employer avoids FICA, Medicare if under Section 125.</p> <p>Age 55 and over "catch up" allowances.</p> <p>Portable / Rollover ability.</p> <p>MSA can be rolled into a new HSA account.</p> <p>Gives employees choice around how to spend their health care dollars.</p> <p>No uniform coverage requirement.</p>	<p>Tax free to accumulate and spend.</p> <p>"Notional" interest not usually granted.</p> <p>Employer controls funds.</p> <p>Gives plan sponsors substantial discretion around plan design and eligible expenses.</p> <p>Employer can make discretionary contributions to employees to reward good health behaviors.</p> <p>Rolls from one year to next.</p> <p>Full contribution available at beginning of year, at discretion of employer.</p>	<p>Tax free to accumulate and spend.</p> <p>Employer avoids FICA, Medicare under Section 125.</p> <p>Funds available first of the year.</p> <p>Employee determines amounts needed.</p>
Critical Disadvantages	<p>Requires a high deductible health plan.</p> <p>No ability to manage consumer behavior with awards/rewards.</p> <p>Requires equal \$ or % of deductible for employer contribution for all participants.</p> <p>Accumulates in 1/12 intervals, and spending cannot exceed fund balance.</p> <p>Complexity of plan design:</p> <ul style="list-style-type: none"> • High deductible plan with HSA most attractive to the young, healthy, and wealthy. • Using an HSA may limit the usability of HRA and FSA funds for specific purposes. • Dis-aggregation of health plans. • Communication to employees regarding enrollment choices 	<p>Not funded.</p> <p>Not portable.</p> <p>Not guaranteed. (non-qualified)</p> <p>Employee perception that employer control their destiny.</p> <p>Employee cannot make contributions.</p>	<p>No rollover.</p> <p>Use it or lose it provision:</p> <ul style="list-style-type: none"> • discourages participation • encourages unnecessary end-of-year spending <p>Uniform coverage requirement may lead to a negative account balance, or forfeiture in case of termination</p>

Anticipated Revisions to Legislations

While lawyers, and tax and benefits experts study the details of the legislation, we await an IRS opinion. We also anticipate a corrections bill this spring to provide additional clarification and detail. Key open issues include:

1. The scope of substantiation required to satisfy that funds are being used for medical purposes. An IRS opinion is expected shortly.
2. Will HSA's be subject to ERISA? Experts feel that ERISA would, indeed, apply in some way when the HSA is funded with employer or pre-tax employee contributions.
3. What, if any, annual reporting will be required for HSA's?
4. Are COBRA continuees entitled to a portion of the HSA upon a qualifying event?
5. Is the entity handling the HSA fund subject to HIPAA privacy requirements?

Regardless of potential changes, we expect HSA's to be a major fixture in benefit plan offerings. And they will be a powerful one. Because they are the first benefit that allows employees to accumulate, invest and spend income on a pre-tax basis for qualified medical coverage, HSA's offer employees the greatest incentive available to stay healthy and spend wisely on health care. Experts contend this will result in continued momentum for consumer-driven health plans and provide strong downward pressure on health care costs by introducing more market forces into the system.

Conclusion: HSA Impact for Employers

What's so special about HSAs? They are first benefit that allows employees to accumulate and spend income tax-free over their lifetime, provided that the funds are used for qualified medical expenses and coverage. HSAs combine the pre-tax treatment of a health flexible spending account, the portability and rollover characteristics of a 401(k) plan, and the tax-free distribution of a Roth IRA. Virtually anyone who has coverage under a qualifying high deductible health plan can participate. HSAs offer employees the greatest incentive to stay healthy and spend their health care dollars wisely. And that could have strong, positive effects on the future price of health care as we know it.

But even now that the Medicare Act has been signed into law, HSAs are still a work in progress. We await an IRS opinion, and it seems likely that Congress will follow-up with a corrections bill this spring to refine key details. We intend to follow these developments closely and keep you informed. Even without all the details in place, however, SHPS believes that consumer driven health care is a sustaining trend, and HSAs are a positive direction.

At first blush, HSAs are reminiscent of the early 401(k) plans. In the beginning, there was uncertainty, but plan design continued to evolve. Ultimately, defined contribution became the driving force behind consumer driven retirement planning. We believe that much the same will occur with HSAs.

The 401(k) analogy is instructive for another reason. Consumer driven benefits require substantially greater levels of communication and counseling. When 401(k)s came to the marketplace as a substitute for traditional defined benefit plans, employers needed to find new and creative ways to educate their employees regarding the basics of investing. We think the same will be true for health care. Consumers will be required to assess their medical risks carefully and make informed spending and asset allocation choices. But being a smart consumer in the health care market is not easy.

To assist consumers, employers and providers will need to create plan designs that are simple to administer and communicate, and provide unprecedented levels of decision support. Some health care consumers may need personal assistance and counseling to manage their health risks—much in the same way that investors manage financial risks with the assistance of a financial planner today.

To be sure, all this change won't take place at once. Open enrollment is already well underway for 2004 plans. But now is the time to begin assessing plan design, technological updates and processing adjustments necessary to make first generation HSAs available in 2005, and anticipate the more sophisticated plan designs in the years to come.

In the long run, allowing employees to pay for qualified medical expenses with pre-tax dollars will make high deductible health plans more palatable to employees. Consumer driven HDHPs may well become the plan of choice. The cost savings are compelling to employers, and new plan designs have the potential to offer both flexibility and control.

HSAs will not replace FSAs or HRAs, but will impact their design and use. Double coverage is not allowed under a qualified HSA, so FSAs and HRAs would need to be rewritten to cover only those benefits not covered under the high deductible health plan, e.g. dental, vision, OTC drugs. In the future, it may make sense to dis-aggregate health plans into smaller components in order

to facilitate this. In the not-so-distant future, it is possible that all three spending accounts could be combined in a coordinated offering. The only caution to this will be in keeping the plan as simple as possible in structure and perception.

A bit farther into the future, we even see a product that combines the features and benefits of HSA's, FSA's and HRA's in one, convenient debit card that can be used for qualified medical and insurance benefits. Advanced transaction algorithms would automatically deduct monies from the proper accounts. The employee would then receive one benefit statement that indicates remaining balances in each type of account and automatically updates files to the insurance carrier.

Bottom Line: We believe HSA's will become the driving force in the trend to consumer driven health care—and a strong permanent addition to benefit program options. Now is the time for employers to begin exploring their options for offering an HSA / high deductible health plan offering for 2005.

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ABOUT SHPS

SHPS, Inc., headquartered in Louisville, KY, offers comprehensive HR and benefits administration, consulting services, and health management services to help employers, public sector enterprises, and health plans manage the administrative, clinical, and financial aspects of benefits and health delivery. SHPS offers mid-sized and large private and public-sector enterprises a single source for outsourcing all or part of their benefits and health programs.

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