Parting Shot

HSAs Need FSAs and HRAs to Work Best

by Royce A. Charney, J.D.

It has been a little over one year since the passage of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, which created Health Savings Accounts (HSAs). While there has been a great deal of interest in HSAs, fewer than 1% of employers have implemented them in 2004, according to a recent survey by benefit consultant, William M. Mercer.

Reasons for their lack of success include limited tax benefits in California, poor consumer education, and non-integrated investment options. In addition, many employees are simply "tapped out." They cannot make new contributions to yet another account after paying for premiums and contributing to their 401(k) plans. From the employers' point of view, what is the interplay among HSAs and the more popular Flexible Spending Accounts (FSAs) or Health Reimbursement Arrangements (HRAs)?

HSAs are tax-exempt trusts or custodial accounts, which allow people to make pre-tax contributions to pay for "qualified" medical expenses now and during retirement. An HSA is established for the benefit of an individual, is owned by that individual, and is "portable." The HSA stays with an employee if he or she changes employers or leaves employment.

Tax-favored HSAs can only be established for eligible people who are covered by a high deductible health plan. They cannot be covered under any other health plan that is not a high-deductible health plan unless the other coverage is "permitted" insurance (workers' compensation or state disability) or is coverage for accidents, disability, dental care, vision care, or long-term care. For 2005, a high-deductible health plan is one with an annual deductible of at least $1,000 for individual coverage ($2,050 for family coverage) and maximum out-of-pocket expenses of $5,100 for individual coverage ($10,250 for family coverage). For 2004, the corresponding figures were $1,000, $2,000, $5,000, and $10,000.

The maximum annual contribution to an HSA is the sum of the limits determined separately for each month. They are based on status, eligibility, and health-plan coverage as of the first day of the month. For 2005, the maximum monthly contribution for eligible people with self-only coverage under a high deductible health plan is 1/12 of the lesser of the following:

- The annual deductible under the high-deductible health plan (minimum of $1,000) or $2,650 (up from $2,600).

The maximum monthly contribution for eligible people with family coverage under a high deductible, is the following:

- 1/12 of the lesser of the annual deductible under the high deductible health plan (minimum of $2,050) or $5,250 (up from $5,150).

Making HSAs Work

Unlike federal law, at press time, in California, individuals cannot deduct the HSA premiums or contributions to their savings accounts from their state income taxes. When employers offer the HSA with high deductible health plans, the employees' premium contributions are pre-taxed in California using a section 125 plan just like other health, dental, or vision premiums, but contributions to the savings account are not deductible.

California had a similar tax problem several years ago when the retirement plan contribution limits increased for simplified employee pension plans, profit sharing plans, 401(k)s, and IRAs. They were stuck with the old limits. Because of political pressure, California amended its income tax laws to match federal law retroactively.

It seems to me that even greater pressure will be exerted on California's legislature this round to match the federal HSA deductibility rule given the need to cover more people with health benefits and the double-digit premium increases that employers received the last few years.

With regard to HSA investment options, mutual fund giants, such as American Funds, Fidelity, and Vanguard say they will be accepting HSA contributions in 2005 on a consumer basis. Brokerage divisions will commence later on.

The Interplay of FSAs & HRAs

In designing the benefit package, the pivotal question for employers that offer both HRAs and FSAs is whose money is spent first – the employer or the employee? The general rule is that if coverage is identical under both plans, the HRA, which is funded exclusively by employers, must be exhausted first (IRS Proposed Reg §1.125-2, Q&A 7(b)(5)).

This seems unfair since employee FSA contributions are subject to the "use-it or lose-it" rule for unclaimed expenses. The IRS recognized the problem and issued "Notice 2002-45" on June 26, 2002 -- also known as the "FSA Ordering Rule." The Notice provides an exception to the

Visit us at
www.calbrokermag.com

general rule of first using HRA funds for identical medical expenses. Before the beginning of the FSA plan year, in the HRA plan document, the employer can specify that coverage under the HRA is only available after expenses exceeding the dollar amount of the FSA have been paid.

The Interplay of HSAs with FSAs and HRAs

To have a successful enrollment, employers may have to contribute to the employees' HSAs. However, the major drawback to HSAs is that employer contributions immediately belong to employees whether or not they are used for qualified medical expenses. The employer's HSA contribution is also portable when employees terminate employment.

