Transitioning to a Health Savings Account and High Deductible Health Plan Offering

Overview

Health Savings Accounts (HSAs) are tax-favored individual trust or custodial accounts that can be contributed to by or on behalf of eligible individuals who are covered by a qualifying high-deductible health plan (HDHP) and no other incompatible coverage. HSAs can be used on a tax-favored basis to pay for medical expenses before the HDHP's deductible is met and also for medical expenses of the account holder and their spouses and tax dependents (not including adult children to age 26 who are not otherwise tax dependents). HSAs offer a significant tax advantage in that contributions are tax-deductible (they may also be made pre-tax through a Cafeteria Plan), earnings and interest are tax-free, and any withdrawals for qualified medical expenses are tax-free.

HSA–HDHP offerings have become increasingly popular with employers because the HDHP premium tends to be lower than a traditional major medical plan. This makes HDHPs more likely to be "affordable" under the Affordable Care Act's Pay or Play mandate. However, implementing a HSA –HDHP requires advanced planning. Introducing this design often requires significant changes to other benefits, to existing plan documents, and to participant communications. Those changes and considerations are discussed below. This discussion assumes that HSAs are offered as a component of the employer's Code §125 Cafeteria Plan and that Comparability Rules do not apply. For more information on the Comparability Rules and Cafeteria Plan exception see our Alliant Insight.

Important Governing Principles

A solid understanding of a few underlying concepts will help tackle the more challenging questions that arise when implementing a HSA/HDHP option.

As noted above, an HSA is an individual trust or custodial account. Some have likened it to a healthcare Individual Retirement Account (IRA). It belongs to the individual alone. Whether contributions can be made to that account (by the employee, the employer, or other individuals) is dependent exclusively on whether the individual who owns the account has qualifying HDHP coverage, and no other impermissible coverage. Other impermissible coverage could be through his or her own employer, a spouse's employer, a parent's employer, a government program, or individual market coverage. However, it is important to understand that it is the individual's coverage that matters.

Example: *Ashton is enrolled in his employer's HDHP at the family tier with no other impermissible coverage. Ashton's employer contributes $2,400 to Ashton's HSA on an annual basis. Demi, Ashton's wife, is enrolled in Medicare.*
Question: Does Demi's Medicare enrollment impact Ashton's eligibility for the employer HSA contribution?
Answer: No. Ashton has a qualifying HDHP and does not have impermissible coverage so he is eligible for the employer's contribution for individuals enrolled in family coverage. If Demi had non-HDHP family medical coverage through her employer, however, he would not be HSA eligible.

Another important concept is the distinction between an employee's eligibility for HSA contributions and the eligibility for expense reimbursements. An employee is eligible for HSA contributions if he or she has qualifying HDHP coverage and no impermissible coverage. An HSA-eligible employee can use those funds to reimburse his or her own eligible expenses and also the eligible expenses of their tax dependents. The tax dependents do not have to be HSA-eligible in order for the employee to reimburse their expenses.

Example: *Example: Ashton is enrolled in his employer's HDHP at the family tier with no other impermissible coverage. Ashton's employer contributes $2,400 to Ashton's HSA on an annual basis. Demi, Ashton's wife, is enrolled in Medicare. Demi does not have a Medicare supplement plan.*
Question: Ashton wants to reimburse some of Demi's out of pocket costs with his HSA funds. Can he do that?
Answer: Yes. Ashton has a qualifying HDHP and does not have impermissible coverage. He can reimburse the eligible out of pocket costs of his tax dependents

It will be helpful to keep these concepts in mind as you consider the various questions that arise when implementing this plan design.

Plan Design and Operation Considerations

Avoiding ERISA

When employers limit their involvement, HSAs are not subject to ERISA, including the ERISA reporting and disclosure rules that apply to health plans (such as the requirement to have an SPD, report on Form 5500, etc.). Employers should avoid the application of ERISA to HSAs if possible.

Employers should understand what involvement triggers the application of ERISA. An employer can do the following and still avoid applying ERISA to HSAs:

- establish an HSA for employees and make employer contributions

- pay HSA fees
- restrict HSA contributions to a single vendor
- choose an HSA vendor that offers the same investments as are offered under the employer's 401(k) plan, and
- include an HSA as part of a Code §125 Cafeteria Plan.

