

## Overview of HSA Options

Health savings accounts (HSAs), the savings vehicles introduced by the Medicare Modernization Act (MMA)<sup>1</sup> that allow accumulation of assets for health expenditures, are alluringly tax-effective, but are not as simple as they seem at first glance. This *Executive Letter* describes key features of HSAs and discusses characteristics that make employers attracted to — and also wary of — this new health plan design feature.

### How Do HSAs Work?

The concept is simple: HSAs allow individuals (except those eligible for and enrolled in Medicare), employers or both to make pre-tax deposits into an account in which investment earnings and distributions used to pay for qualified health expenses are not taxed *ever*. These three features — pre-tax deposits, tax-free growth and untaxed distributions — make HSAs uniquely tax-effective vehicles for funding health care expenditures. In contrast, although §401(k) plans also provide for pre-tax deposits and tax-free growth, §401(k) funds used to pay for medical expenses during retirement are taxed like ordinary income.

Additionally, distributions from HSAs made for purposes *other* than paying qualified health expenses are subject to tax (and surtax if withdrawn before age 65 for non-health expenses) just

like other tax-favored savings vehicles, such as §401(k) plans.<sup>2</sup> Employers will appreciate the ability of this surtax to discourage employees from dipping into their HSA accounts for non-health expenditures during their working years. After age 65, however, such HSA distributions are only subject to ordinary income tax because the *surtax* does not apply to non-qualified expenditures after that age.

Employers will also appreciate that employees can contribute to HSAs. This contrasts with health reimbursement arrangements (HRAs) to which only employers contribute.

*“Perhaps the most appealing characteristic of HSAs from the employees’ perspective is their portability.”*

Employees will welcome the fact that they can accumulate money in HSAs, in contrast to flexible spending arrangements (FSAs), which are subject to the use-it-or-lose-it rule. Perhaps the most appealing characteristic of HSAs from the employees’ perspective is their portability. Unlike any other form of employer-supported health coverage, employees can take their HSA accounts with them wherever they go. The accounts truly belong to them, like their individual retirement accounts, even if the employer has contributed to them.

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HSAs can also be used to pay premiums on a pre-tax basis for coverage that cannot be funded by some other pre-tax medical spending vehicles. For example, a long-term care insurance premium can be funded with withdrawals from an HSA but not from an FSA.

### WHAT’S THE CATCH?

In order to contribute to an HSA (or to have contributions made to his/her HSA), an individual needs to be enrolled in a qualified, high-deductible health plan (HDHP), defined in the MMA as having (among other things) a minimum deductible of \$1,000 and a maximum out-of-pocket exposure of \$5,100 for individual coverage in 2005.<sup>3</sup> Not only must an individual be enrolled in an HDHP to contribute (or have funds

<sup>1</sup> MMA is the abbreviation used by the Centers for Medicare & Medicaid Services for the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law No. 108-173).

<sup>2</sup> The age limit for early distributions from §401(k) plans is 59½, not 65.

<sup>3</sup> Separate amounts apply for families. In 2005, the annual deductible for family coverage is \$2,000 and the maximum out-of-pocket expense is \$10,200. See the table on page 2. The amounts for individuals and families will be indexed annually.

**2005 MINIMUMS AND MAXIMUMS FOR HIGH-DEDUCTIBLE HEALTH PLANS, HEALTH SAVINGS ACCOUNTS AND ARCHER MEDICAL SAVINGS ACCOUNTS**

**2005 Minimums and Maximums for HDHPs Required for HSAs and Archer MSAs**

	HDHP Required for HSAs	HDHP Required for Archer MSAs
<b>Individual Coverage:</b>		
Minimum Deductible	\$1,000	\$1,750
Maximum Deductible	None	\$2,650
Maximum Out-of-Pocket Expense*	\$5,100	\$3,500
<b>Family Coverage:</b>		
Minimum Deductible	\$2,000	\$3,500
Maximum Deductible	None	\$5,250
Maximum Out-of-Pocket Expense*	\$10,200	\$6,450

**2005 Maximum Annual HSA Contributions**

<b>Individual Coverage**</b>	Lesser of HDHP deductible or \$2,650***
<b>Family Coverage</b>	Lesser of HDHP deductible or \$5,250****

\* The out-of-pocket expense does not include premiums.

