

Benefit Brief



SUBJECT: Health Savings Accounts, Flexible Spending Accounts, and Health Reimbursement Arrangements

DATE: November 16, 2007

This Benefit Brief discusses three methods consumers can use to pay for medical expenses and what employers need to know to select the best arrangement to meet their needs.

Consumer-Driven Health Care (CDHC) is a term used to describe a variety of methods for providing health insurance or funding health care costs. It encourages individuals to become actively involved in making health care decisions, such as designing their health insurance coverage, choosing their service providers, selecting health care services, and managing their own fitness and wellness. It increases the control consumers have over their health care spending.

One component commonly found in CDHC is a personal savings account through which consumers can pay for, or be reimbursed for, certain medical expenses of the employee, their spouse, and/or any eligible tax dependents. Three such savings accounts are the Health Savings Account (HSA), Flexible Spending Account (FSA), and Health Reimbursement Arrangement (HRA).

Employers need to know the rules and design options that apply to these arrangements in order to choose whether an HSA, FSA, or HRA best suits the employer's needs. The comparison chart below will help employers identify and focus on the features that matter most to them. Also included is a question and answer document on Health Savings Accounts from the U.S. Treasury Department.

If you have questions about the legal rules and requirements for HSAs, FSAs, or HRAs, please contact Danielle Omans at The Benecon Group, Inc. at domans@benecon.com or the number shown below.

This Benefit Brief is provided for informational purposes only and does not constitute legal advice. The Benefit Brief contains only a summary of the applicable legal provisions and does not purport to cover every aspect of any particular law, regulation or requirement. Depending on the specific facts of any situation, there may be additional or different requirements. Please use this Benefit Brief as a guide and not as a definitive description of your compliance obligations.

	HSA	FSA	HRA
Account Ownership	Employee	Employer	Employer
Eligibility	<ul style="list-style-type: none"> Individual must be covered by a qualified High Deductible Health Plan and no other plan (that provides coverage for benefits covered by the HDHP) Individual can not be claimed as a dependent on another person's tax return Medicare entitled individuals are not eligible Self-employed, partners and Sub S owners above 2% cannot receive pre-tax employer contributions 	Owners, including sole proprietors, partners and Sub S owners above 2%, cannot participate; spouse of owner can participate if bona fide employee	Owners, including sole proprietors, partners and Sub S owners above 2%, cannot participate; spouse of owner can participate if bona fide employee
Source of Contributions	<ul style="list-style-type: none"> Employee, family member, employer or any other person can contribute to the account (Employer is subject to comparability rules for contributions) One time rollover from HRA or FSA is permitted (amount is restricted) 	Either employee or employer can contribute to the account	Only employer can fund the account
Pre-Tax Contributions through Cafeteria Plan	Yes	Yes	No – employees cannot contribute
Annual contribution amount available at beginning of year	No	Yes	Not necessarily; employer can make funds available at beginning of year, or make a portion available each month (or other period)
Rollover of unused dollars at the end of the year	Yes	No – however, funds may be available for health reimbursement during an additional 2½ month grace period following the end of the plan year	Only if permitted by employer in plan design
Portability of unused dollars at termination of employment	Yes	No, except COBRA	<ul style="list-style-type: none"> Usually no, except for COBRA An ex-employee may have access at employer discretion as part of plan design

