

Benefit Fact Sheet

What is it?

An HSA is a tax-favored savings account designed to integrate with a [High Deductible Health Plan](#) (HDHP). Similar to a 401(k) or IRA, HSA balances are owned by the participant and accumulate earnings on a tax-free basis. Both employers and employees can make contributions to an HSA. Employee contributions to the HSA are tax-deductible or can be made on a pre-tax basis through a Section 125 plan. Employer HSA contributions (if any) are not taxable to the employee.

In most cases the HSA owner has full discretion to decide how to invest their HSA dollars. HSA balances roll from one year to another and are not forfeited when employment changes - there is no "use it or lose it" rule. HSA owners can withdraw funds tax-free from their HSA, provided the funds are used to pay for qualified medical expenses and certain permissible health care premiums. Non-qualified distributions from the HSA are taxable as income for disabled individuals or those over age 65. An additional 20% excise tax applies for non-qualified distributions for those under age 65 who are not disabled.

The core attributes of an HSA include:

- An HSA may only be established in conjunction with a qualifying HDHP. There are a number of guidelines that determine the plan design of a qualifying HDHP plan, but in general an HDHP plan must meet the following parameters:

2012 HDHP Guidelines		
	Individual	Family
Minimum Deductible	\$1,200	\$2,400
Maximum Out-of-Pocket Cost	\$6,050	\$12,100

Additional HSA Considerations:

- Contributions of up to \$3,100 for an individual and \$6,250 for a family are allowed for 2012. Individuals age 55 and older (not enrolled in Medicare) can make "catch-up" contributions up to \$1,000 in 2012.
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- Persons covered under an HDHP cannot be covered under any other health plan that is not high deductible.
 - Copayment based prescription drug plans are not permitted, unless they are subject to the medical plan deductible.
 - Most [Flexible Spending Accounts](#) (FSAs) are not compatible with high deductible health plans and cannot be elected by an HSA participant or his or her spouse. Certain limited purpose or post-deductible FSAs may be allowable. Employees may enroll in an HSA during the grace period of the FSA (if applicable) provided that there is a zero balance by the end of the plan year. For more information please reference [IRS Notice 2007-22, 2007 10 I.R.B. 670](#).
- Wellness programs, including [Employee Assistance Programs](#) (EAPs), may be offered by employers if they do not pay for significant medical benefits.

Benefit Fact Sheet

- Employer contributions to an HSA on behalf of an employee are not taxable income to the employee and employee contributions to an HSA can be made on a pre-tax basis. The combined contribution of employer and employee dollars may not exceed the legislative limits applicable to the covered person/family for the plan year.
- The HSA must be established with a qualified HSA trustee or custodian such as banks, credit unions, insurance companies and other entities that are approved through the IRS to offer HSA's. From an administrative perspective, an employer may endorse a single custodian to which employer HSA contributions (if any) are directed, with employees choosing to redirect those contributions to an alternative HSA custodian of their preference. It is expected that most HSA custodians will provide the account holder with a debit style card that will allow the account holder to easily access the account balance when paying for services not subject to payment by the HDHP.
- HSA funds may be withdrawn by the account owner at any time without taxation to pay for their or their qualified dependents' expenses.. IRS Publication 502 broadly defines eligible expenses as those related to "the diagnosis, cure, mitigation, treatment, or prevention of disease and the costs for treatments affecting any part of function of the body." As such, an HSA can be used to pay deductibles, coinsurance, and copayments not otherwise paid by the underlying HDHP.
- In addition to medical expenses, HSA funds may be withdrawn -- without taxation -- to pay for COBRA premiums, Medicare premiums (but not MediGap), out of pocket expenses, and qualified long term care insurance premiums.
- HSA funds withdrawn for expenses not covered under Publication 502 (or otherwise permissible under HSA legislation) are taxable income to the participant and are subject to a 20% excise tax. After age 65 the 20% excise tax is no longer applicable; HSA funds withdrawn for non-qualified expenses would be taxable at ordinary income rates. HSA withdrawals are "self-substantiated," meaning the HSA custodian is not specifically required by law to confirm the tax qualification of the withdrawal, although the HSA custodian is required to report on all withdrawals. The HSA account owner is required to report any taxable HSA withdrawal via the annual federal tax filing process.
- A person who ceases to be covered under a qualifying HDHP does not forfeit or jeopardize the HSA balance. The account owner is no longer eligible to contribute new money to the HSA until such time as he or she again becomes covered under a qualifying HDHP. The existing HSA can be used to pay for qualified HSA expenses, even if the account owner is not covered by a qualified HDHP at the time of the claim.
- HSA owners will establish a beneficiary(s) to receive any account balance remaining upon the owner's death. If the beneficiary named is the surviving spouse, then the account will become the spouse's HSA account and will only be subject to taxation if distributions are not for qualified medical expenses. If the account is transferred to someone other than the spouse, the full value of the HSA at the time of death (both principal and earnings) is taxable to the beneficiary as ordinary income. However, this amount can be reduced by any payments made for the decedent's qualified medical expenses, if paid within one year after death.
- An employer can avoid [ERISA](#) related compliance for the HSA if an employer sponsored HSA meets safe harbor guidelines set forth by the Department of Labor. Generally, these guidelines require that the employer does not (i) limit the ability of eligible individuals to move their funds to another HSA beyond restrictions imposed by the Code; (ii) impose conditions on utilization of HSA funds beyond those permitted under the Code; (iii) make or influence the investment decisions with respect to funds contributed to an HSA; (iv) represent that the HSAs are an employee welfare benefit plan established or maintained by the employer; or (v) receive any payment or compensation in connection with an HSA.