\*\* Individuals age 55 or over by the end of 2005 can contribute an additional \$600 to their HSAs for 2005.

\*\*\* This amount is pegged to the Archer MSA deductible limit for individual coverage.

\*\*\*\* This amount is pegged to the Archer MSA deductible limit for family coverage.

contributed by an employer) to an HSA, but the HDHP must be that individual's only source of health coverage.

In addition to having to enroll in less comprehensive health coverage, which may be a significant drawback for lower- and middle-income employees, especially those with health problems in their families, from the employees' perspective, the fact that annual employee and employer contributions to HSAs are capped may also detract from the appeal of this savings vehicle. The maximum annual HSA contribution considers *both* the employee's contribution and any contribution made by the employer, and is limited to the lesser of the following two amounts: (1) the annual amount contributed cannot exceed

the deductible amount for the associated HDHP (*i.e.*, \$1,000, if the HDHP is the most generous allowed) and (2) the maximum contribution permitted for an Archer MSA<sup>4</sup> (*i.e.*, \$2,650 in 2005 for individual coverage).<sup>5</sup>

Employees may also be disappointed that they cannot use their FSAs to pay for expenses incurred in satisfying the HDHP's high deductible and that few benefits can be provided on a first-dollar or co-paid basis "in front of" the deductible. The high deductible is meant to represent a significant hurdle before the HDHP begins paying benefits (although withdrawals from an HSA that are spent on health care can be used to satisfy the deductible).

HDHPs can provide preventive benefits, but only certain benefits can be provided before the deductible applies. Prescription drug cards that pay 100 percent after a copayment cannot be offered as part of the HDHP (except during a short transition period ending December 31, 2005). The good news is that a long list of wellness and preventive care services can be covered by the HDHP at 100 percent, outside of the high deductible. Such services include mammograms, routine physicals and immunizations.

**WHAT KIND OF EMPLOYEES WILL BE ATTRACTED TO HSAs?**

Although HSAs have a number of advantages, the high deductible will detract from their appeal to certain employees. The economics of HSAs suggest that employees with the following characteristics are likely to be attracted to HSAs:

➤ **Individuals in Relatively Good Health** An individual who expects

to have little or no health care expenditures in a given year will have relatively more confidence that he or she will not need to draw on the funds contributed to the HSA to pay for health care expenditures and, therefore, will be able to use the HSA contribution as part of a longer term health care savings strategy.

➤ **Individuals Who Can Afford to Pay the Plan's High Deductible**

In the event that a participant in an HDHP has significant (and, presumably, unexpected) health care expenditures, he or she will need to be able to pay the plan's high deductible out of pocket, or miss out on the opportunity for tax-free growth of funds in the HSA by making a withdrawal from the HSA. This suggests that HDHPs/HSAs will have greater appeal to higher income individuals. It is also likely that higher income employees have "optimized" their §401(k) plan contribution and are looking for ways to save additional money on a tax-advantaged basis.

➤ **Younger Employees** The real power of a savings vehicle such as an HSA is the ability to accumulate funds over a long period. As with a §401(k) or other retirement-focused savings vehicles, HSAs will be most effective if they are funded annually, and if the balance is able to accumulate investment earnings without withdrawals, over a long period. This phenomenon should make HSAs relatively more appealing to individuals who are knowledgeable about the merits of long-term savings, disciplined about saving and have a long time horizon before expecting to need the funds.

Employers will need to think carefully about who will be attracted to HSAs within their employee populations. This is particularly true if HSAs are offered as an option alongside

<sup>4</sup> An Archer MSA is yet another variety of individual health savings vehicle, one whose availability is severely limited.

