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Health Savings Accounts: Fueling The Consumer-Driven Health Plans Fire

In the Medicare Prescription Drug, Improvement and Modernization Act of 2003, Congress created health savings accounts (HSAs) as new Internal Revenue Code section 223. Employers can now cut health care costs by offering employees a high deductible health plan combined with an HSA. The goal of this plan design is to make participants more cautious health care consumers and thereby reduce health costs. Employees will find HSAs desirable because they can keep what they don't spend and earn interest on their account balance! Unlike certain plan design options, HSAs can be funded with employer contributions, pre-tax or after-tax employee contributions, or a combination of both.

Learn More. Seyfarth Shaw's Employee Benefits Practice Group is hosting a teleconference client briefing on HSAs in February. Details on the teleconference and instructions for signing up at our website, www.seyfarth.com/events, will be sent via e-mail in the near future.

HSAs Do More. Tax-favored contributions to HSAs may be accumulated year to year, and may be distributed (i) on a tax-free basis to pay qualified medical expenses or (ii) subject to income and excise taxes, for any other purpose. The ability to accumulate contributions over time and to use them for non-medical purposes make HSAs a very important development in the health care arena.

When HSAs are Permitted. Beginning in 2004, an employer may establish an HSA for an employee who is an "eligible individual" or an eligible individual may establish his or her own HSA. If an employer funds the HSA, contributions must be in the same amount or the same percentage of the deductible for all comparable participating employees. Generally, an eligible individual for a month must be covered by a "high deductible health plan" (HDHP) as of the first day of that month.

An HDHP has an annual single deductible of at least \$1,000 and an annual family deductible of at least \$2,000. HDHPs may provide preventive care without deductibles. However, except for preventive care, the HDHP may not provide benefits for any

year until the family deductible is met. For HSA purposes, an HDHP's out-of-pocket expense limits may not exceed \$5,000 for single coverage and \$10,000 for family coverage. The deductible and out-of-pocket limits are indexed for inflation. For a network plan, separate non-network deductible and out-of-pocket maximums are not taken into account.

An individual covered by an HDHP is not eligible for an HSA if he is covered by a non-HDHP that covers for any benefit also covered by the HDHP (with exceptions for plans providing certain limited types of coverage). For example, an individual is disqualified if he is covered by an HDHP and also covered under a spouse's health plan that has a \$300 deductible.

Health reimbursement arrangement (HRA) coverage or health flexible spending account (HFSA) coverage are generally impermissible non-HDHP coverage unless severely limited. Permitted non-HDHP coverages include coverage for accidents, disability, dental care, vision care or long-term care. Further, insurance under workers' compensation laws, tort liabilities, ownership or use of property liabilities, specified disease or illness (e.g., cancer insurance) and insurance paying a fixed amount per day (or other period) for hospitalization are permitted. No HSA contributions can be made by or on behalf of a Medicare-eligible individual or an individual who can be claimed as a dependent on another individual's tax return.

Limits on Contributions. The maximum annual HSA contribution is the lesser of (i) 100% of the HDHP annual deductible or (ii) \$2,600 for single coverage or \$5,150 for family coverage (indexed for inflation). Limits are applied monthly. Individuals who are age 55 (or older) can make "catch-up contributions." Rollovers into an HSA are permitted from another HSA or an Archer MSA. A 6% excise tax applies to contributions that exceed the applicable limit.

Tax Treatment. Contributions by an eligible individual are tax-deductible. Employer contributions and employee salary reduction contributions (permitted through a cafeteria plan) to an HSA are excludable

from the employee's gross income, not subject to income tax withholding, FICA or FUTA, and are deductible by the employer. Earnings in an HSA accumulate tax-free.

Distributions. HSA distributions for "qualified medical expenses" of the individual, his or her spouse, or dependents are excludable from gross income. HSA funds spent for non-medical expenses are subject to income tax, plus a 10% excise tax, but the HSA is not disqualified. For distributions made after the individual's death, disability or attaining age 65, the excise tax does not apply. An individual may name a spouse or other person as the beneficiary of the HSA. A spouse beneficiary retains the HSA. For the non-spouse beneficiary, the HSA terminates and the beneficiary is subject to income tax on the value of the account's assets.

Qualified Medical Expenses. "Qualified medical expenses" are expenses paid by the individual, his or her spouse or dependents for medical care under Code Section 213(d), to the extent not covered by insurance or otherwise. Qualified medical expenses must be incurred after the HSA has been established. Generally, health insurance premiums are not qualified medical expenses except for: qualified long-term care insurance, COBRA coverage, and health care coverage while an individual is receiving unemployment compensation. In addition, individuals over age 65 may pay premiums for Medicare Part A or B, Medicare HMO, and the employee share of premiums for employer-sponsored health insurance (including retiree health) from an HSA (but not premiums for Medigap policies).

Trust Requirement. An HSA must be established through a qualified HSA trustee or custodian. Any insurance company or bank qualifies. Any IRS-approved trustee or custodian of IRAs or Archer MSAs is automatically approved. Other parties must receive IRS approval.

On the next page is a chart comparing HSAs, HRAs and HFSAs.

If you have questions about HSAs, please contact the Seyfarth Shaw Employee Benefits Group attorney with whom you work or any employee benefits attorney listed on the website at www.seyfarth.com.

This newsletter is a periodical publication of Seyfarth Shaw and should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult a lawyer concerning your own situation and any specific legal questions you may have. For further information about these contents please contact the firm's Employee Benefits Practice Group.

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Compare. The chart below summarizes some of the main tax and compliance issues to consider in deciding if a health plan design is well-suited to an HSA in addition to, or instead of, an existing HRA or HFSA.

	HSA	HRA	HFSA
Required Limits on Contributions	Lesser of 100% of deductible or \$2,600 single/\$5,150 family	None	None
Salary Reduction Funding	Permitted	Not permitted (funded only by employer)	Permitted
Medical Expenses Reimbursable Tax-Free	Section 213(d) medical expenses, but not health insurance premiums except long-term care insurance, COBRA, premiums paid while individual receives unemployment benefits and, for individuals at least age 65, any health insurance premiums except a Medigap policy	Section 213(d) medical expenses, including premiums for eligible health insurance and long-term care insurance	Section 213(d) medical expenses but may not reimburse health insurance premiums or long-term care services
Claims Substantiation	Required only of eligible individual	Required of plan	Required of plan
Other Distributions (i.e., cash outs)	Permitted for any reason subject to income tax and 10% penalty tax (some exceptions)	None permitted	None permitted
Vesting	Fully vested	No vesting requirement	No vesting requirement
Carryover of Unused Amounts Year to Year	Required	Permitted (subject to plan design)	Not permitted
Portability	Yes. Can move employer to employer or be held by individual	No, but design may allow continued coverage after termination of participation	No. Only expenses incurred during active participation may be reimbursed after termination of participation
Nondiscrimination Rule	Employer must make “comparable contributions” (i.e., same amount or same	Section 105(h) (i.e., cannot favor highly compensated)	Section 105(h) (i.e., cannot favor highly compensated)
Funding	Trust required	No trust required	No trust required
COBRA	No under Code (probably no under ERISA)	Yes	Yes