	HSA	FSA	HRA
Applicability of HIPAA Privacy and Security	Yes (though not clear)	<ul style="list-style-type: none"> • Privacy – yes (unless the employer pays the claims and there are fewer than 50 participants) • Security – yes if any protected health information is maintained on the computer system; limited compliance if none is maintained 	<ul style="list-style-type: none"> • Privacy – yes (unless the employer pays the claims and there are fewer than 50 participants) • Security – yes if any protected health information is maintained on the computer system; limited compliance if none is maintained
Applicability of COBRA	COBRA applies only to the high deductible health plan and not the HSA	Yes	Yes
Applicability of ERISA	<p>Yes, if the employer does any of the following:</p> <ul style="list-style-type: none"> • Limits the ability of eligible individuals to move funds to another HSA beyond restrictions already in the IRC • Imposes conditions on the utilization of HSA funds beyond those contained in the IRC • Makes or influences investment decisions regarding funds in the HSA • Represents that the HSA is an employee welfare benefit plan established and maintained by the employer • Receives payment or compensation in connection with an HSA 	Yes	Yes
Contribution Limits	For 2008 - \$2,900 for individual and \$5,800 for family coverage regardless of deductible in HDHP	No limits, except those imposed by employer in plan.	Employer determines contribution in plan design
Eligible Expenses	Any IRC §213(d) expenses; if employer limits the eligible expenses, the plan may be subject to ERISA	Any IRC §213(d) expenses, but employer can limit in plan design	Any IRC §213(d) expenses, but employer can limit in plan design (often covers only deductible expenses)
Insurance premiums eligible	Yes, but only COBRA, long term care, health insurance while unemployed, Medicare Parts B & D (but not a Medicare supplement policy)	No health or long term care premiums	Yes, but only if permitted by employer in plan design

What is a Health Savings Account (HSA)?

A Health Savings Account is an alternative to traditional health insurance; it is a savings product that offers a different way for consumers to pay for their health care. HSAs enable you to pay for current health expenses and save for future qualified medical and retiree health expenses on a tax-free basis.

You must be covered by a High Deductible Health Plan (HDHP) to be able to take advantage of HSAs. An HDHP generally costs less than what traditional health care coverage costs, so the money that you save on insurance can therefore be put into the Health Savings Account.

You own and you control the money in your HSA. Decisions on how to spend the money are made by you without relying on a third party or a health insurer. You will also decide what types of investments to make with the money in the account in order to make it grow.

What Is a High Deductible Health Plan (HDHP)?

You must have an HDHP if you want to open an HSA. Sometimes referred to as a "catastrophic" health insurance plan, an HDHP is an inexpensive health insurance plan that generally doesn't pay for the first several thousand dollars of health care expenses (i.e., your "deductible") but will generally cover you after that. Of course, your HSA is available to help you pay for the expenses your plan does not cover.

In order to qualify to open an HSA, your HDHP minimum deductible must be at least \$1,100 (self-only coverage) or \$2,200 (family coverage). The annual out-of-pocket (including deductibles and co-pays) cannot exceed \$5,600 (self-only coverage) or \$11,200 (family coverage). HDHPs can have first dollar coverage (no deductible) for preventive care and apply higher out-of-pocket limits (and co pays & coinsurance) for non-network services.

How can I get a Health Savings Account?

Consumers can sign up for HSAs with banks, credit unions, insurance companies and other approved companies. Your employer may also set up a plan for employees as well.

How much does an HSA cost?

An HSA is not something you purchase; it's a savings account into which you can deposit money on a tax-preferred basis. The only product you purchase along with [or "in connection with" so that people don't think the HDHP is purchased with HSA funds] an HSA is a High Deductible Health Plan, an inexpensive plan that will cover you should your medical expenses exceed the funds you have in your HSA.

Does the amount of my deductible on my HDHP impact my HSA?

No. The maximum contribution amount is the statutory maximum for single or family coverage, whichever is applicable. For single coverage, the amount for 2008 is \$2900. For family coverage, the amount for 2008 is \$5800. These amounts will be increased for inflation in future years and must be decided by June of the preceding year. You can put that money in over the course of a year, or all at once. You do not have to make equal contributions to your account every month. If your employer or anyone else contributes some of the money, you can only contribute the difference.

If you join an HSA mid-year, you will be eligible to contribute the full amount of the statutory maximum for single or family coverage, as applicable. However, you must remain eligible under the HDHP for the remainder of the plan year plus the next 12 months. If you do not remain eligible, the amount over the amount you would have been able to contribute under the 2007 rules will be taxable. In addition, a 10% excise tax will be applied. The penalty is not assessed if the reason for loss of eligibility was death or disability.

Who is eligible for a Health Savings Account?

To be eligible for a Health Savings Account, an individual must be covered by an HSA-qualified High Deductible Health Plan (HDHP) and must not be covered by other health insurance that is not an HDHP. Certain types of insurance are not considered "health insurance", including insurance for specific injuries or accidents, disability, dental care, vision care, and long-term care, and will not jeopardize your eligibility for an HSA. If you are enrolled in Medicare or Medicaid, you are not eligible for an HSA. If you have coverage under Tricare, you are not eligible for an HSA. If you are eligible for VA benefits, you can still have an HSA unless you have used VA benefits and services (including prescription drugs) within the past three months. Finally, dependent children cannot have their own HSAs.