<sup>5</sup> Like the deductible and out-of-pocket limits for HDHPs, the \$2,650 maximum HSA contribution will be indexed each year.

traditional plans. The above characteristics suggest that optional HDHP/HSA plans will be subject to adverse selection, drawing off the healthy, the young and the highly paid and leaving those with more serious or imminent health needs in the employer's traditional plan. The selection will likely be less severe than the typical selection experienced by the introduction of a HDHP alone (without HSAs). The tax-advantageous nature of HSAs generates broader appeal and may serve to limit the degree of selection.

### IS AN HDHP WITH HSAs A GOOD FIT FOR MY ORGANIZATION?

HSAs are likely to be particularly attractive to law firm partners, other self-employed individuals and owners of small businesses because they provide a way to shield more income from tax. For family-owned businesses, HSAs can be used to compensate family members tax-effectively through HSA contributions. In addition, depending on their workforce demographics, larger employers may also be interested in offering HSAs as a low-option plan for employees that need less insurance than their co-workers.

Some of the reasons why HSAs may appeal to employers are described below:

- ***HDHPs Already in Place*** Employers with multiple health plan options may already offer a plan that could be easily converted into a qualified HDHP. The requirements are quite extensive to be a qualified HDHP and should be reviewed carefully. Adding the HSA feature will allow the employer to enhance the attractiveness of its HDHP option.
- ***Opportunity to Reduce Payroll Taxes*** HSA contributions (whether made by the employee or the employer) are not subject to payroll taxes. This provides an incentive for employers to set up the plan on a payroll-deduction

basis so the employer can capture those savings, as opposed to encouraging employees to establish HSAs on their own (in which case employees would deduct their contributions as an above-the-line deduction on their personal income taxes and, perhaps, get a refund of excess payroll taxes withheld by the employer).

- ***Role in a Consumer-Driven Health Strategy*** HSAs may be more appealing than HRAs as part of a consumer-driven health strategy because they are actually funded accounts. Employees using their HSA funds to pay for medical care are using *their own* money, not just the employer's money.

Some employers are likely to be more cautious. The following are employers' chief concerns about HSAs:

- ***Potential Clash with the Corporate Culture*** If an HDHP replaces conventional managed care plans, such as preferred provider organizations (PPOs), point-of-service (POS) plans or health maintenance organizations (HMOs), it would represent a significant change in benefit philosophy for many employers. For this reason, as initial experience is showing, HDHP/HSA plans are being offered as an optional form of coverage. By pooling costs, traditional medical coverage entails cross-subsidies, with low users of health care services helping to fund the expense of high users. HDHPs reduce the level of this subsidy since high users will experience higher out-of-pocket costs and will be less likely to accumulate significant amounts in their HSAs. It will also leave lower income employees with less protection.

**“HSA contributions (whether made by the employee or the employer) are not subject to payroll taxes.”**

- ***Additional Cost of Making HSA Contributions*** If an employer elects to contribute to employees' HSAs, those contributions are real, *fully funded, immediately vested and portable*. Unlike HRAs, for which no cash needs to be put up until claims are submitted (pay-as-you-go funding), rollover amounts can be limited, and forfeitures are possible, HSA contributions represent a real and irrevocable employer outlay. In other words, they can be expensive. In addition, employers that choose to fund employees' HSAs have little latitude in determining how much to fund. Employers may only contribute a flat-dollar amount or a fixed percentage of the deductible for all participants unless the HSA is part of a cafeteria plan. In that case, employers may make matching contributions or incentive payments, which need to be controlled carefully because they are subject to the §125 non-discrimination rules. In addition, because of the need to establish and oversee management of actual accounts, the administrative costs for employers could be higher for HDHP/HSA options. Of course, these costs could be passed on to participants. Also, an employer cannot control what the money is used for and the flip side of portability is that an account funded by employer A may help an employee who changes jobs fund her health coverage from employer B.
- ***Ability to Accomplish Similar Objectives by Using an HRA*** Many employers looking at HSAs have decided that an HRA can accomplish similar goals regarding increasing consumer awareness of health care. Moreover, if an HRA is coupled with a consumer-driven health plan, there is no automatic minimum deductible requirement as there would be with an HSA — the employer can define “high deductible” however it wishes. In addition, plan design rules

for HRAs are extremely flexible, withdrawals from HRAs can be allowed only for qualified medical expenses, they do not have to be funded, and employers do not have to allow employees to keep their accounts even if they change jobs (subject, of course, to COBRA).

