

CONSUMER DRIVEN HEALTH CARE

The Solution To Rising Health Premiums



An Overview of:

**Health Reimbursement
Arrangements**

Health Savings Accounts

Flexible Spending Accounts

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An Introduction to Consumer Driven Health Care

Flexible Spending Accounts (FSAs): The idea of consumer driven health care is not new. It started with the Tax Reform Act of 1978 and the enactment of cafeteria plans under Internal Revenue Code section 125 effective January 1, 1979. Because many small employers were unable to match their larger rivals in offering employees a smorgasbord of benefits to choose from, including a “cash-out” option, Flexible Spending Accounts (“FSAs”) were created and officially sanctioned in March, 1984 by the IRS.

In addition to allowing employees to set aside up to \$5,000 per calendar year per household for adult or child care expenses, health FSAs allow employees to deduct pre-tax salary to pay for co-insurance, deductibles, mileage and lodging related to medical care and over-the-counter drugs for themselves, their spouse and dependents (including domestic partners).

The drawback to FSAs was that unclaimed amounts were forfeited (“use-it or lose-it” rule). But, on 5/18/05 the IRS issued Notice 2005-42 allowing participants to rollover funds and incur expenses for up to 2-1/2 months in the new plan year exhausting prior contributions.

Health Reimbursement Arrangements (HRAs): HRAs are also not a new phenomenon since they are a form of self-funding under Code section 105(h). HRAs are funded solely by employers. These plans have been around for over 50 years and in practice, operate like employer-funded health FSAs. According to U.S. Department of Labor attorney Susan Abelson, HRAs present the easiest way for employers to control rising premiums since they can pick and choose the benefits they want to fund.

Health Savings Accounts (HSAs): HSAs represent the newest type of health plan within the consumer driven movement and are akin to medical IRAs. They were created by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, effective 1/1/04.

Which approach is best? Individuals and employers with young employees should consider **HSAs** since the premiums are low and contributions can be made pre-tax through an FSA under federal tax law and in most states. Employers may also contribute to the employees’ accounts either as a flat amount or a percentage based on the employees’ contributions - like a 401(k). The main concern with HSAs involve the cost for co-payments and deductibles along with the tax implications for improper HSA usage. **HRAs** fit the entire size range of employers, from small to very large, because the employer’s reimbursement risk is determined in advance and therefore predictable. Unused funds may be carried forward to subsequent plan years, but is not required.

FSAs provide tax savings for both employees and employers and are a perfect compliment to both HSAs and HRAs (see page 7 for details about coordinating all the consumer driven health care plans).

About Trust Administrators, Inc.

The firm was founded in 1984 by Royce A. Charney, J.D., a former official with the U.S. Department of Labor’s Pension Welfare Benefit Administration in San Francisco. While at the DOL, starting in 1979, Mr. Charney worked with the IRS, FBI, Comptroller of the Currency and other agencies regarding the administration and enforcement of the Employee Retirement Income Security Act of 1974 (“ERISA”).

Mr. Charney provided technical advice to other attorneys, union officials, employers, employees and brokers regarding health and retirement benefits. Most issues centered around fiduciary duties and prohibited transactions under ERISA, but also involved investments and overall benefit plan compliance. During this time, Mr. Charney provided local litigation support for the Labor Department’s solicitor and worked on some of the most prominent and complicated cases on the West Coast.

Over the last 26 years, Mr. Charney has authored numerous articles about employee benefits. He also conducts continuing education seminars for certified public accountants and insurance agents throughout California. Today, the firm has grown into one of the premier administrators for cafeteria, commuter, self-funded dental and vision plans, health reimbursement and health savings accounts.

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Part One: Plan Design & Tax Issues

Health Reimbursement Arrangements (HRA)

Health Savings Accounts (HSA)

Flexible Spending Accounts (FSA)

Plan Requirements and Eligibility Rules

Any HMO, HSA, PPO, POS or indemnity plan may have an HRA feature per Code §105(h). Some carriers have specific HRA plans.

