

DEFINED CONTRIBUTION HEALTH CARE ALPHABET SOUP:

HSAs, HRAs and FSAs

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Health Savings Accounts

- Tax-free accounts maintained in connection with a high deductible health plan (“HDHP”).
- Both employee and employer contributions permitted.
- Tax-free distribution for qualified medical expenses.
- Accounts are fully portable.

Health Savings Accounts (cont'd)

- Annual HSA contribution limit for 2007:
 - \$2,850 (individual coverage)
 - \$5,650 (family coverage)
 - \$800 (age 55 and over “catch-up”)
- Minimum HDHP deductible in 2007:
 - \$1,100 (individual coverage)
 - \$2,200 (family coverage)
- Maximum HDHP out-of-pocket limit in 2007:
 - \$5,500 (individual coverage)
 - \$11,000 (family coverage)

Health Savings Accounts (cont'd)

- Who can establish an HSA?
 - Individual or employer
- Eligible individual
 - Covered by HDHP
 - Not covered by another health care plan
 - Not eligible to be claimed as a dependent
 - Not enrolled in Medicare

Health Savings Accounts (cont'd)

- HDHP can provide “first dollar” coverage for preventive care.
- Safe harbor definition of preventive care:
 - Periodic health evaluations (including related tests and diagnostic procedures)
 - Routine prenatal and well-child care
 - Child and adult immunizations
 - Tobacco cessation and weight loss programs
 - Screening services
 - See IRS Notice 2004-23 for approved list
- Preventive care does not include any service or benefit intended to treat an existing illness, injury or condition.

Health Savings Accounts (cont'd)

- An HDHP may have different in-network and out-of-network benefits.
- A network HDHP can require charges for services provided outside network that exceed annual out-of-pocket limit.

Health Savings Accounts (cont'd)

- Remember: Eligible individual can be enrolled only in an HDHP.
- Exceptions:
 - Worker's comp
 - Coverage for tort liabilities
 - Coverage under property insurance (car or homeowners)
 - Specified diseases or illness policies
 - Insurance paying fixed amount for hospitalization policies
 - Accident or disability coverage
 - Dental, vision or long-term care coverage

Health Savings Accounts (cont'd)

- Prescription drug plans
 - Cannot “carve out” prescription drugs
 - Cannot offer “first dollar” or non-HDHP prescription drug coverage
- This is one of the reasons why HSAs have not been as popular.

Health Savings Accounts (cont'd)

- Contributions can be made by individuals, their family members or employers.
- Contributions must be made in cash.
- Beginning in 2007, contributions are not limited to the HDHP deductible.
- Catch-up contributions – OK for age 55 and over; will reach \$1,000 in 2009.
- Archer medical savings accounts can be rolled over into HSAs.

Health Savings Accounts (cont'd)

Comparability Rules:

- Employer HSA contributions must be “comparable” for individuals in same category of employment and same category of coverage.
- Employer categories:
 - Current full-time employees
 - Current part-time employees
 - Former employees (excluding individuals on COBRA coverage)
- Coverage categories:
 - Self-only coverage
 - Self plus one
 - Self plus two
 - Self plus three or more

Health Savings Accounts (cont'd)

Comparability Rules (cont'd)

- “Comparable” – Employer generally must make the same HSA contribution for all eligible employees either as a dollar amount or as a percentage of the deductible (dollars for family can thus be greater).
- Exceptions: Employer can make no or different contributions for part-time employees (customarily working less than 30 hours per week) and also can make greater contributions for employees who are not HCEs.
- Contributions that are not comparable are subject to a 35% excise tax.

Health Savings Accounts (cont'd)

- What are “qualified medical expenses”?
- HSAs cannot be used for insurance premiums, except for:
 - COBRA premiums
 - Health care coverage while individual is receiving unemployment compensation
 - Health insurance for individuals age 65 and over (but not for Medicare supplement coverage)
 - Qualified long-term care insurance

Health Savings Accounts (cont'd)

- Tax treatment of HSAs:
 - Individual contributions (up to the dollar limit) get an “above the line” deduction; no need to itemize.
 - Individuals can also contribute to HSA on a pre-tax basis, if the HSA is offered through a cafeteria plan.
 - Employer contributions excludable from income and not subject to income tax, FICA or FUTA withholding.
 - HSA earnings on “qualified distributions” are not income for federal income tax purposes.

Health Savings Accounts (cont'd)

- HSA Reporting Requirements
 - Employer – Contributions reported on Form W-2 using Code “W.”
 - Trustee/Custodian – Contributions reported on Form 5398; distributions reported on Form 1099-SA.
 - Account owner -- Must file Form 8889.

Health Savings Accounts (cont'd)

- States without same tax treatment as federal for HSAs:
 - Alabama
 - California
 - New Jersey
 - Wisconsin

Health Savings Accounts (cont'd)

- Excess contributions to HSAs:
 - Individual excess contributions are income to the individual, regardless of who made contributions; subject to 6% excise tax on the excess.
 - Treasury to provide excess contribution correction procedures.

Health Savings Accounts (cont'd)

- Qualified distributions for medical expenses of individual or family members are excluded from income.
- Nonqualified distributions are includable in gross income and subject to a 10% excise tax, unless payment made after death, disability or attainment of age 65.

Health Savings Accounts (cont'd)

- On death, if the spouse is the HSA account holder's beneficiary, he/she becomes the new account holder, and the decedent's estate gets a deduction for the HSA account.
- If there is a non-spousal beneficiary on death (including the decedent's estate), that beneficiary generally is subject to income tax on the account value.
- In separation or divorce situations, HSAs can be transferred to spouse or former spouse tax-free and spouse or former spouse becomes the account holder.