Benefit Fact Sheet

Why offer it?

HSAs can be a core component of a [Consumer Directed Health Plan](#) (CDHP). CDHPs seek to reduce short-term total costs and flatten long-term inflationary pressures by reducing health care waste and empowering employees to seek both more cost effective and higher quality health care.

What types of employers offer it?

Employers of all sizes and industries will offer HSAs. Professional service firms like law firms, accounting, and engineering firms are particularly good candidates because HSAs give shareholder employees a means of paying for out-of-pocket costs with tax-deductible dollars.

What are the critical underwriting or participation requirements?

Among the core questions that employers will need to address are the following:

- Will an HDHP create adverse selection for the HMO and traditional PPO plans?
- How, if at all, does the HSA administrator coordinate with the HDHP provider (e.g., insurer) to streamline the transfer of claim activity information?

What's new in this area?

The passage of the Patient Protection and Affordable Care Act (PPACA) did result in some changes to HSA's. Effective January 1, 2011, non-prescription medicines (other than insulin) are no longer considered qualified items for reimbursement. Over the counter items, such as aspirin or ibuprofen, are not qualified expenses without a prescription. In addition, the penalty for non-qualified distributions from an HSA account was increased to 20%.

Despite these changes, Health Savings Accounts are expected to continue to grow in popularity. According to a census conducted by America's Health Insurance Plans (AHIP), as of January 2010 approximately 10 million people were covered by an HSA, an increase of approximately 25% since 2009. The census also revealed that between 2009 and 2010 group plans were the fastest growing market for HSA's, followed by small group coverage which grew by 22% within the same period. These statistics indicates HSA's will remain prevalent in the health insurance market and their popularity will continue to grow as employers look for ways to control escalating insurance premiums and implement plans which require employees to manage their own health care costs and consumption

How much does it cost?

The premium savings from implementing an HDHP will vary significantly depending on the plan design elements of the pre-existing HMO or PPO plans and the HDHP. Most payers will see anywhere from a 10% to a 30% reduction in premiums (prior to HSA funding). In many cases employers will target their initial HSA contribution to equal the difference between the premium for the new HDHP and what the premium would have been for a traditional PPO plan. This means that that the HDHP + HSA plan costs the same in the first year as a traditional PPO plan.

It is likely that the HSA account will have minimal or no administrative fees if it is offered as part of an employer provided package or if it is bundled as part of a larger investment portfolio. Investment management fees will apply depending upon the type of investment options elected and in most cases will approximate the fees charged inside of 401(k) style plans.

Benefit Fact Sheet

Informational link(s)

- IRS HSA Publications
 - [Notice 2004-2](#) — Questions & Answers on HSAs.
 - [Notice 2004-23](#) — Safe harbors for preventive care benefits
 - [Revenue Ruling 2004-45](#) — Clarifies how health FSAs and HRAs interact with HSAs. The guidance provides a number of ways that individuals may have access to benefits from FSAs and HRAs and remain eligible to contribute to an HSA.
 - Publication 969, Health Savings Accounts and Other Tax Favored Plans
- [Department of Labor FAB 2004-1](#) – HSAs and ERISA

Pros and cons

Pros

- Improved flexibility for employers and employees
- Improved prospects for long term health cost management
- New means for funding post retirement health insurance

Cons

- New communication challenges
- More moving parts create more opportunities for real and perceived problems
- Potential for adverse selection

Notes

- HSA contributions must cease once a person enrolls in [Medicare](#).
- [Cal-COBRA](#) premiums are not qualified HSA expenses.

This Fact Sheet is designed to provide a general overview of the benefit program, service, or regulatory act it describes. The information included in this document is not a substitute for legal or professional opinion relative to a plan sponsor's particular fact pattern. Your ArlenGroup consultant can answer more specific questions relative to its application for your organization. A menu of additional topics is available online at: www.arlengroup.com/facts.