May cover expenses for: employees, retirees, COBRA qualified beneficiaries, spouses and dependents (and domestic partners - note the tax consequences if not dependent for income tax purposes), Notice 2002-45 (6/26/02), PLR 910960.

Limited by statute. Plan must be a High Deductible Health Plan (HDHP) with at least a \$1,000 deductible for individual (maximum of \$5,000 total out-of-pocket other than premiums) and a deductible of \$2,000 for family coverage (\$10,000 total out-of-pocket cap). IRC §223(c)(2)(A), IRS Notice 2004-2, Q&A 7.

Out of network plans may exceed the deductibles noted above and still qualify as an HDHP. IRC §223(c)(2)(D).

If spouse is covering individual under a non-HDHP, individual may not participate in HSA. However, coverage for accidents, disability, dental, vision, or long-term care is allowed - referred to as "permitted" coverage. IRC §§223(c)(1) and (1)(B), Rev. Rul. 2004-38.

Qualified Expenses

Co-pays, dental, vision, chiropractic, mileage, over-the-counter drugs and supplies, lodging; Code §213(d), Rev. Ruls. 2003-58, 2003-102.

May reimburse for individually owned health, dental or disability insurance; not long term care, Code §7702B(c). See also Rev. Rul. 61-146.

Preventive care includes: health evaluations, routine exams, prenatal/well-child care, child/adult immunizations, tobacco cessation, obesity weight loss programs and screening services.

Same as HRA for account holder, spouse or qualifying dependents to the extent not covered or reimbursed by insurance or otherwise. Using HSA for non-qualified expenses means individual pays income tax on amount plus a 10% penalty tax. Long-term care insurance may be purchased with HSA, IRC §223(d)(2)(A) and over the counter drugs (IRB: 2004-2, 1/12/04).

Same as HRA and FSA. HSA funds may not be used to purchase other health insurance except for COBRA premium, health insurance while unemployed or Medicare Parts A and B or Medicare HMO policies, not Medigap policies. Notice 2004-2, Q&A 27.

Same as HRA except premiums for insurance policies not sponsored by Employer with FSA Plan is prohibited, IRS Prop. Reg. §1.125-2, Q&A 7(b)(4), 3/7/89. No retiree benefits. FSA codified in Code §106(c) under §301(c)(2) of HIPAA 1996.

Same as HRA for all Code §213(d) expenses for Health FSA enrollees and their dependents.

Premiums for insurance policies not sponsored by Employer with FSA Plan is prohibited, IRS Prop. Reg. §1.125-2, Q&A 7(b)(4), 3/7/89. Retirees ineligible because no salary reduction.

Preventive care includes: health evaluations, routine exams, prenatal/well-child care, child/adult immunizations, tobacco cessation, obesity weight loss programs and screening services.

Participation - Individual or Business

C Corp. owners and their rank and file employees. Individuals, Owners of LLCs, LLPs, 2% S Corp. owners, sole-proprietors, partnerships, not eligible for pre-tax premium or Health FSA; Code §§105(g), 162(l), but may deduct premium on Schedule C tax return. See also Notice 2002-45, Part III. Owners share in the overall HRA savings.

Individual or any business entity without HRA or FSA limitations.

Note: Some states do not recognize an income tax deduction for HSA premium, the amount contributed to savings account or HSA earnings.

All business entities eligible for Dependent Care, Code §129(e)(3). For all other business entities, HRA rules apply.

