SOCIETY OF ACTUARIES

Article from:

Taxing Times

May 2009 – Volume 5 – Issue No. 2

SO, WHAT ABOUT HSAs?

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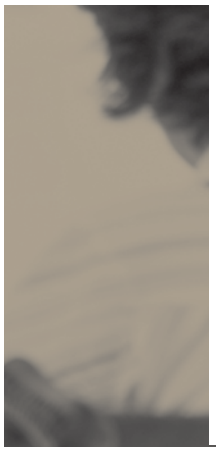

The economic crisis has certainly captured the attention of the media and, for that matter, everyone else as homes and jobs continue to be lost. With the new year in full swing, and a new administration in the White House, it will be interesting to see what actions are taken by President Obama and Congress for economic recovery toward financial stability. In addition, the details regarding President Obama's health care plan and universal coverage have not yet been revealed, so the future of individual health care coverage is currently unclear.

Employers have also taken action to maintain profitability or to stem financial losses. Many employers have cut both jobs and benefits, particularly health benefits. In recent years, employers have gradually increased the amount of health premiums required to be paid by employees, and the health plans being offered by employers are now providing streamlined coverage, with significantly higher deductibles and copayments. Unfortunately, the high deductible coverage offered by most employers is not provided through qualified "high deductible health plans" ("HDHPs") that would allow an employee to open a health savings account ("HSA"). As a result, only 2 percent of the individuals with private health insurance in 2006 were covered by HSA-eligible plans; which is much less than HSA advocates had envisioned.

SO, WHAT ABOUT HSAs, AND WHAT ARE THEY?

According to the U.S. Treasury—HSA Web site, "A Health Savings Account is an alternative to traditional health insurance; it is a savings product that offers a different way for consumers to pay for their health care. HSAs enable you to pay for current health expenses and save for future qualified medical and retiree health expenses on a tax-free basis."

The funds contributed to an HSA are not subject to federal income tax at the time of deposit. Although an HSA might appear to be similar to a flexible spending account ("FSA"), the funds contributed to an HSA are owned and controlled by the individual, not an employer, and they can accumulate tax free year after year. HSA participants can withdraw their funds at any time and for any reason, without approval from their employer, the insurance company or the HSA trustee. If withdrawn funds are used for something other than qualified medical expenses, the amount of such funds is subject to income tax *and* a 10 percent penalty; however, if the HSA participant has reached the age of 65 or is disabled at the time of the withdrawal, the 10 percent penalty is waived.

Internal Revenue Code ("IRC") §223, entitled "Health Savings Accounts," was created by Public Law 108-173, the "Medicare Prescription Drug, Improvement and Modernization Act of 2003," which was signed into law by President Bush on Dec. 8, 2003. Since their inception, HSAs have been viewed as a way for millions of individuals to meet their current and future health care needs because they are designed to help save for qualified medical and retiree health expenses on a tax-advantaged basis.

In general—and from a practical standpoint—HSAs offer a great way for individuals to pay for qualified medical expenses with pre-tax income both before and during retirement. Currently, HSAs are far more tax favored than any other health or retirement account. Contributions from an employee or an employer may be made on a pre-tax basis, and individual contributions to an HSA are tax deductible. The investment income earned on an HSA is earned on a tax-deferred basis. Withdrawals from an HSA are not subject to income tax if made for qualified medical expenses, including dental and vision care. Finally, when a person dies, any remaining funds in the HSA can be transferred tax free to a surviving spouse. In effect, HSAs provide a triple tax advantage—deductible, deferred and tax-free withdrawals (with some restrictions).

HOW DO I QUALIFY FOR AN HSA?

To be an eligible individual and qualify for an HSA, you must be covered under an HDHP on the first day of the month. In addition, you cannot have any other health coverage, except for certain types of permitted coverage; and, you cannot be enrolled in Medicare. Finally, you cannot be claimed as a dependent on someone else's federal income tax return.

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A qualifying HDHP has a higher annual deductible than other health plans, and as a result, such plans typically charge a premium that is approximately 50 percent less than certain other types of coverage. Unlike some HDHPs, a qualifying HDHP must have a maximum limit on the sum of the annual deductible and the out-of-pocket medical expenses, which includes copayments and other amounts but not premiums. The minimum and maximum annual deductibles and the other out-of-pocket amounts are adjusted for inflation and determined annually. Finally, although the HDHP may provide preventive care benefits without a deductible, such care is limited to certain specific types of benefits.

Although many people incorrectly believe that qualifying HDHPs, by definition, do not provide first-dollar coverage, a July 2007 industry survey conducted by the America's Health Insurance Plans ("AHIP") found that "84% of the HDHPs purchased in the group and individual markets provide first-dollar coverage for preventive care." This was true for 99 percent of the policies in the large-group market, 95 percent of small-group plans, and 59 percent of plans purchased by individuals.

