The Fine Print on HSAs

by Dan Coyle, CEBS

A health savings account (HSA) plan, when properly understood, can be a great tool for managing health care costs for employers. It also can be a great tool for employees who want to save for future medical costs. Unfortunately, most presentations and articles about HSA plans skip the details and there are many administrative and compliance complexities, as would be expected with any plan that involves a tax break. This article provides ten points human resource (HR) and benefit professionals should know when considering whether to add an HSA plan. In this collective learning curve, the more accurately employers address questions, the happier their employees will be with their new plans.

Most benefit and HR professionals are familiar with the reasons to add an HSA plan:

• HSA plans are tax-free.
• There's no use-it-or-lose-it rule.
• They can lower an employer's overall medical costs.
• They can help employees pay for postretirement medical costs. Most are also familiar with the reasons not to add an HSA plan:

• HSA plans have to come with a high-deductible health plan (HDHP).
• Employees view them as a way to make them pay more.
• They're mainly attractive to the rich and healthy.

Here are ten points HR and benefit professionals should know when considering whether to add an HSA plan. They may talk you out of it—or into it.

1. No more copays. HSA plans cannot have office visit or prescription drug copays until the annual deductible is met. The member must pay the full cost of the service (although if the HSA plan is connected to a network-based plan, network discounts will apply). That's how HSA plans succeed at changing behavior. Under a non-HSA plan, a child's flu could be resolved with a $25 office visit and a $15 antibiotic. With an HDHP/HSA plan, that same visit will be $125, the antibiotic will be $75 and the parent may decide to try an over-the-counter remedy first. In the past, the plan benefited from cost avoidance; with an HSA plan, the member benefits.

2. Family coverage has no individual deductible. Most employees are used to having individual deductibles for their family (i.e., if only one person in the family uses the plan, the individual deductible applies). Not so with an HSA. If only one person in the family uses the plan, that person still has to meet the family deductible, which could be three times higher. With a high deductible to begin with, that's substantial.

3. HSA money is not always tax-free for state purposes. Only the federal tax exemption is guaranteed. Members who live in California, New Jersey, New Mexico and Wisconsin will be taxed on HSA contributions and possibly earnings, unless the laws change.

4. Members without a qualified HDHP may use their HSA money but may not make contributions to their HSA. Members leaving a job that has a qualified HDHP with an HSA, and going to a job that does not have either, may still use the money accumulated in the HSA but may not contribute to it anymore. If they are later covered by a qualified HDHP, they may resume contributions to their HSA.
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5. Excess contributions are penalized. Excess contributions can occur in two situations:
   - The annual maximum contribution is exceeded.
   - HDHP coverage ends midyear and contributions exceed the monthly allowed amount.

In the first situation, if total contributions (not including earnings) exceed $2,900 for individual coverage or $5,800 for family coverage (2008 limits), the excess is taxed. If it is not withdrawn by April 15 of the following calendar year (regardless of plan year), it is also penalized at 6%.

The second excess contribution situation is tricky because an employer may fully fund (i.e., make the entire employer contribution) on the first day of the plan but, in doing so, it is assuming that all employees will be covered by the HDHP for all 12 months of the plan year. If an employee changes from HDHP coverage to non-HDHP coverage midyear, there is an excess contribution.

What amount is considered excess? Any amount contributed for a month in which the employee was not covered for any days by an HDHP. For example, if an employee has HDHP coverage on February 1 but not February 2, the allowed contribution for the year is two-twelfths (January and February). Two-twelfths of what? From the employer's perspective, two-twelfths of the annual employer contribution. From the employee's perspective, two-twelfths of the maximum annual contribution after being reduced by the annual employer contribution.

For example, in 2008, the individual annual maximum is $2,900. If the employer contributes $500 over a year, and the employee leaves the company and has no HDHP coverage after February 2, then the company would only contribute two-twelfths of $500, or $83.33. The employee, however, may contribute up to $400, which is two-twelfths of the difference between $2,900 and $500. If total contributions to the account (not including earnings) exceed $483.33 ($400 from the employee and $83.33 from the employer) for the tax year, an excess contribution has occurred.