**Part One: Plan Design &
Tax Issues (con't)**

**Health Reimbursement
Arrangements (HRA)**

**Health Savings
Accounts (HSA)**

**Flexible Spending
Accounts (FSA)**

Group Size	None by statute.	None by statute.	None by statute.
Claims Required	Yes. Each expense submitted for reimbursement must be substantiated, Notice 2004-45, Sec. II, 2002-28 IRB 93. When using debit or credit cards, substantiation required if system cannot identify products purchased, Rev. Rul. 2003-43, 2003-21 IRB 814.	No. But, upon IRS audit, account holder must provide substantiation, Notice 2004-2, Q&A 37. If employer funds HSA, claims may be required for reimbursement and subject the HSA to ERISA, outside the "safe harbor" provision - see below under "ERISA Covered."	Yes, same as HRA.
Source of Contributions	Employer Only, Code §105(h)(6)	Individual and/or Employer. Note: If Employer funded, must contribute same amount for each employee whether or not funds used. Employer subject to 35% excise tax on the aggregate HSA amount for failing to follow rule. Code §4980G(a). A 6% excise tax is levied on individual for excess contributions.	In practice, usually Employee funded through salary reduction. Code §125 allows for Employer contributions or any combination between Employer and Employee.
Contribution Limits and Rules	None by statute. Employer may impose reimbursement or benefit limits to control risk. Note: HRAs will save Employers more money than Employer funded HSAs because HRA funds are used only "as needed" to pay claims when incurred while HSA contributions are made to each employee's account whether or not the money is spent for qualified expenses. In fact, HSA funds can be used for nonqualified expenses and the Employer will never find out because HSAs are self-administered by the employee.	Maximum contributions (calculated on a monthly basis) for an eligible individual are the lesser of 100% of the annual deductible of the HDHP up to \$2,600 for self-only coverage or \$5,150 for family coverage in 2004. IRC §223(b)(2). Limits are indexed. Account holders age 55 and up may make additional contributions of \$500 in 2004, increasing by \$100 each year until it reaches \$1,000 in 2009. If Employer contributes to HSA, contributions must be equal for all employees. IRC §§4980G and E(d)(4). Employees keep Employer contributions if they terminate employment. Not subject to FICA, Notice 2004-2, Q&A 19. The annual contribution limits apply whether an employee, employer or a self-employed person makes the contribution. Note: There is no requirement that the individual have earnings. The limit is zero for a Medicare eligible individual (e.g. individual who has attained age 65). IRC §223(b)(7).	None by statute for Health FSA. Employers limit Health FSA employee contribution to control risk because of the "uniform coverage" rule - see page 5, upper left corner. Dependent Care contribution limited by statute to \$5,000 per household, per calendar year, Code §129(a) (2)(A).

Part One: Plan Design & Tax Issues (con't)	Health Reimbursement Arrangements (HRA)	Health Savings Accounts (HSA)	Flexible Spending Accounts (FSA)
Prefunding ("Uniform Coverage" Rule)	No. Notice 2002-45, Part IV, 6/26/02.	No. HSA is individual account	Yes. For Health FSA, not Dependent Care FSA; Prop. Reg. 1.125, Q&A 7(b)(2), 3/7/89.
Forfeit Contributions	No. Funds provided by Employer.	No. Unused funds retained in HSA.	Yes. Employees' risk, "Use-It or Lose It"
Rollover Contributions	Permitted, but employer may retain savings. Notice 2002-45, Sec. I, 2002-28 IRB 93.	Yes (includes Employer funds, if any). IRC §223(d)(1)(E).	Not Permitted
Employer Payroll Savings	No. Deduction under Code §162(a)	Yes, if employee funds through cafeteria plan. No, if Employer funded - deduction, see HRA.	Yes. 7.65% FICA to \$87,900 for 2004 and Workers' Compensation
Employee Tax Savings	Yes. Tax-Free Reimbursement, Code §§105(b), 106.	Yes, if funded through cafeteria pan, Code §125. Note: At the time of this publication, some states do not allow a tax deduction for HSA premiums, the contributions to the savings account or its earnings.	Yes. Same as HRA, see also Code §§125(a), 129(a)(1). Yes. HSA contribution pre-tax effective 1/1/04, Medicare Act §1201(i) created Code §125(d)(2), Notice 2004-2, Q&A 33. A HDHP is required - see Source of Contributions.