For an individual or a family that has coverage from only one health plan, the HSA and HDHP rules discussed here are relatively straightforward. First, your health plan must qualify as an HDHP. For 2009, this means a self-only plan must have a deductible of at least $1,150 and a maximum out-of-pocket amount of $5,800. For a family plan, which includes the typical family plan as well as employee and spouse, and self-plus-one, the amounts are $2,300 and $11,600, respectively. Keep in mind that the deductible must apply to all medical expenses before any insurance coverage or employer reimbursement is received. If your plan is an HDHP you may contribute up to $3,000 to a HSA for self-only coverage and $5,950 for family coverage. For individuals age 55 and older, an additional $1,000 annual "catch-up" contribution can also be made.

WHAT ABOUT SPOUSAL COVERAGE?

If you and your spouse have health coverage under more than one plan, the rules get more involved and you need to closely examine your coverage. Your employer likely will not know about your other coverage and may be of little help in determining what you should do. Unfortunately, under certain circumstances, a well-intentioned HSA contribution from your employer could potentially result in an excess contribution and a 6 percent excise tax unless the amount of the excess contribution from your employer is included as additional compensation on your Form W-2.

The first thing you must do is examine the health insurance policies under which you receive coverage. Do any of them not meet the HDHP requirements? If so, you are not eligible to make contributions to an HSA. For example, if you have self-only coverage under an HDHP plan through your employer, but you are also covered by your spouse's first-dollar coverage plan, you are not eligible to contribute to an HSA.

Once you have determined that both you and your spouse are HSA-eligible individuals, the amount you each may contribute to an HSA depends on the type of plans you have. If you both have self-only coverage, you can each contribute up to $3,000 into your own HSA. If at least one of you has family coverage, then your total combined contributions are limited to the family coverage limit of $5,950. The amount each spouse contributes to a separate, individual HSA can be determined by agreement. If only one spouse is an eligible individual then that spouse may contribute to an HSA based on the type of coverage they have, either self-only or family.

WHAT HAPPENS IF I LOSE MY JOB?

Currently, many employees are finding themselves in the unfortunate situation of having lost their job. In certain situations, health coverage may continue to be provided by their employer for a short period of time. The Consolidated Omnibus Budget Reconciliation Act of 1985, better known as COBRA, generally requires employers, with a group health plan for 20 or more employees, to provide former employees and dependents with the opportunity to continue group health coverage for a limited period of time. Many rules apply to COBRA benefits; however, in general, the continuation coverage must be the same and the "applicable premium," which

is typically paid in full by the employee, is equal to or slightly more than the cost to the plan of providing coverage.

It is permissible for a terminated employee to pay the "applicable premium" for COBRA coverage with funds withdrawn from an HSA. Although qualified medical expenses generally exclude payment for insurance premiums, an exception is also provided for health coverage for a spouse or dependent during any period of continuation coverage. In addition, a similar exception is provided for the expense of coverage for a spouse or dependent during a period in which an individual is receiving unemployment compensation.

If an employee previously had coverage under an HSA-eligible HDHP, the employee can continue to make tax deductible HSA contributions provided the employee pays the "applicable premium" and such qualifying HDHP coverage continues. Since the HSA contribution limits are calculated on a monthly basis, the employee needs to ensure that the annual maximum HSA contribution has not already been reached before making additional contributions.

WHAT ABOUT RETIREMENT?

It has been estimated that a couple retiring at age 65 might need $200,000 or more to pay for health care costs after retirement. As previously mentioned, after you turn age 65, funds can be withdrawn from the HSA at any time and for any reason without penalty since the penalty is waived after age 65; however, if the withdrawn funds are used for something other than qualified medical expenses, the amount of such funds is subject to income tax. HSA funds can be used to pay premiums for Medicare Part A, B or D and for qualified long-term care insurance for the participant, spouse and dependents without being subject to tax; however, HSA funds may not be used to pay Medicare supplement insurance premiums.

Although Medicare premiums can be paid from existing HSA funds, no additional contributions can be made to an HSA after an individual becomes eligible *and* actually enrolled in Medicare Parts A, B, and/or D. According to IRC §223(b)(7), an individual who is enrolled in Medicare is not an eligible individual in any month during which the individual is enrolled in Medicare.

WHAT'S NEW WITH HSAs?

During 2008, a plethora of information regarding HSAs was released, including a detailed report from the U.S. Government Accountability Office ("GAO") regarding HSA participation; and, a significant amount of technical guidance from Treasury. According to findings from the April 2008 GAO study and related testimony provided on May 14, HSA-eligible plans increased from 438,000 in September 2004 to 6.1 million in January 2008. However, in spite of this rapid growth in qualifying HDHPs, 42 percent to 49 percent of the HSA-eligible enrollees from 2005 to 2007 did not open an HSA; and, just as amazing, 20 percent to 24 percent of the enrollees do not intend to open an HSA due to their inability to afford contributions, or a belief that they did not need one.

