

## HEALTH SAVINGS ACCOUNTS (HSAs)

An HSA is a tax-exempt trust or custodial account similar to an IRA. It allows both employers and employees to make deductible cash contributions on behalf of “eligible individuals.” Any HSA withdrawals used to pay medical expenses that are not deducted for income tax purposes are excluded from the account beneficiary’s income. These expenses include, in addition to medical expenses typically covered by group health plans, the cost of over-the-counter drugs, vision and dental care (including laser eye surgery and orthodontia) and long-term care insurance premiums. For HSA account beneficiaries who attain age 65, funds can be withdrawn for any non-medical purposes without payment of the 10 percent excise tax that otherwise applies to such withdrawals.

HSAs can be used to pay medical expenses of family members, including spouses who themselves are not eligible to set up an HSA, so long as such expenses are not also reimbursed by another health plan. Medical expenses incurred after the establishment of the HSA can be reimbursed years later from the HSA so long as adequate records are maintained by the account beneficiary. Unlike an IRA, an HSA is not required to make distributions at any particular time and HSA balances can be retained indefinitely. Consequently, some observers regard HSAs as attractive retirement savings vehicles.

Individuals eligible to set up an HSA are those who:

- (1) are covered by a high deductible health plan (HDHP);
- (2) are not covered by any other plan providing general health coverage (this includes coverage under a spouse’s group health plan, FSA or health reimbursement account);
- (3) are not enrolled in Medicare (i.e., those who have attained age 65 and have elected such coverage); and
- (4) are not claimed as a dependent on another person’s tax return.

An HDHP is a health plan with a minimum annual deductible of \$1,000 for individuals (and an out-of-pocket expense limit of not more than \$5,000) and \$2,000 for family coverage (with an out-of-pocket expense limit of not more than \$10,000). With the exception of certain “preventive care” benefits, an HDHP may not provide benefits until the deductible for the year is met. This means that after a transition period, separate reduced deductibles for emergency room treatment and general drug coverage cannot be maintained in an HDHP.

HSA contributions from all sources are limited during any year to an amount equal to the applicable deductible up to \$2,600 for single coverage and \$5,150 for families (these figures are indexed and increase with increases in the cost of living). Individuals who have attained age 55 by the end of the year can contribute an additional \$500 per year with respect to 2004 and increasing amounts in later years. The eligible employee is entitled to an income tax deduction for contributions within the foregoing limits that are made to the employee’s HSA by the

employee and family members. The deduction is “above the line” and can be taken regardless of whether or not the individual itemizes deductible expenses.

An HSA is intended to cut monthly premium expense through the HDHP and to allow tax benefits through the payment of medical expenses from the HSA with pre-tax dollars. Some employers will contribute a portion of their premium savings to employee HSAs, giving them additional pre-tax dollars to use to pay medical expenses. By giving each employee a stake in medical expenditures starting with the first dollar of such expense, HSA participation can help control overall health care costs. If employees spend less on medical care for this reason, the HDHP claims experience will be favorable and the rate of health insurance premium increases could be reduced.

**Recommendations:** HSAs are not for everyone. Consider offering an HDHP to employees as an option to an existing PPO or other group plan. Eligible employees who are interested can then choose to participate in an HSA. However, it probably makes sense to wait until 2005 to set up an HDHP. Even the largest insurance companies have not worked out all the details in their HSA programs, and it may take time to do so. Further, getting into an HSA now will offer limited opportunities for participants to realize medical cost savings through the end of the calendar year, but will still expose participants to significantly higher deductibles under the related HDHP. Employers and HR professionals should also consider the significant challenge of analyzing the details of an HDHP-HSA program and effectively communicating those details to employees in a timely fashion.

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