In order to avoid the application of ERISA, employers cannot require employee HSA contributions (employee contributions must be completely voluntary) or do the following:

- limit an employees' ability to move funds to another HSA
- impose conditions on how employees use HSA funds
- make or influence individual investment decisions
- represent that the HSA in an ERISA plan
- receive any payments in connection with the HSA

Very few employers involve themselves in HSAs to the extent required to trigger ERISA. Some involvement, like setting a reasonable minimum monthly HSA contribution ($10-$20), is considered acceptable, recognizing there is cost associated with account maintenance. However, setting a monthly limit that was too great could be considered crossing the line on requiring employee contributions. In addition to avoiding ERISA, HSAs are also not required to comply with laws like HIPAA and COBRA because they are not considered health plans.

Incompatible Coverage

Employers offering HSAs to employees should understand what other benefits are considered HSA-compatible and what benefits make an employee ineligible to contribute to or receive contributions to an HSA.

The following coverage is "incompatible" and makes an individual ineligible to contribute to an HSA:

- Coverage through a spouse's non-HDHP major medical plan
- Coverage through a general purpose health flexible spending account (H-FSA) — **even a spouse's H-FSA;**
- Coverage through an employer-paid general purpose health reimbursement arrangement (HRA) — **even a spouse's HRA**;
- Non-HDHP "carve-out" coverage (like a prescription drug plan that is not subject to the HDHP deductible);
- On-site clinics - unless the fair market value for the services is charged to participants or services are limited to providing limited-scope or post-deductible benefits OR the clinic does not provide "significant benefits in the nature of medical care"
- Coverage through Indian Health Service, if benefits have been received in the past three months;

- Certain veteran's medical benefits received in the past three months (receipt of VA hospital care or medical services "for a service-connected disability" will not adversely affect an individual's ability to make HSA contributions, regardless of when the VA care or services were provided);
- Medicare – including coverage under Parts A and B, Part C (Medicare Advantage plans) or Part D (prescription drug coverage)
- Medicaid, and TRICARE coverage.
  Note that a spouse's coverage can make an employee ineligible to contribute to an HSA, but only where the employee's expenses below the HDHP plan deductible can be paid or reimbursed (spouse's non-HDHP major medical, HRA, or general purpose FSA).

The following coverage and benefits do not impact HSA eligibility:

- Coverage for preventive care/screenings described in Notice 2004-23 and 2004-50;
- Coverage for preventive care for certain chronic conditions listed in Notice 2019-45;
  - Notice 2024-75 amends the above notices to expand preventive care to include oral contraceptives, male condoms, glucose monitors and insulin, and all breast cancer screenings;
- Coverage for preventive care under the ACA (includes COVID-19 vaccine once available);
- Coverage for testing and treatment of COVID-19 as described in Notice 2020-15 (plan years ending on or before **December 31, 2024**);
- All telemedicine services (effective March 27, 2020, regardless of whether related to COVID-19) but only applies for plan years beginning on or before **December 31, 2024** (2023 and 2024 plan years);
- AD&D coverage (permissible when any health benefits are limited to expenses triggered by the accident or injury);
- Automobile insurance with medical coverage benefits (permissible if medical coverage is provided in the event of accident);
- Dental or vision coverage, as long as general medical benefits are not provided;
- Coverage through a limited purpose H- FSA (dental, vision and/or post deductible);
- Coverage through an limited purpose HRA (dental, vision and/or post deductible);
- Disability coverage;
- Disease management programs and EAPs, as long as "significant" benefits in the nature of medical care are not provided;
- Disease-specific insurance (i.e., cancer policy) or fixed dollar indemnity insurance, as long as the benefit is insurance and principal health coverage is provided through the HDHP.

What is an employer's duty to confirm an employee is HSA eligible?
Employers have fairly limited duties to confirm an employee's HSA eligibility. Employers must verify that the employee doesn't have incompatible coverage through one of the employer's plans, but does not have an obligation to verify the employee's coverage beyond that.

Even so, employers should carefully communicate what constitutes compatible and incompatible coverage to employees with an HSA–HDHP benefit option. Employers should also include an express acknowledgment that enrolling employees have no incompatible coverage as part of open enrollment and the HSA-HDHP election process.

Implementing this Design in an Aging Population: HSAs and Medicare

There are special considerations when implementing this design where there is a significant population of Medicare-entitled employees, or employees who will soon be entitled to Medicare.

If the employee is enrolled in any part of Medicare and also covered by the employer's HDHP, the employee cannot contribute to an HSA or receive employer contributions to an HSA. Employers that contribute to their employees HSAs may want to provide additional taxable income, an HRA contribution, or an FSA contribution for those Medicare-entitled employees enrolled in the HDHP.