Based upon that statistic, it appears that the enrollees—whether as employees or as individual subscribers—were not provided with the necessary information to make the right decision to open an HSA. Although the health insurance industry could do a better job in educating its subscribers about the many financial benefits from opening an HSA, it appears that employers are also partly to blame for the lack of enthusiasm for HSAs. According to the Kaiser Family Foundation/Health Research and Education Trust 2007, two-thirds of employers offering single coverage through HSA-eligible HDHPs made no contributions to HSAs for their employees.

The GAO also reported some interesting income statistics with respect to HSA enrollees, based upon their detailed review of IRS data: the average adjusted gross income ("AGI") for HSA enrollees or those reporting HSA activity in 2005 was approximately $139,000, compared to $57,000 for other filers; and, 59 percent of HSA filers had an AGI of $60,000 or more, compared to 26 percent of other tax filers. Finally, with respect to HSA contributions and distributions in 2005: average contributions were $2,100, compared to average withdrawals of $1,000; and, 41 percent of the enrollees did not withdraw any HSA funds,

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compared to 22 percent that withdrew all or more than their reported contributions.

Although some commentators state that the income statistics cited by the GAO show that HSAs are a highly tax-advantaged savings vehicle for high income individuals with low expected use of health care, this should not be construed as a bad result. Those statistics seem to reflect an expected demographic in that older workers with higher AGIs and grown children would be more interested, as early adopters, in lower cost coverage provided under HSA-eligible HDHPs since they typically have more control over their health care costs than families with young children. Taking advantage of an opportunity to save for health care costs that are expected to be incurred during retirement is a good result.

The Treasury Department ("Treasury") and Internal Revenue Service ("IRS") have issued a significant amount of formal guidance since 2003 when HSAs were first created, and they have done an excellent job in responding to developing issues on a relatively timely basis. Most of this formal, technical guidance, as well as additional information regarding HSAs, including HSA Basics, FAQs, Fact Sheet: Dramatic Growth of HSAs, the 2009 HSA indexed amounts, and Labor Department guidance can be found on the Treasury—HSA Web site at: *http://www.treas.gov/offices/public-affairs/hsa/*.

The GAO report seems to indicate that HSAs are predominantly being utilized by wealthy individuals with AGIs greater than $60,000; however, the Treasury Fact Sheet puts a slightly different spin on it by stating that 42 percent of the individuals or families buying HSA type insurance on their own in 2005 had incomes below $50,000, and nearly 50 percent are age 40 or over. In addition, the Treasury Fact Sheet notes that 31 percent of the HSAs are held by previously uninsured individuals that are now buying their own health insurance. Similarly, 33 percent of the HSAs are being offered through small businesses that previously did not offer any health coverage.

During 2008, the HSA-specific technical guidance issued by the Treasury and the IRS included the following: final regulations under IRC §4980G (T.D. 9393, dated April 17); Revenue Procedure 2008-29, May 13, the 2009 HSA and HDHP indexed amounts; Notice 2008-51, June 3, one-time, tax-free transfer from IRA to HSA; Notice 2008-52, June 3, implements changes in the annual HSA contribution limits; and, Notice 2008-59, June 25, HSA "grab-bag" containing more than 40 new frequently asked questions and answers covering a wide-range of topics.

SO, WHAT'S THE FUTURE FOR HSAs?

For numerous reasons, HSAs make good sense from a health policy perspective, particularly during difficult economic times. Introducing consumer-driven supply and demand, and controlling health care inflation were key drivers for the initial legislation and those drivers are still important today, perhaps even more so. The premiums for qualifying HDHPs are typically 50 percent less than premiums for traditional first-dollar coverage. As a result, more employers will provide such coverage to their employees, and individuals are better able to afford some form of health coverage, as opposed to being uninsured.

Although many critics are concerned that wealthy enrollees will use HSAs to accumulate tax-advantaged savings, it is prudent to save for future health care costs that might be incurred during a period of employment, unemployment, or retirement. There are currently a number of unemployed individuals that likely would have appreciated the opportunity to fund an HSA with pre-tax dollars to help pay the COBRA premiums they are now paying.

According to the Treasury HSA Fact Sheet, based upon current law, there could be a total of 14 million HSA-eligible policies by 2010, covering 25 to 35 million people. Although there have been several legislative proposals that could impact the growth of HSAs, it appears there are no current proposals that would significantly encourage, or restrict, the growth of HSAs. Perhaps this will change.

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