The Fundamentals of Health Savings Accounts

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Included in the Medicare Prescription Drug Improvement and Modernization Act of 2003 (prescriptions for seniors) were provisions that called for Health Savings Accounts (HSAs). The purpose of HSAs was to enable people to save for qualified medical expenses and retiree medical expenses on a tax-free basis.

I. BASICS

The Health Savings Account approach combines a Qualified High Deductible Health Plan (QHDHP) with an HSA, which is an IRA-like account. Money can be taken from the HSA to pay for medical expenses not covered by the health insurance plan or to pay for other qualified medical services.

The first step is to have a health insurance policy that meets the statutory definition of a Qualified High Deductible Health Plan. Some will err by thinking their existing policy qualifies as a QHDHP, because from their perspective, it has a high deductible. In order to qualify as a QHDHP the annual deductible must be a minimum of $1,400 (2020) for individual coverage, or $2,800 (2020) for family coverage and the deductibles must be comprehensive in nature. Comprehensive means that the deductible must apply to all covered services, with the exception of eligible preventive care. This is a change for most people who are accustomed to making copayments for prescription drugs and office visits at any time of the year.

It is also important to note how the deductible works with the Qualified High Deductible Health Plan. In some products the deductible is considered “embedded” and the deductible is “individually accumulated”. In other products the deductible is considered “non-embedded” and is “collectively accumulated”. For example, under an embedded policy, one member of the family may reach the deductible by incurring $5,000 of expenses. In contrast, in a non-embedded policy, the deductible would not be reached until the entire family incurs $10,000 of covered services. The distinction is important to those covering dependents and should be understood by the purchaser.

To be eligible to make contributions to the HSA, a person may not also be covered by another plan that is not a qualifying “Qualified High Deductible Health Plan”. There are some exceptions to this that include dental, vision and qualified long term care. Individuals covered under a spouse’s traditional health insurance policy are not eligible to make contributions to an HSA. In addition, an employee generally cannot have access to a standard medical Flexible Spending Account in either his/her name or the spouse’s name (Section 125 cafeteria plan) or a Health Reimbursement Account unless they are designed as either a limited FSA or HRA (i.e. they don’t cover any part of the comprehensive front end deductible). Finally, one cannot be enrolled in Medicare or Tricare and be eligible to enroll in an HSA.

II. FUNDING A HEALTH SAVINGS ACCOUNT

An HSA must be established with a qualified trustee or custodian if HSA contributions are to be tax deductible. The trustee may be an insurance company, bank, or approved non-bank trustee. The HSA account owner may select among investment options if offered by the trustee/custodian. HSA investment earnings accrue tax-free.

Contributions may be made by the employer, or the individual, or both, subject to annual contribution limits. Contributions made directly to the HSA account by an individual that are not payroll deducted pre-tax through the individual’s employer, are tax deductible “above the line” on the federal tax return. So, HSA contributions in this situation are deducted before the individual’s adjusted gross income is calculated and any standard or itemized deductions are taken.

In 2020, the maximum contribution for individual coverage is $3,550; the maximum contribution for family coverage is $7,100. In 2007, a special rule was implemented which allows people to contribute the maximum amount for the year and to avoid the pro rata partial year limitation as long as they have QHDHP coverage in December and for the entire following year. If one fails to remain covered by a QHDHP the entire following year, the extra contribution above the prorated amount is included in income and subject to an additional 10 percent tax. The pro rata limitation requires someone with a June 1 start date to only contribute 7/12 of the annual limit.

People who have attained age 55 and who are not enrolled in Medicare may make “catch-up” contributions of up to $1,000 annually.

Contributions to an HSA from an employer are not taxable income to the employee and are also not subject to FICA taxes. Employer contributions must be comparable for all employees participating in the HSA. The same dollar amount or percentage of deductible must be made for each covered employee.

It should be remembered that the individual owns the HSA account and not the employer. Each individual HSA owner should ensure that contributions do not exceed the annual maximums. The HSA must be opened before the date of the medical service for the withdrawal to be permissible. In other words, one can’t incur medical expenses and then open the account and expect reimbursement.

Contributions may be made on the first day of the year and made any time prior to the deadline for filing taxes for the year (April 15 of the following year). Contributions must cease upon enrolling in Medicare or the termination of participation in the QHDHP if the prorated contribution has been made. An employer’s contribution to an HSA is not subject to COBRA continuation.