Health Savings Accounts (cont'd)

- Individual is not eligible to make HSA contributions if he/she is covered by a “general purpose” health FSA or HRA of either the individual or the individual’s spouse.
- Exception for:
 - “Post-deductible” FSAs and HRAs (reimbursements made only after HSA statutory minimum deductible is exceeded); and
 - “Limited purpose” FSAs and HRAs (only pays for benefits for “permitted coverage” or “preventive care”).
- “Permitted Coverage” – long-term care, dental or vision, accident or disability, insurance covering specific diseases or hospitalization.

Health Savings Accounts (cont'd)

- Contributions to an HSA are permitted:
 - If distributions from HRA are voluntarily suspended by individual, or
 - If the HRA covers post-retirement medical expenses (individual must suspend HRA contributions once he/she retires to keep contributing to HSA).
- Employers can contribute to HRAs during voluntary payment suspension period.
- Combination of HSA, FSA and HRA – OK to receive distributions from HRA or FSA before receiving from HSA, but:
 - Unless HRA provides a different ordering rule, HRA funds must be used before FSA funds.

Health Savings Accounts (cont'd)

Tax Relief and Health Care Act of 2006:

- One-time rollover of IRA assets can be made to fund up to one year's maximum HSA contribution.
- Increase in HSA contribution limits – may contribute up to the annual contribution limit, even if HDHP deductible is less than this amount.
- Allows full-year contribution to HSA even if individual enrolls in HDHP after start of year.
- One-time rollover of existing HRA or FSA funds into HSA (see next slide).
- Greater employer contributions permitted for lower-paid employees.

Rollovers to HSA

IRS Notice 2007-22

- One-time rollover from existing HRA or health FSA into HSA (through 2011).
- Maximum amount of rollover is lesser of:
 - HRA or FSA balance on 9/21/2006 or
 - HRA or FSA balance on date of transfer.
- Timing of rollover is critical
 - Individual must be covered by HSA on first day of month in which transfer occurs;
 - Rollover from general purpose health FSA must be made during grace period; and
 - Entire balance of general purpose health FSA or HRA must be rolled over.

Health Reimbursement Accounts

- HRAs are solely employer-funded – individual cannot contribute.
- Can be offered to current or former employees, including individuals electing COBRA coverage.
- Amounts in an HRA must be used for qualified medical expenses; HRA balances can be carried forward from year to year.
- Depending on terms of HRA, coverage may or may not continue after termination of employment.
- HRA benefits are not portable from employer to employer.

Health Reimbursement Accounts(cont'd)

- HRAs are unfunded – payments from and coverage under the HRA are excluded from income under IRC §§ 105 & 106.
- HRAs are subject to the nondiscrimination rules contained in IRC § 105(h).
- Although individual cannot contribute to an HRA, an HRA can be offered in conjunction with a cafeteria plan, but no carryover of HRA benefits is allowed in this situation.
- Medicare-eligible individuals can be provided with coverage under an HRA.

Health Reimbursement Accounts(cont'd)

- There is no requirement for HRAs that individuals covered not have other health insurance coverage.
- HRAs also do not have to be maintained in connection with an HDHP.
- There is this no minimum deductible requirement for HRAs, and HRAs can thus provide “first dollar” coverage for qualified medical expenses, and not just for preventive care.

Health Reimbursement Accounts (cont'd)

- With the exception of one-time rollover permitted under recent legislation, amounts available under HRAs cannot be rolled over to an HSA; thus, a contribution to an HSA from an HRA reduces the HSA contribution limit.
- An HRA established by a church employer is not covered by ERISA.

Flexible Spending Accounts

- FSAs are typically funded by the employer, or by the employee through salary reduction.
- FSAs can only be offered to employees (self-employed individuals are not eligible), including former employees and former employees with COBRA coverage.
- Amounts in FSAs can only be used for qualified medical expenses and, subject to a limited exception, cannot be carried forward (subject to a “use it or lose it” rule).
- FSAs are not portable from employer to employer.

Flexible Spending Accounts (cont'd)

- Like HRAs, payments from and coverage under an FSA are excluded from an employee's income under IRC §§ 105 and 106.
- Also like HRAs, FSAs are subject to IRC § 105(h) nondiscrimination testing.
- Employee contributions via salary reduction are not subject to income tax (or FICA or FUTA taxes).
- Medicare eligible individuals can be covered under an FSA.

Flexible Spending Accounts (cont'd)

- Like HRAs, there are no maximum deduction or exclusion rules for FSA contributions, other than that provided by the IRC § 105(h) nondiscrimination rules.
- For FSAs, qualified medical expenses are basically the same as for HSAs and HRAs, except FSAs may not be used to reimburse insurance premiums, including long-term care insurance.
- FSA accounts can only be used to cover qualified medical expenses and not for any other purpose.

Flexible Spending Accounts (cont'd)

- The HSA rules requiring linking to an HDHP do not apply to an FSA; thus, individuals participating in an FSA can have other health insurance coverage, and the minimum deductible rules applicable to HSAs do not apply; so “first dollar” coverage is not a problem, whether or not for preventive care.
- FSAs must operate like insurance; maximum coverage under the FSA must be available from day one of the coverage period, even if the covered individual has not contributed the required maximum to the FSA.

Flexible Spending Accounts (cont'd)

- Employees cannot change their FSA elections except in certain instances.
- Amounts unused in an FSA at the end of a coverage period must be forfeited if not used for expenses incurred by March 15 following a particular coverage year.
- Rollovers from FSAs are not permitted (except for one-time rollover to HSA).
- COBRA is inapplicable to FSAs that are maintained as part of a church benefit plan.