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HEALTH SAVINGS ACCOUNTS

by
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HEALTH SAVINGS ACCOUNTS – WHAT EMPLOYERS WANT TO KNOW

With the skyrocketing cost of health care, many employers find themselves unable to provide their employees with the same level of health care coverage as in the past. Similarly, employees are struggling to meet the cost of health coverage and are concerned with how to finance such costs into retirement.

Given these concerns, many employers are turning to consumer driven health care options and are specifically offering high deductible health plans (HDHPs) coupled with health savings accounts (HSAs). Although HDHPs require the payment of a deductible prior to coverage kicking in, the premiums are much more affordable, allowing employer and/or employee contributions to be made with less financial burden. Similarly, participation in a qualified HDHP allows an employee to open an HSA, which is an individual portable account, to pay for most qualifying Section 213 medical expenses at any time. HSAs can be funded with after-tax contributions or with pre-tax contributions if the employer's cafeteria plan allows.

Although initial restrictions were placed on these accounts, they have become much more attractive recently with the passage of the Tax Relief and Health Care Act of 2006, effective January 1, 2007. HSAs were modified by no longer limiting the contribution amount to the lesser of the HDHP deductible or the statutory maximum. Now, HSA-eligible participants can fully fund their accounts to the statutory maximum (the 2008 limits are $2,900 for those with self-only HDHP coverage and $5,800 for those with family HDHP coverage; the 2009 limits are $3,000 for self-only and $5,950 for family coverage). Moreover, the law allows FSA, HRA and IRA rollovers into HSAs (with certain restrictions), provides for limited relief to HSA participants who would otherwise be disqualified for participating in a general health FSA grace period,[1] and allows participants to fully fund the HSA even if a participant joins the HDHP later in the plan year (subject to certain restrictions).

HSAs are becoming increasingly popular, and if not already, you will most likely be approached with employee requests for compatible coverage.

Please see page 3 for a quick reference to HSA Basics.

(*continued*)

[1] For example, the employee will not be disqualified if she or he has exhausted the FSA funds prior to the beginning of the grace period or if she or he makes a one-time FSA rollover (called a "qualified HSA distribution") to the HSA prior to the grace period (which, if properly adopted in a cafeteria plan, typically runs from January 1st to March 15th for calendar year plans). The employer can also consider amending its cafeteria plan to convert the health FSA to an HSA-compatible account (ie, limited-purpose and/or post-deductible health FSA account) during the grace period for all participants. This account could pay for such expenses as dental, vision and preventive care or any expenses incurred after the HDHP deductible is reached. Unfortunately, such an amendment must be applied to all participants, not just those who want to have an HSA (ie, participants cannot elect between the general and restricted accounts during the grace period). The affect is that those jumping into an HDHP will not lose HSA eligibility. On the flip side, those participants who are not in an HDHP can only be reimbursed for dental/vision/preventive care expenses during the grace period.

Comparability Rules for Employer Contributions to HSAs

If employers decide to contribute to their employees' HSAs, they must do so on a comparable basis (unless made through a cafeteria plan); otherwise a 35% excise tax will be imposed equal to the aggregate amount the employer contributed to all HSAs for that calendar year. Therefore, it is very important to follow these rules. The comparability rules do not apply to HSA contributions made within a Section 125 cafeteria plan; however, such contributions will then instead be subject to Section 125's nondiscrimination rules.[2]

In July 2006, the IRS released its final regulations on the HSA comparability rules, which specified that employers can contribute different amounts (or different percentages of the deductible) to the following categories of coverage without becoming subject to the excise tax: (1) single; (2) self plus one; (3) self plus two (cannot be less than employer contribution to self plus one); or (4) self plus three or more (cannot be less than employer contribution to self plus two). Under the previous proposed regulations, the only categories of coverage were single or family, so this provides an employer with more options. Contributions can also vary based on the category of employee (ie, part-time, full-time and former employees).

