Health Savings Accounts 101

By

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Health Savings Accounts (HSAs) are all the buzz these days. Everyone wants to talk about them. Everyone thinks this may be *"the"* answer to the rising cost of healthcare. And, everyone thinks the premium savings associated with HSAs is the only consideration. However, the truth is that few truly understand what an HSA is and, more importantly, even fewer truly understand the overall costs associated with this new option.

HSAs are the result of Title XII of the Medicare Prescription Drug Improvement and Modernization Act of 2003, signed into law by President Bush in December 2003. An HSA is a consumer-oriented, tax-advantaged savings account that is always combined with a certain type of health insurance plan referred to as a High Deductible Health Plan (HDHP). The tax deductible contributions to an HSA, the tax free growth within an HSA and the tax free distributions of funds from the HSA provides the consumer control of when to use these funds to pay for qualified expenses, be it now or save them for use in the future.

The theory behind HSAs argues that by having the consumer save and spend their own money, healthcare expenditures will be questioned thereby bringing marketplace competition to the world of health care. The consumer can take all or a portion of the premium savings when purchasing a HDHP and use those savings to fund an HSA. The savings grows tax free to help pay for qualified future medical and retiree health expenses. The tax advantaged savings and the reduced taxable income can appeal to consumers of different income levels.

The key features of HSAs make them extremely appealing to a broad cross-section of the insured and uninsured population. Individuals and businesses alike are prime candidates for HSAs, which is unusual in new or legislated options. HSAs will:

- Enable the consumer to lower their healthcare premium expenditure via the purchase of a HDHP. The higher the deductible on your health plan, the lower the premium. And, depending upon your current deductible level, the savings could be 20% to 30% or more. (The 2012 minimum deductible to qualify as a HDHP is $1,200 for single coverage and $2,400 for family coverage.)

- Enable the consumer to set aside funds each year on a tax deductible basis to help offset the additional out of pocket costs associated with an HDHP.

- Enable the consumer to establish interest bearing or investment accounts for their HSA funds and permit account balances to roll over from year to year on a tax-free basis. The "use-it-or-lose-it" rule does not apply to HSAs.

- Enable the consumer to withdraw the funds tax-free for qualified medical expenses as covered under section 213(d) of the Internal Revenue Code.

- Provide flexibility in who can make contributions to the HSA. Individuals, family members and employers may make contributions to an eligible individual's HSA.

- Provide the consumer with more choices in financing health care expenses. They can decide how much to contribute, how much to use, which expenses will be reimbursed and what types of investments to utilize to grow the savings account.

- Permit individuals of all income levels to establish an HSA, as there are no income limits.

The total cost of an HSA includes a combination of three separate areas. To make an accurate comparison of an HSA to a more traditionally funded health insurance program, all three areas must be included.

First, acquire the premium of the HDHP and the administration cost of the HSA. This insurance product is the critical component in an HSA as nothing else can be set up or distributed without it. In 2007, a change was implemented to allow full contribution maximums when enrolled before 12/1 of the plan year. To avoid a tax penalty, one must remain eligible until 12/31 of the year following enrollment. In addition, HSA account trustees will have service fees associated with the use of the account.

Second, calculate the contribution amount permitted by the legislation. The maximum contribution amount limits will increase each year. There will always be an annual limit of the maximum contribution. In 2012 the maximum contribution for single coverage is $3,100 and $6,250 for family. If the account holder or spouse is age 55 or older there is a provision for additional catch up contributions that can be made. For 2011 the catch up contribution amount is $1000.

Note: The provision that limited the contribution to the amount of the deductible or the amount of the annual maximum whichever is less has been repealed. Effective January 1, 2007, the maximum contribution can be made regardless of the HDHP deductible amount.

Third, be prepared to pay for medical expenses out of pocket until enough funds in the HSA are available for distribution to reimburse for the expense. Depending upon the HDHP selected and the use of the health plan, it could take 18 to 24 months or longer before an account is fully funded to cover all of the out of pocket costs.