The other problem with HSAs is that employers do not have control over the "healthcare items" that employees purchase. Current HSA law does not require employees to submit claims substantiating their expenses. The employer's HSA funds can be spent on vacations or other nonqualified medical expenses, such as cosmetic surgery, clothing, alcoholic beverages, etc.

The solution is to implement an HRA or FSA along with the HSA. With these plans, employers have complete control over their contribution limits and plan design. With FSAs and HRAs, employees have to file claims supporting their expenses and employers fund claims on an as-needed basis up to the specific benefit limits outlined in the plan document – all of which translates into greater cost containment for employers. Unclaimed employer funds can be rolled over to the next plan year or be retained for other business expenses. Many third-party administrators can provide single-source administration of HSAs, FSAs, and HRAs, regardless of the insurance carrier.

For benefit planning, the key question is whether employees can make HSA contributions when employers offer HRAs or FSAs. The IRS outlined five examples interpreting the interplay of HSAs with HRAs and/or FSAs in "Revenue Ruling 2004-45" issued on May 11, 2004. Benefit consultants must also consider the FSA ordering rule mentioned above. The Ruling was required because FSAs and HRAs constitute "other coverage" under Code §223(c)(1)(A)(ii). Below are the five examples outlined in the Ruling:

1. Traditional Health FSA or HRA ("Wide-Open" Reimbursement)

In this example, the individual is covered by an HRA and a health FSA. The high-deductible health plan has an 80/20 coinsurance feature above the deductible. The Health FSA and HRA reimburse all "Code §213(d)" medical expenses that are not covered by the high-deductible health plan – co-payments, coinsurance, expenses not covered due to the deductible, and other medical expenses. The Health FSA and HRA coordinate reimbursement according to the "FSA Ordering Rule."

(We will also use these facts in examples 2 through 5.)

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 cannot contribute to an HSA. The result would be the same even if the individual was covered by a Health FSA or HRA sponsored by the spouse's employer.

2. Limited Purpose Health FSA or HRA

HSA contributions are allowed because they are only designed to reimburse vision and dental expenses and preventive-care benefits as described in "Notice 2004-23." This is true whether or not the high deductible health plan's minimum annual deductible has been satisfied. Premiums and long-term care services are not eligible for reimbursement. HRA and/or FSA plan documents must detail the reimbursement priority and the expenses covered.

3. Suspended HRA

The individual is not covered by a Health FSA. Contributions to an HSA are allowed during the suspension period. Before the HRA coverage period, the individual must elect 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, such as excepted medical expenses.

The individual is entitled to receive HRA reimbursement of other "Code §213(d)" expenses after the suspension period ends. At that time, the HRA resumes its role as a general purpose HRA, but without the individual's HSA contributions. The employer can continue making HRA contributions during the suspension period. The IRS states that the salary reduction election must indicate that contributions are only for the HSA if it is funded under a cafeteria plan during the suspension period.

4. Post Deductible Health FSA or HRA

The Health FSA and HRA are "post deductible" arrangements that only reimburse medical expenses after the high-deductible health plan's minimum annual deductible has been satisfied. This includes the individual's 20% coinsurance for expenses above the deductible. HSA contributions are permitted in this example.

5. Retirement HRA

The individual is not covered by a Health FSA and the employer's HRA is a "retirement HRA," which only reimburses medical expenses after the individual retires. In this example, the individual can make HSA contributions before retirement.

In summary, success of HSAs depends on employers implementing or maintaining their FSAs and HRAs. With the IRS guidance outlined in the "FSA Ordering rule and Revenue Ruling 2004-45," employers can craft effective cost-containment strategies that save money at renewal and into the future. ❑

Royce A. Charney, J.D. is president of Trust Administrators Inc. in Oakland, Calif. Mr. Charney founded the firm in 1984 after spending nearly six years with the U.S. Department of Labor's ERISA Division. The firm administers cafeteria, commuter, HRAs, HSAs, COBRA, dental and vision plans. Mr. Charney can be reached through the firm's website at www.trustadmin.com or at (800) 932-3539.

Visit us at
www.calbrokermag.com