I don't have health insurance; can I get an HSA?

You cannot establish and contribute to an HSA unless you have coverage under a HDHP.

Does an HSA pay for the same things that regular insurance pays for?

HSA funds can pay for any qualified medical expense, even if they are not covered by your health insurance. For example, most health insurance does not cover the cost of over-the-counter medicines, but HSAs can. If the money from the HSA is used for qualified medical expenses, then the money spent is tax-free.

How do I know what is included as qualified medical expenses?

We cannot provide a definitive list of "qualified medical expenses". A partial list is provided in IRS Pub 502 (available at www.irs.gov). There have been many cases involving the many nuances of what constitutes "medical care" for purposes of section 213(d) of the Internal Revenue Code. A determination of whether an expense is for "medical care" is based on all the relevant facts and circumstances. To be an expense for medical care, the expense has to be primarily for the prevention or alleviation of a physical or mental defect or illness. The determination often hangs on the word "primarily." The two significant differences are that: 1) HSAs can only be used to pay health insurance premiums in limited situations (see discussion below), and 2) HSAs can also pay for non-prescription drugs (even though they are not qualified medical expenses for purposes of the itemized medical expense deduction, as described in IRS 502).

What happens if I don't use the money in the HSA for medical expenses?

If the money is used for other than qualified medical expenses, the expenditure will be taxed and, for individuals who are not disabled or over age 65, subject to a 10% tax penalty.

Are dental and vision care qualified medical expenses under a Health Savings Account?

Yes, as long as these are deductible under the current rules. For example, cosmetic procedures, like cosmetic dentistry, would not be considered qualified medical expenses.

What is the definition, or eligibility criteria, for qualified preventive health care expenses covered by HSA policies?

Treasury and IRS have issued technical guidance on this topic. See <http://www.treas.gov/offices/public-affairs/hsa/technical-guidance/> for examples of services that qualify as "preventive care".

I'm over 55 and would like to make catch-up contributions to my HSA, like I've done with my IRA. Is that possible?

Yes, individuals 55 and older who are covered by an HDHP can make additional catch-up contributions each year until they enroll in Medicare. The additional "catch-up" contributions to HSA allowed are as follows:

2007 - \$800
2008 - \$900
2009 and after - \$1,000

I turned 55 this year. Can I make the full \$800 “catch-up” contribution?

If you had HDHP coverage for the full year, you can make the full catch-up contribution regardless of when your 55th birthday falls during the year. If you did not have HDHP coverage for the full year, you must pro-rate your “catch-up” contribution for the number of full months you were “eligible”, i.e., had HDHP coverage.

If both spouses are 55 and older, can both spouses make “catch-up” contributions?

Yes, if both spouses are eligible individuals and both spouses have established an HSA in their name. If only one spouse has an HSA in their name, only that spouse can make a “catch-up” contribution.

Can couples establish a “joint” account and both make contributions to the account, including “catch-up” contributions?

“Joint” HSA accounts are not permitted. Each spouse should consider establishing an account in their own name. This allows you to both make catch-up contributions when each spouse is 55 or older.

If a couple has HDHP coverage under a family policy with a \$2,000 deductible, how much can they put into their respective HSAs?

Your total contribution is limited to the statutory maximum for family coverage equal to \$5,800. If each spouse establishes an HSA account in their own name, the couple can divide their contribution however they wish and make deposits into the separate accounts. If either of the spouses is 55 or older, that spouse can also make an additional “catch-up” contribution to their account.

Can I get an HSA even if I already have health insurance?

Generally speaking, if you have an HSA you cannot be covered by any other health insurance that is not an HDHP. You are only allowed to have auto, dental, vision, disability and long-term care insurance at the same time as an HSA. You may also have coverage for a specific disease or illness as long as it pays a specific dollar amount when the policy is triggered. Wellness programs offered by your employer are also permitted if they do not pay significant medical benefits.