6. Conversely, a member joining an HDHP/HSA plan midyear may fully fund the HSA on the first day. It sounds counterintuitive given point five, but there is an exception for members who join a calendar year plan late in the year. A member enrolling in the HDHP/HSA plan may contribute up to $2,900—all in December, if they wish. The catch is that they must remain eligible for 12 months (this is known as the testing period). If not, then the amount that was allowed by the exception, and for which they were not eligible, is taxed.

For example, an employee enrolls on December 1, 2008 and is eligible for that month (i.e., they are covered by a qualified HDHP). Even if they were not eligible for any other month in 2008, they may still make a full year's contributions ($2,900) all in December, or spread out over the next 12 months ending November 30, 2009. If the member ceases to be eligible in, say, June 2009, then all contributions allowed because of the exception (i.e., any contributions other than the contribution made in December) should be included in gross income for 2009. In addition, a 10% additional tax applies to the amount includable.

7. HSA members cannot sign up for their spouse's plan. An employee who contributes to an HSA may not have other nonqualified HDHP coverage, including coverage under their spouse's plan. They also cannot be eligible for Medicare. Other coverage disqualifies a person from contributing to an HSA. However, they can have dental and vision coverage (even though HSA funds can be used for dental and vision services), and they can also have disease-specific coverage (like a cancer plan) without jeopardizing their HSA eligibility.
8. Catch-up contributions start in the year of the 55th birthday and end on the 65th birthday. The law allows for catch-up contributions ($900 in 2008) starting in the year the accountholder turns 55, even if they haven’t had their 55th birthday. Contributions must stop on the 65th birthday, even if the spouse is not aged 65 yet. Only one catch-up contribution may be made per account, so a married couple wishing to make two catch-up contributions should open two separate HSAs. Of course, they both must be covered by a qualified HDHP (unlike with one HSA account, where only the accountholder must be covered by a qualified HDHP).

9. There is no substantiation on HSAs. With a flexible spending account (FSA), if a member makes a purchase at a nonmedical or non-pharmacy vendor, or if the purchase does not match the plan’s copays (or multiples of the copays up to five), the member must produce a receipt that substantiates the purchase (proves it is eligible for purchase with FSA money). The substantiation process is manual, prone to error, time-consuming and frustrating for many members. Thankfully, the substantiation process does not exist with an HSA unless the member is audited by IRS. Neither the HSA bank nor the claims administrator will ask members to provide receipts proving they used the money for eligible items. This makes HSAs quite practical. When patients go to the doctor’s office and pay for parking, they don’t need to file a claim for that $10. They can save the receipt in their tax file and just write themselves a check from their HSA account to be deposited into their normal checking account.

Patients who are audited and don’t have receipts to justify purchases will be taxed on the amount of the unsubstantiated items and assessed a 10% penalty. Exceptions apply: patients won’t be taxed or penalized if they become disabled; heirs won’t be penalized if the patient dies; and patients won’t be penalized if becoming eligible for Medicare in the tax year in question.

10. The money has to be there in order for a member to use it. Unlike in an FSA, all HSA dollars must be in the account before they can be used. Otherwise, the account becomes overdrawn and the member is subjected to returned check charges and penalties. If a member has large expenses in the first month of the plan year, there are options. No matter what, he or she will probably have to pay the medical bill from a non-HSA and then reimburse himself or herself, since the doctor probably will not want to wait until payroll deductions fill up the HSA.

The question is: when can a member reimburse himself or herself? The answer depends on whether he or she has elected to contribute the annual maximum through payroll deduction. If not (for example, if the employer’s and the employee’s payroll contributions will not reach $2,900 for individual coverage or $5,800 for family coverage), then the member should make a supplemental contribution to the HSA by writing himself or herself a check from his or her normal checking account and then depositing it into the HSA, taking an above-the-line deduction on his or her taxes. Then, he or she should turn around and write himself or herself a check from the HSA. He or she has just reimbursed himself or herself and reaped the tax benefit of the HSA. Members in this situation need to make sure the amount they contribute to the HSA outside of payroll, plus all payroll contributions from the company and the member, do not exceed the maximum annual contribution.

If an HSA member has elected to contribute the annual maximum contribution through payroll deduction, then he or she cannot make a supplemental contribution without changing his or her election, which the employer may allow without a qualifying life status change. Members in this situation may reimburse themselves after each paycheck or in a lump sum at the end of the year.

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