III. WITHDRAWALS FROM A HEALTH SAVINGS ACCOUNT

Withdrawals from an HSA are tax free if used to pay for qualified medical expenses. It is the HSA account holder who must ensure that expenses paid from the HSA are qualified medical expenses. Qualified medical expenses are defined in Section 213(d) of the Internal Revenue Code (see IRS publication 502) and are for the account holder, the legal spouse, and the tax dependents and include expenses for:

- Most items covered but not paid by health insurance
- Many medical related items not covered by insurance (e.g. Lasik surgery)
- Prescription drugs and qualifying over-the-counter drugs (OTC drugs require a valid prescription…2011 change)
- Qualified long-term care services and long-term care insurance
- COBRA premiums
- Medicare Part A, B and D premiums, but not Medigap premiums
- Unreimbursed dental expenses

HSA withdrawals can be taken at any time, provided the funds are available, even when the individual is no longer eligible to make contributions. Balances remaining in an HSA at the end of the year roll to the next year. In other words, there is not a “use it or lose it” rule. The account owner may access the HSA funds for reasons other than qualified medical expenses; however, they are subject to ordinary income tax and a 20 percent federal tax penalty (note: there are some limited rules that allow repayment of withdrawals for non-qualified expenses without penalty). At age 65 and beyond, withdrawals for qualified medical expenses are still tax free. Withdrawals after age 65 for non-medically qualified expenses are subject to ordinary income taxes, but not the 20 percent penalty that applies to those under age 65. People should be reminded that each individual is responsible for maintaining records that document that HSA funds spent were for medically eligible expenses.

IV. WHO MIGHT SELECT AN HSA?

Employers continue to move away from a “one size fits all” approach to health insurance. Many are making the QHDHP/HSA approach an option for employees to select.

There are a number of reasons why the QHDHP/HSA approach may appeal to individuals. First, it may appeal to those who consider themselves healthy or desire lower health premiums than may be traditionally available. Second, those wanting or willing to take more risk (i.e. higher deductible) may want an HSA. Third, those individuals in the higher tax brackets may derive greater value from the tax-advantaged HSA. Fourth, some may view the HSA as a vehicle to supplement other retirement accounts. Fifth, those who already have a high deductible may want to switch to a comparable QHDHP for tax savings. Finally, it may appeal to the employer who wants to shift more responsibility to the employee, or to employees who want to have greater control of their health expenditures.

Conversely, others will not find the QHDHP/HSA approach appealing for a variety of reasons. These individuals may have chronic illnesses, or want the security of a first-dollar prescription drug card, or the certainty of fixed co-pay amounts. Others may be averse to assuming more risk, willing to pay more in premium, and thus be unable or unwilling to assume the large deductible associated with the QHDHP. Those in the lower tax brackets may see only a limited tax advantage with the HSA. And finally, some may not want to take on the additional administrative requirements associated with an HSA.

In 2014, community rating was implemented for individual products, as well as groups with as many as 50 employees. Under community rating, the rates are no longer based on medical underwriting, thus in theory, the healthy will subsidize the unhealthy. Therefore, more and more healthy people are considering the high deductibles and lower premiums associated with the tax-favored health savings account approach.

V. EMPLOYER CONSIDERATIONS

There are a number of things an employer may want to consider before implementing the QHDHP/HSA approach. An employer may be more likely to offer employees this approach to health insurance if it is an alternative, rather than the lone insurance option. Employers should ask themselves, if a QHDHP is offered to employees, which employees might find it appealing and why? What other health insurance options should also be offered?

Employers will want to employ a sound premium contribution strategy if traditional HMO/PPO product(s) are offered next to a QHDHP. Part of this premium contribution strategy should evaluate whether or not HSA contributions will be made by the employer, or solely by the employee.

Another item to consider is what the deductible amount should be for the QHDHP? Will a QHDHP with a very high deductible be more risk than employees will want to take? How might employees react to each QHDHP?

Finally, employers will need to recognize the administrative responsibility of the QHDHP/HSA approach and provide proper education to employees so everyone may make an informed decision.

In summary, QHDHP/HSAs may be a constructive health care alternative for your organization. As with all health care solutions it is particularly important that you carefully analyze all of the pertinent facts and issues so that you have a good understanding of the products’ true value and fit for your organization. Only then can you make an informed, long-term decision.