Can my employer offer me an HSA or help me pay for one, or do I have to get it on my own?

Contributions to HSAs can be made by either the employer or the individual, or both. If contributions are made by the individual, it is an “above-the-line” deduction. If contributions are made by the employer, it is not taxable to the employee (excluded from income). Contributions can also be made by others on behalf of an eligible individual and deducted by the individual. All contributions are aggregated to determine whether you have contributed the maximum allowed.

How much can I (and/or my employer) contribute to a Health Savings Account?

The maximum contribution is the statutory maximum allowed for the current year. For 2008, those limits are \$2,900 for individuals with self-only coverage and \$5,800 for those with family coverage. These dollar limits will be adjusted for inflation each June for the following year.

Do unused funds in a Health Savings Account roll over year after year?

Yes, the unused balance in a Health Savings Account automatically rolls over year after year. You won't lose your money if you don't spend it within the year.

Can the funds in an HSA be invested?

Yes, you can invest the funds in your HSA. The same types of investments permitted for IRAs are allowed for HSAs, including stocks, bonds, mutual funds, and certificates of deposit.

Who has control over the money invested in a Health Savings Account?

The account holder controls all decisions over how the money is invested. You can also choose not to invest your funds.

What happens to the money in a Health Savings Account after you turn age 65?

Once you turn 65, you can continue to use your account tax-free for out-of-pocket health expenses. If you enroll in Medicare, you can use your account to pay Medicare premiums, deductibles, copays, and coinsurance under any part of Medicare. If you have retiree health benefits through your former employer, you can also use your account to pay for your share of retiree medical insurance premiums. The one expense you cannot use your account for is to purchase a Medicare supplemental insurance or "Medigap" policy.

Once you turn age 65, you can also use your account to pay for things other than medical expenses. If used for other expenses, the amount withdrawn will be taxable as income but will not be subject to any other penalties. Individuals under age 65 who use their accounts for non-medical expenses must pay income tax and a 10% penalty on the amount withdrawn.

Can I roll the money in a Health Savings Account over into an IRA?

You cannot roll the HSA funds over into an IRA. They will stay in the HSA or be rolled into another HSA.

Can I roll over an IRA, 401(k) or other retirement plan into an HSA?

A one time trustee to trustee transfer to an HSA from an IRA can be made, except from a Simplified Employee Pension (SEP) or a SIMPLE account. The transfer is limited to the current maximum HSA contribution for that year for single or family coverage in effect at the time of the transfer. If you transfer the single coverage amount and later in the year change your coverage to family coverage, you can then transfer the difference from single to family coverage as applicable in the year of the transfer. This transfer does reduce the amount you would be able to contribute on a dollar for dollar basis for that year. You must remain eligible in the HDHP for 12 months from the month the rollover was done or the amount becomes taxable. In addition, a 10% excise tax will be applied. The penalty is not assessed if the reason for loss of eligibility was death or disability. The penalty can be avoided if you enroll in another HDHP or make a COBRA election for HDHP coverage.

You cannot directly roll funds in a 401(k) or other retirement plan into an HSA. You can withdraw funds from one of these accounts, pay applicable taxes (and penalties) on the amount you withdraw, and then use the remaining funds to make a contribution to your HSA, and take a deduction for the amount contributed to the HSA. However, the amount you contribute to your HSA is still limited by the annual contribution limits.

Can I take a tax deduction for my HDHP premium?

Not at this time, unless you are self-employed. President Bush has proposed allowing individuals not covered by an employer plan to deduct their HDHP premiums as well as their HSA contributions. However, this proposal will not be effective until enacted by Congress.

My employer offers an FSA. Can I have both an FSA and an HSA?

You can have both types of accounts, but only under certain circumstances. General health Flexible Spending Arrangements (FSAs) will probably make you ineligible for an HSA. If your employer offers a "limited purpose" (limited to dental, vision or preventive care) or "post-deductible" (pay for medical expenses after the plan deductible is met) FSA, then you can still be eligible for an HSA.

If you participate in a health FSA and wish to enroll in an HSA during the FSA grace period, you may make HSA contributions during the grace period as long as you have used all of your FSA contribution by the end of the plan year. If you have contribution remaining in your FSA account, you can make a one time transfer to the HSA in the amount equal to the lesser of 100% of your balance as of the end of the prior plan year or the balance of the account as of September 21, 2006.