Part Two: Administration	Health Reimbursement Arrangements (HRA)	Health Savings Accounts (HSA)	Flexible Spending Accounts (FSA)
ERISA Covered	Yes. Department of Labor (DOL), 29 USC §1002(1).	The HDHP is ERISA covered, but the HSA is not an "ERISA" covered welfare benefit plan even with Employer contributions if HSA qualifies for DOL's "safe harbor" exemption consisting of 5 conditions (see below). Under the HSA safe harbor exemption, the HSA must be completely voluntary on the part of the employee and the Employer: (1) cannot limit the ability of eligible employees to move their funds to another HSA beyond the restrictions imposed by the Code; (2) cannot impose conditions on utilization beyond the Code's restrictions; (3) cannot make or influence investment decisions with respect to HSA contributions; (4) cannot represent that HSA is an employee welfare plan established or maintained by the employer; and (5) cannot receive any payment or compensation in connection with the HSA. DOL Field Assistance Bulletin 2004-1, 4/7/04. See also safe harbor exemption for group insurance plans at 29CFR §2510.3-1(j).	Yes. Same as HRA

Part Two: Administration (con't)	Health Reimbursement Arrangements (HRA)	Health Savings Accounts (HSA)	Flexible Spending Accounts (FSA)
Legal Documents	Yes. Plan Document and Summary Plan Description ("SPD") for Employees, 29 USC §§1021(a), 1022(a)(1) and 1102(a)(1). SPD furnished to participant within 90 days of plan's effective date.	Same as HRA for HDHP, provided by carrier. For HSA, must be written trust document created by bank or insurance company to hold funds for the exclusive purpose of paying "qualified medical" expenses of the "account beneficiary." Code §223(d)(1)(A).	Yes. Same as HRA plus Code §§125(d)(1)(A) and (B), 129(d)(1).
Trust & Fidelity Bond Required	Yes if trust arrangement or separate account established to reimburse employees. 29 USC §§1103(a), 1112. May use TAI's Master ERISA Trust & Fidelity Bond. Bond must equal 10% of funds handled up to a maximum of \$500,000 and be issued by a Treasury approved surety. Not required if benefits are reimbursed directly from Employer's general assets.	Banks and insurance companies are exempt from fidelity bond requirement. 29 USC §1103(a)(2)(B).	Yes. Same as HRA
IRS Reporting, Form 5500 Filing, W-2 Reporting	Yes. Form 5500 required to be filed if more than 100 participants in group health plans (on a consolidated basis); Code §6039D.	No Form 5500 for HSA. Required for HDHP if more than 100 participants in group health plan; Code §6039D. Employer must report amounts contributed to HSAs on Form W-2 in box 12 with code W; Code §6051(a)(12). IRS may require trustee or custodian to report contributions, distributions, return of excess contributions and any other matters it deems appropriate. Code §223(h)(1).	No Form 5500 required. IRS suspended §6039D filing for all §125 Plans. Suspended filing applies to Premium Only Plans (POPs) as well as for Health and Dependent Care FSAs irrespective of the number of participants. IRS News Release 2002-43, 4/4/02; DOL Media Release #03-02, 1/9/03
COBRA & HIPAA	Yes. Follows Group Health Plan. Carrier will issue Certificate of Creditable Coverage. Notice 2002-45, Part VII.	Same as HRA for HDHP, not HSA portion.	Yes. Follows group health plan. Health FSA portion has limited COBRA application. Privacy issues maintained under HIPAA along with Business Associate. HIPAA Certificate of Creditable Coverage not required because benefit not portable.
Nondiscrimination Rules	May vary benefits per class, but be equally applied for each class, must include controlled and affiliated groups, Code §§105(h)(3), (4), (8), Notice 2002-45	If Employer contributes to HSA, under comparability rule, must contribute same amount for all employees eligible to participate without class distinction. IRC §4980G(a), Notice 2004-2, Q&A 32.	Same as HRA. Also separate tests for Dependent Care, HCEs and Aggregate Benefits.
Excluded Employees	May exclude union members and other employees up to 3 years and age 25.	Same as HRA for HDHP.	Same as HRA, plus age 21 and 1 year of service for Dependent Care, §129(d)(9).