Moreover, in June 2007, the IRS released proposed regulations on comparable HSA contributions regarding (1) employees who have not opened HSA accounts by year end and (2) employers' acceleration of HSA contributions. Specifically, employers will not fail the comparability rules with regard to employees who have not established an HSA by year end if the employer provides written notification to such employees and provides comparable contributions plus interest to those who do open their accounts by the end of February. Additionally, an employer that accelerates contributions for the calendar year for employees who have incurred qualified medical expenses which exceed the employer's contributions at the time will not violate the comparability rules if they are available throughout the calendar year on an equal and uniform basis to all eligible employees.

Finally, in July 2008, the IRS released additional proposed regulations on the comparability rules with regard to (1) contributions for mid-year participants; (2) larger contributions to non-highly compensated employees; and (3) qualified HSA distributions.

If you are considering implementing an HSA-compatible HDHP, you should have your benefit structure reviewed by your attorney to ensure that all programs are compatible, that your cafeteria plans are properly amended, and that your benefit design is compliant with the comparability and/or cafeteria plan nondiscrimination rules. If you currently are operating a HDHP, be sure you are receiving legal updates as the law in this area is rapidly changing.

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[2] The IRS has recently released new proposed regulations on Section 125 plans, including much needed guidance on the nondiscrimination rules for cafeteria plans. See Prop. Treas. Reg. § 1.125-7. We anticipate much tighter enforcement of these rules; therefore, employers proceed with extreme caution if they decide to run non-comparable HSA contributions through their cafeteria plans.

HSA Basics

An "HSA eligible individual" means, with respect to any month, any individual who is:

- covered under a high-deductible health plan (HDHP) on the 1st day of month;
- not covered under any non-HDHP (with certain exceptions for plans providing limited types of coverage);
- not entitled to Medicare (generally, not yet reached age 65); and
- not claimed as a dependent on another person's tax return.

A qualifying HDHP is a plan that meets the following requirements for 2008:

- For individual coverage, it has an annual deductible of at least $1,100 ($1,150 for 2009) and annual out-of-pocket expenses not exceeding $5,600 ($5,800 for 2009);
- For family coverage, it has an annual deductible of at least $2,200 ($2,300 for 2009) and annual out-of-pocket expenses not exceeding $11,200 ($11,600 for 2009).

Generally, disqualifying non-HDHP coverage includes any plan that provides medical care prior to a $1,100/$2,200 (or $1,150/$2,300 for 2009) deductible being met.[3] For example, general HRA and health FSA coverage would disqualify an otherwise HSA eligible individual. However, certain exceptions exist if the plan documents are amended accordingly:

- Limited-Purpose Health FSA or HRA (allowing reimbursement of dental, vision and preventive care services);
- Post-Deductible Health FSA or HRA (allowing reimbursement of expenses incurred after the HDHP's deductible has been met);
- Suspended HRA (where an employee elects prior to the beginning of the plan year to "suspend" all reimbursement options for that year); or
- Retirement HRA (only allowing reimbursement of expenses post-retirement).

The 2008 maximum annual contribution to an HSA is:

- $2,900 ($3,000 for 2009) for those with self-only HDHP coverage;
- $5,800 ($5,950 for 2009) for those with family HDHP coverage; and
- Catch up contribution for individuals (and their spouses covered under the HDHP) between ages 55 and 65 is $900 in calendar year 2008 (and increases in $100 increments annually until it reaches $1,000 in calendar year 2009)

Also, certain taxes and penalties may be imposed on employees and employers who do not follow the rules:

- Distribution for non-medical expense - taxed plus 10% penalty tax
- Overfunding of an HSA – 6% excise tax on excess contributions (unless removed within a certain time period)
- Failure to make comparable contributions - 35% excise tax to employer of the aggregate amount contributed by the employer to HSAs for that period (except in the case of distributions made after the account beneficiary's death, disability, or attaining age 65)

[3] Certain permitted coverage, permitted insurance and preventive care services are excepted from this classification.

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