My employer offers an HRA. Can I have both an HRA and an HSA?

You can have both types of accounts, but only under certain circumstances. General Health Reimbursement Arrangements (HRAs) will probably make you ineligible for an HSA. If your employer offers a "limited purpose" (limited to dental, vision or preventive care) or "post-deductible" (pay for

medical expenses after the plan deductible is met) HRA, then you can still be eligible for an HSA. If your employer contributes to an HRA that can only be used when you retire, you can still be eligible for an HSA.

Can I transfer amounts from my HRA or FSA to my HSA?

Yes. You can make a one time rollover per health FSA or HRA to an individual HSA of the remaining balance in your HRA or FSA. This must be done by December 31, 2011. The rollover does not reduce the individual maximum HSA contribution for the applicable year. The transfer must be the lesser of the balance of the HRA as of September 30, 2006 or the balance on the date of the transfer. If you do not remain eligible for 12 months from the beginning of the month of the rollover, the transfer is deemed taxable. In addition, a 10% excise tax will be applied. The penalty is not assessed if the reason for loss of eligibility was death or disability. The penalty can be avoided if you enroll in another HDHP or make a COBRA election for HDHP coverage. Your HRA or FSA plan must include language to allow for the transfer.

I'm on Medicare; can I have an HSA?

You cannot make contributions to an HSA after you enroll in Medicare. You must stop making contributions (including "catch-up" contributions) with the month for which your Medicare enrollment is effective. However, this should not discourage those nearing the age of 65 from opening HSAs because you can keep whatever money is in the account and use it for a number of things – including payment of your Medicare premiums – after you enroll in Medicare.

I am a Veteran; can I have an HSA?

If you have received any health benefits from the Veterans Administration or one of their facilities, including prescription drugs, in the last three months, you cannot contribute to an HSA.

I'm active-duty military and have Tricare coverage; can I have an HSA?

At this time, Tricare does not offer an HDHP options so you are not eligible for an HSA.

Can I start an HSA for my child?

No, you cannot establish separate accounts for your dependent children, including children who can legally be claimed as a dependent on your tax return.

I don't have a job; can I have an HSA?

Yes, if you have coverage under an HDHP. You do not have to have earned income from employment – in other words, the money can be from your own personal savings, income from dividends, unemployment or welfare benefits, etc.

I have a high income; can I have an HSA?

Yes, you can. There are no income limits when it comes to HSA eligibility.

Do my HSA contributions have to be made in equal amounts each month?

No, you can contribute in a lump sum or in any amounts or frequency you wish. However, your account trustee/custodian (bank, credit union, insurer, etc.) can impose minimum deposit and balance requirements.

Can I roll over my MSA funds into my HSA?

Yes, if you do so within 60 days of withdrawing the funds from the MSA.

My bank/credit union doesn't offer HSAs; are they eligible to do so?

Most likely, yes. Insured credit unions and banks are automatically qualified to handle HSAs. Any bank, credit union or any other entity that currently meets the IRS standards for being an IRA or Archer MSA trustee or custodian can be an HSA trustee or custodian. Insurers can also be HSA trustees or custodians. Your bank should also know that their reporting responsibilities on these accounts are minimal. Financial institutions only need to report – to you and the IRS – contributions to the account, the amount that has

been taken out of the account, and the value of the account at the end of the year. Best of all, banks don't need to develop any new forms. Treasury has model forms that they can use, or they can adapt the forms they already use for IRAs for HSAs.

Will my bank notify me if I've exceeded my allowable contribution amount?

No, it is your sole responsibility to keep track of the amounts deposited and spent from your account, just like a normal savings or checking account.

Can I borrow against the money in my HSA?

No. You may not borrow against it or pledge the funds in it.

Who decides how the money in my HSA is spent?

You are responsible for that decision, and if you spend the money for something that is not a qualified medical expense, the amount becomes taxable and, if under age 65, subject to a 10 percent penalty. Therefore you should familiarize yourself with what qualified medical expenses are (as partially defined in IRS Publication 502) and also keep your receipts in case you need to defend your expenditures or decisions during an audit.