Employers of all sizes are researching and considering implementation of HSA's. The premium savings and flexibility appeal have sparked the interest of many. However, among the many advantages of implementing an HSA option are disadvantages that need to be seriously considered before a determination is made whether the plan is right for that particular employer and their employee population.

Some of the advantages to be considered are identified below. This is not intended to be a complete list as each employer will have different features and benefits that are advantageous or disadvantageous to them.

- Employers are not required to provide any additional reporting other than recording their contributions, if any, on the employee's W-2.
- Employers do not hold any fiduciary responsibility for the contributions that are made to an HSA. The account holder is completely responsible to monitor the maximum contributions permitted within the legislation and the assigned increases each year.
- Employers do not hold any fiduciary responsibility for the appropriate distribution of the funds for qualified medical expenses. The account holder is completely responsible to manage their accounts within the guidelines set up by the legislation and the Treasury Department. (Unqualified medical expenses will be subject to income tax and a 20% penalty until age 65 when the penalty goes away.)
- Employers are not required to make any contributions to an employee's HSA. However, if an employer contributes to one employee's HSA, that employer must contribute to all employees that have selected the HSA option.
- Employers are not required to pay any of the administrative expense associated with the establishment, use and maintenance of the actual Health Savings Account.
- Employers cannot limit what qualified medical expenses may be reimbursed. Employers do have this capability in other forms of funding arrangements such as Flexible Spending Accounts (FSAs) and Health Reimbursement Arrangements (HRAs).

Some of the disadvantages to be considered are identified below. This is not intended to be a complete list as each employer will have different features and benefits that are advantageous or disadvantageous to them.

- Employees or their spouses that have Flexible Spending Arrangements (FSAs) and/or Health Reimbursement Arrangements (HRAs) may be ineligible for an HSA unless they are "limited purpose" or "post-deductible".
- Employees or individuals immediately own the HSA. Once the funds are contributed to the account, they become the property of the accountholder regardless of who made the contribution.
- Employees retain ownership of their account and take the funds with them wherever they go if ever to change employment. This would include any funds as a result of employer contributions.
- Employees control how and when the funds are used. Employers cannot set parameters for eligible expenses or timeframes for distribution.

HSAs have eligibility requirements regarding the establishment of an account. In addition to participating in an HDHP, the consumer must not have health benefits under any other health plan that is not a high deductible; must not be eligible to be claimed as a dependent on another's tax return; and, must not be entitled to receive Medicare benefits. Further, the eligibility rules and contribution limits are applied on a month-to-month basis.

HDHPs and HSAs work in tandem to deliver and fund healthcare but should be thought of as two separate buckets. For **HDHPs,** the expense must be a covered benefit under the HDHP for it to apply to the plan deductible. For **HSAs,** the expense need not be a covered benefit under the HDHP to be eligible for distribution from the HSA account. However, the expense must be eligible as defined by Section 213(d) of the Internal Revenue Code. Examples of 213(d) eligible expenses include dental, vision, medical care, prescription drugs and over the counter medications. A full list may be obtained on the Treasury website at www.irs.gov under publication 502.

HSAs can be an effective tool in the fight against rising healthcare costs as long as the purchaser and accountholder understand all of the advantages and disadvantages associated with them. This article is not intended to provide a full analysis of every component and requirement of HSAs. Rather, it is intended as a crash course in some of their features and benefits with the understanding that more detail is needed to fully assess whether it makes sense in any particular situation.

Cheri Gillfillan is a health insurance expert with more than 25 years in the field in various capacities. Cheri and the rest of the staff at One Source Advisors, Inc. are available to discuss strategies, ideas and new approaches to health care. Please give One Source a call prior to your next renewal to see if their approaches to healthcare solutions are able to help. The One Source Advisors, Inc. staff is available toll-free at 866-270-2441.