➤ **Inability to Limit Use of HSA Dollars to Pay Health Expenses** As noted above, individuals may use HSA money to pay non-qualified health expenses, subject to tax and, if under age 65, surtax. Employers are concerned that funds contributed by the employer to be used to pay health costs may be used for other purposes, contrary to the employer’s intent and outside the employer’s control.

Before deciding whether to introduce an HDHP with HSAs, employers may want to consider how the benefits — and shortcomings — of HSAs compare with those of other health spending or savings vehicles, such as HRAs and FSAs.

**IF WE DECIDE TO OFFER AN HDHP WITH HSAs, WHAT’S INVOLVED?**

Unlike other types of structured health-care savings vehicles for employees, HSAs do not require an employer-sponsored or employer-provided vehicle. While an employer may choose to offer one or more HSA options, and can then offer the convenience of automatic funding through payroll deductions, there is no obligation — and in a sense no need — for an employer to provide such an option. An individual participating in an HDHP may open an HSA with any financial organization that offers them. In that case, the employer would not save the payroll tax on the employee contributions to the HSA. So far the types of employers that have adopted HSAs or indicated

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an interest in doing so are largely the ones one would expect: banks, money management companies and insurance companies. If HSAs become more popular and total dollars being contributed to them increase, it is likely that, the number and diversity of HSA products will also increase.

As with §401(k) plans, employers can increase the likelihood that employees will take full advantage of HSAs if they provide clear, concise, consistent and continuous communications to explain the employees’ future need for resources to pay for health care and the advantages of the new savings vehicle. Prior to developing a communications plan and timeline, it is important to provide context about why you are offering HDHP/HSAs and assess your employees’ levels of understanding to determine the best approach, messengers and media to deliver the information. As experience with consumer-driven health plans that use HRAs has shown, the success of HDHP/HSAs is likely to be closely linked to the extensiveness of the communications campaign used to introduce them.<sup>7</sup>

Although debit cards that will ensure appropriate adjudication (*i.e.*, application of the correct discounts) are being developed, the “point-of-sale” technology that is common among prescription drug plans is not fully perfected for broader based medical plans. Debit cards work well for FSAs, but HSA administration at point-of-sale is still

a bit awkward and may generate employee dissatisfaction.

**CONCLUSION**

The employee-employer relationship is changing. Large increases in health care costs have made it difficult for employers to continue to treat health coverage as an entitlement. The movement from “entitlement” to “shared-responsibility” in how benefits are provided is under way. HSAs represent one alternative that some employers can use to engage employees in the health care purchasing process.



*For more information on or assistance with HSAs and HDHPs, contact your Segal Company benefits consultant or John Asencio at 212.251.5085 or [jasencio@segalco.com](mailto:jasencio@segalco.com)*

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<sup>6</sup> The Segal Company has prepared a chart comparing FSAs, HRAs and HSAs. It is available, in PDF format, on the following Web page: [http://www.segalco.com/publications/presentations/FSA\\_HRA\\_HSA\\_chart.pdf](http://www.segalco.com/publications/presentations/FSA_HRA_HSA_chart.pdf)

<sup>7</sup> In late 2004, The Segal Company conducted a survey of employers that had offered a consumer-driven health plan for at least one year, which confirmed the importance of communications on the success of this plan design. A report of the highlights of Segal’s *Survey of Consumer-Driven Health Plans* is available on the following Web page: <http://www.segalco.com/publications/surveysandstudies/spring05CDHP.pdf>