Who will be the "bookkeeper" for my HSA?

It is your responsibility to keep track of your deposits and expenditures and keep all of your receipts. If you run out of HSA funds (and therefore need to use your HDHP), you may need to send those receipts to your insurer.

Can I use the money in my HSA to pay for something that is non-medical?

You can, but you will need to pay income tax plus a 10 percent penalty tax on the withdrawal of those funds. If you are 65 years or older, you will still have to pay income tax in this situation, but you will not have to pay the 10 percent tax penalty.

Can I use the money in my HSA to pay for medical care for a family member?

Yes, you may withdraw funds to pay for the qualified medical expenses of yourself, your spouse or a dependent without tax penalty. This is one of the great advantages of HSAs.

Can I use my HSA to pay for medical services provided in other countries?

Yes.

Can I pay my health insurance premiums with an HSA?

You can only use your HSA to pay health insurance premiums if you are collecting Federal or State unemployment benefits, or you have COBRA continuation coverage through a former employer.

Can I purchase long-term care insurance with money from my HSA?

Yes, if you have tax-qualified long-term care insurance. However, the amount considered a qualified medical expense depends on your age. See IRS Publication 502 for the amounts deductible by age.

What happens to the money in my HSA if I die?

If married, your spouse becomes the owner of the HSA when you die. If unmarried, the HSA passes to the beneficiary you name in your HSA or becomes part of your taxable estate.

What are the IRS reporting requirements for HSAs?

Banks, credit unions and insurance companies that are trustees, custodians and HSA administrators need to file two IRS forms: one for distributions (IRS Form 1099-SA) and one for contributions and the value of the account at the end of the year (IRS Form 5498-SA). Both forms must be sent to both the account owner and the IRS.

I am an employer; do I own my employees' HSAs? Can I control how they spend the money in them?

No, you do not own your employees' HSAs. The employee fully owns the contributions to the account as soon as they are deposited, just as with a personal checking or savings account to which you would deposit their compensation.

My employees want to contribute to their HSAs but want to make sure they get a tax benefit out of doing so. How does that work?

Employee contributions can be made to HSAs on either after-tax or pre-tax basis. If made on an after-tax basis they should be counted as an above-the-line deduction on their tax return, effectively making their contributions free of federal income tax. If they want to make the contribution pre-tax it can be done through a Section 125 (also called a "salary reduction" or "cafeteria plan"), which would make the contributions free of FICA taxes as well as federal income tax.

How much do I have to contribute to my employees' HSA, as an employer?

As much or as little as you want (while staying below the legal limit on the account of \$2,900 or \$5,800 for employees with family coverage). However, see the next question and answer concerning the comparability rules.

As an employer, do I have to contribute the same amount to every employee's HSA?

Employer contributions must be "comparable", that is they must be in the same dollar amount or same percentage of the employee's deductible for only non-highly compensated employees. This allows the employer to contribute greater contributions for non-highly compensated employees. You do not need to consider employees who do not have HDHP coverage as they are not eligible for HSA contributions.

Our company offers benefits through a Section 125 plan; do contributions have to be comparable under these plans as well?

Section 125 plans (aka "salary reduction" or "cafeteria" plans) must meet a different set of rules. Under these plans, contributions (both from employer and/or employee) must meet "non-discrimination" rules. These rules require the employer to ensure that contributions do not favor higher compensated employees.

Our company wants to offer "matching" contributions; can we do that?

Yes, but your company can only offer "matching" contributions through a Section 125 plan. Remember that the non-discrimination rules still apply.

I don't offer health insurance, but some of my employees have opened HSAs and I'd like to help them out: what can I do?

Your company can make pre-tax contributions to your employees' HSAs as long as you do so for all eligible employees. If you have a Section 125 plan, then the non-discrimination rules apply.

I'm self-employed. Can I contribute to an HSA on a pre-tax basis?

Since you are not considered an employee under current tax law, you cannot contribute on a pre-tax basis, but you may take an above-the-line deduction for your personal HSA contributions on your personal income taxes. You are already able to deduct the full cost of your health insurance premiums on your taxes.

SOURCE DATA: U.S. TREASURY DEPARTMENT