Part Two: Administration (con't)	Health Reimbursement Arrangements (HRA)	Health Savings Accounts (HSA)	Flexible Spending Accounts (FSA)
Reimbursement Priority between HRA and FSA "FSA Ordering Rule"	General Rule for Employer with HRA and FSA: If coverage provided by both an HRA and FSA for the same medical expense, the HRA must be exhausted first. Proposed Reg §1.125-2, Q&A 7(b)(5). Exception: In Notice 2002-45 (6/26/02), the IRS provides an exception to the general rule of first using HRA funds for identical medical expenses. The Employer may specify in the HRA plan document, before the beginning of the Health FSA plan year, that coverage under the HRA is available only after expenses exceeding the dollar amount of the FSA have been paid.	N/A	Yes. Same as HRA

Are HSA Contributions Allowed When Employer Sponsors an HRA or Health FSA?

The answer depends on the type of expenses eligible for reimbursement and the proper drafting of plan documents conforming to IRS Notice 2002-45 (6/26/02), referred to as the FSA Ordering Rule. In Rev. Rul. 2004-45 (5/11/04), the IRS outlines five (5) examples interpreting the interplay of HSAs with HRAs and/or FSAs with regard to making HSA contributions. The ruling was required because FSAs and HRAs constitute "other" coverage under Code §223(c)(1)(A)(ii).

1. Traditional Health FSA or HRA: Contribution to HSA not allowed. In this example, the individual is covered by an HRA and a Health FSA. The HDHP has an 80/20 coinsurance feature above the deductible. The Health FSA and HRA reimburse all Code §213(d) medical expenses not covered by the HDHP (i.e. copayments, coinsurance, expenses not covered due to the deductible, and other medical expenses not covered by the HDHP). The Health FSA and HRA coordinate reimbursement per the "FSA Ordering Rule" noted above. Because the reimbursement is wide-open and reimburses expenses that are not limited to the exceptions for "permitted insurance" (disability, workers' compensation) or "permitted coverage" (accidents, disability, dental care, vision care or long-term care), the individual may not contribute to an HSA. The result would be the same even if the individual were covered by a Health FSA or HRA sponsored by his spouse's Employer.

2. Limited Purpose Health FSA or HRA: Same facts as "1" above. HSA contributions allowed because these arrangements are designed to reimburse only vision and dental expenses (whether or not the minimum annual deductible of the HDHP has been satisfied) and preventive care benefits as described in Notice 2004-23. Premiums and long-term care services are not eligible for reimbursement.

3. Suspended HRA: Same facts as "1" above except individual is not covered by a Health FSA. The result is contributions to HSA allowed during the suspension period. In this example, the individual must elect in advance of the HRA coverage period to forgo reimbursement of medical expenses during the HRA coverage period. The HRA may reimburse expenses only for permitted insurance, permitted coverage or preventive care (i.e. "excepted medical expenses" - see "1" above).

The individual is entitled to receive HRA reimbursement of other Code §213(d) expenses after the suspension period ends at which time the HRA resumes its role as a general purpose HRA, but without HSA contributions by the individual. The Employer may continue to make HRA contributions during the suspension period. The IRS states that if the HSA is funded under a cafeteria plan during the suspension period, the salary reduction election must indicate that contributions are only for the HSA, not the HRA.

4. Post Deductible Health FSA or HRA: Same facts as "1" above except that the Health FSA and HRA are "post deductible" arrangements that only reimburse medical expenses (including the individual's 20% coinsurance for expenses above the deductible) after the minimum annual deductible of the HDHP has been satisfied. In this example, HSA contributions are permitted.

5. Retirement HRA: Same facts as "1" above except the individual is not covered by a Health FSA and the Employer's HRA is a "retirement HRA" that reimburses medical expenses only after the individual retires. In this example, the individual may make HSA contributions prior to retirement.

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