

Health Savings Accounts

INTRODUCTION

Last year’s passage of the Medicare Act introduced a highly attractive benefits option that employers can offer to their employees immediately: Health Savings Accounts (“HSAs”). HSAs are intended to be a key component of consumer-directed benefits programs, and insurers appear to be assisting with that effort as they are already advertising (although not yet selling) HSA products.

This issue of the Trade Association Issue Brief explains the HSA framework and notes the areas still requiring further guidance from Treasury and/or the IRS. Collier Shannon Scott, in conjunction with the Council of Insurance Agents & Brokers, submitted comments addressing many of these unanswered questions. Guidance from Treasury is expected shortly.

HEALTH SAVINGS ACCOUNT OVERVIEW

An individual is eligible for an HSA if s/he is (1) under 65 years, (2) is covered by a high deductible health plan (“HDHP”), and (3) is not also covered by another health plan that is not an HDHP, and which provides the same benefits as the HDHP.

The health plan is a qualifying HDHP if it has an annual deductible of at least \$1,000 for self-coverage (\$2,000 for family coverage) and annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but not premiums) are no more than \$5,000 for self-coverage (\$10,000 for family coverage).

Contributions by an individual are deductible by the individual as an above-the-line deduction (to the extent they are within the statutory limits). Individuals, their employers, or both can contribute tax-deductible funds yearly up to the amount of the policy’s annual deductible, subject to a cap of \$2,600 for individuals and \$5,150 for families.

Distributions from an HSA are not taxable if they are used to pay for “qualified medical expenses,” which include out-of-pocket costs, prescription and over-the-counter drugs, qualified long-term-care services, Medicare expenses (but not MediGap), and COBRA insurance for the unemployed. Once eligible for Medicare, HSA funds also may be used on a tax-exempt basis to pay for Medicare premiums, and premiums for employer-sponsored retiree health insurance. Also, once Medicare-eligible, the funds can be used for non-health purposes like an IRA. A more detailed analysis of HSAs is provided on the next page.

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HEALTH SAVINGS ACCOUNTS

Eligibility

The Medicare Act's provision establishing health savings accounts (HSAs) is likely the most dramatic change to health service products. Effective January 1, 2004, HSAs can be established by anyone (1) under 65 years (2) who is covered under a "high deductible health plan" (HDHP).

An individual remains eligible for an HSA when, in addition to an HDHP, the individual also has "permitted insurance." Permitted insurance relates to liabilities incurred under workers' compensation laws, tort liabilities, liabilities relating to ownership or use of property (e.g., automobile insurance), insurance for a specified disease or illness, and insurance that pays a fixed amount per day (or other period) of hospitalization. An individual also remains eligible for an HSA if, in addition to an HDHP, s/he has coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

High Deductible Health Plan

A "high deductible" plan is a health plan requiring an annual deductible of at least \$1,000 for self-coverage (\$2,000 for family coverage) and an annual out-of-pocket limit no greater than \$5,000 for self-coverage (\$10,000 for family coverage), indexed for inflation. Both of these requirements must be met. In the case of a plan using a network of providers, the plan does not fail to be an HDHP (if it would otherwise meet the requirements of an HDHP) solely because the out-of-pocket expense limits for services provided outside of the network exceeds the maximum annual out-of-pocket expense limits allowed for an HDHP.

In addition, a plan does not fail to be an HDHP merely because it does not have a deductible (or has a small deductible) for "preventive care" (e.g., first dollar coverage for preventive care). The definition of "preventative care" within the context of an HSA is not yet defined. Except for preventive care, a plan may not provide benefits for any year until the deductible for that year is met.

Contributions

Annual contributions to an HSA are tax deductible up to the lesser of (1) the qualified annual deductible amount, or (2) \$2,250 for individual coverage and \$4,500 for family coverage, indexed for inflation. Individuals and their employers may both contribute to the employee's HSA an amount equal to 100% of the health plan deductible, but the total contribution amount cannot be more than \$2,600 for individual coverage and \$5,150 for family coverage. Individuals who are 55 years or over may contribute an additional \$500 beginning in 2004, phasing up in \$100 annual increments to \$1,000 in 2009. Contributions are not allowed once the individual is eligible for Medicare. Any contribution to an MSA reduces the maximum allowable contribution to the HSA.

Employer contributions may be provided via a salary reduction through a cafeteria plan. Individual contributions to HSAs are tax deductible and employer contributions are not included in income. Rollovers are acceptable from an Archer Medical Savings Account ("MSA") or from other HSA. Rollovers are not permissible if from an IRA, a health reimbursement arrangement ("HRA"), or from a health flexible spending

account (“FSA”).

The HSA is portable and travels with the employee, and an eligible individual may establish an HSA with or without the involvement of the employer. Indeed, the individual may be self-employed, unemployed, and still be eligible for an HSA. If the employee dies or the employment position is terminated, the HSA is treated similarly to an IRA. In the case of death, the spouse or estate would take over the HSA. Finally, HSAs must be held in a tax-exempt trust.

Comparability Rules

Employer contributions to an HSA must be made on a comparable basis to all employees in a similar high deductible plan. Contributions are comparable if they are the same percentage of the deductible amount or are the same dollar amount. If the requirement for comparable contributions is not met, a 35% excise tax must be paid by the employer on the actual contributions made. For purposes of this comparability rule, all companies under common control are treated as a single employer. The Rule is also applied separately to part-time employees (*i.e.*, employees who are customarily employed for fewer than 30 hours per week). Notably, the Act does not address further how non-discrimination rules will affect whether and how contributions are made. For example, it is unclear whether the employer may carve out a subset of employees from an HSA-offering to provide matching funds without violating non-discrimination rules. Further guidance is expected from Treasury in the next few weeks on this point.

Distributions

Distributions from HSAs that pay for “qualified medical expenses,” including out-of-pocket, prescription and over-the-counter drugs, qualified long-term-care services, Medicare expenses (but not MediGap), and COBRA insurance for the unemployed, will be excludable from income. Qualified medical expenses are those defined under the tax rules (section 213(d) for itemized deductions for medical care), but generally do not include premiums for health policies until the individual is eligible for Medicare. Distributions made for non-qualifying purposes are subject to income tax and a 10% penalty. Once eligible for Medicare, HSA disbursements may be used for Medicare premiums, premiums for employer-sponsored retiree health insurance, or even for non-health reasons similar to an IRA. Indeed, we expect HSAs will be designed as a general savings vehicle and be paired with non-traditional health financial entities, such as mutual funds and stock investments.

Guidance from Treasury and/or IRS Expected

As we mentioned in the introduction, further guidance on the Health Savings Accounts is expected from the Department of Treasury and the IRS. Please let us know if you would like to receive a copy of Collier Shannon’s comments and/or an update on the HSA guidance when it is released.

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