Some employers do not provide the incentive through other means reasoning that if other incompatible coverage is in place the need to fund the HDHP's deductible is diminished. Note that while Medicare-entitled individuals cannot contribute to an HSA, they can reimburse expenses out of the HSA even after they become entitled to Medicare.

Another issue is where an employer is contributing to employees HSAs and an employee becomes Medicare entitled in the middle of the plan year. This could create some adverse tax consequences, depending on how the employer makes contributions. Timing of contributions is discussed in further detail below, but where an employer makes a monthly HSA contribution, there is less tax risk to the employee because the employee can notify the employer of their Medicare-entitlement and stop the monthly employer contribution before or shortly after the employee loses eligibility for the contribution. Where an employer makes a lump sum contribution, annually or quarterly, the Medicare-entitled employee will have some tax liability if the employer does not revoke the pro-rated portion of the contribution attributable to those months the employee was Medicare entitled.

Medicare Part A entitlement can be further complicated for older Medicare enrollees. If you enroll in Medicare during the three-month period before your 65th birthday, Medicare is effective on the first day of the birthday month. However, if an individual enrolls after that, Medicare Part A is effective retroactively to the first day of the birthday month or 6 months,

whichever is less. This can create problems for employees over age 65 ½ that are working (or those who retire) and choose to enroll in Medicare while contributing to an HSA. If this is the case, employees (or recent retirees) should work backwards 6 months or to their 65th birthday to plan HSA contributions accordingly. This can mean understanding whether the 6 months fall within 1 tax year or 2. Note that the retroactive coverage rule only applies to those who receive premium free Medicare Part A.

It is also important to remember that HSA contributions are described as annualized amounts but they are in fact prorated monthly amounts based on the number of months you are HSA eligible. If you contributed to an HSA during the months that were retroactively covered by Medicare a correction is only required if that resulted in contributions in excess of the prorated limitation. Even then you can generally withdraw the excess contributions (and any net income attributable to the excess contribution) from the HSA without penalty if you do it by the due date for filing your tax return.

Employers should clearly communicate these issues with their employees. It is also important to keep their population demographic in mind when considering how to make HSA contributions.

With respect to spouses with Medicare, as noted above, spousal Medicare entitlement does not impact the employee's ability to contribute to an HSA. An employee can elect either the individual tier of HDHP coverage or the family tier and enroll the Medicare entitled spouse in the HDHP as a dependent. If the employee elects the family tier of HDHP coverage, the spouse will have dual coverage under the HDHP and Medicare, but will not be eligible to contribute to an HSA. The employee, however, is HSA eligible if he/she has no disqualifying coverage and can contribute the family limit to their HSA in this situation. Regardless of the tier of HDHP coverage and HSA contribution limit, the medical expenses of both the employee and the Medicare-entitled spouse can be reimbursed from the HSA.

HSAs and Domestic Partners

Where employees' domestic partners are eligible for the employer plan, employees enrolled in family HDHP coverage can contribute the family coverage limit to their HSAs. However, an employee cannot reimburse the expenses of the domestic partner out of the HSA unless that domestic partner is also a tax dependent (as defined by IRC § 152 as modified by § 105). Most domestic partners are not tax dependents. To be a tax dependent a domestic partner must generally meet the following conditions:

- for the taxable year of the employee have the same principal place of abode as the employee and be a member of the employee's household (must not violate local law);
- receive over half of his or her support from the employee;
- not be anyone's qualifying child; and

- be (1) a citizen or national of the U.S., or (2) a resident of the U.S. or a country contiguous to the U.S.

Non tax dependent domestic partners can establish their own individual HSAs as long as they have HDHP coverage and no disqualifying coverage (e.g., general purpose FSA or HRA, Medicare, Tricare). A domestic partner can also contribute the family coverage limit to their HSA if covered by family HDHP coverage.

When Participants Fail to Open an Account

To encourage HSA enrollment and contributions or to simplify the process for employees, many employers want to unilaterally open HSAs for their employees when implementing a HSA –HDHP. However, HSAs are individual custodial accounts and generally cannot be opened without some direct involvement from employees. HSA eligibility restrictions, like incompatible coverage (including a spouse's general purpose H-FSA or HRA), also make employee involvement critical to the process. Required employee involvement can create administrative issues when employees fail to open accounts (or fail to provide the information necessary for an account to be opened on their behalf).

The Comparability Rules have strict notice and procedural requirements for employees that fail to open HSAs. Those rules do not apply to HSAs that are offered as part of the employer's Code §125 Cafeteria Plan, which is the prevalent and recommended practice. There are no specific rules for employees that fail to open accounts under Code §125. Best practices include establishing a reasonable window within which employees must establish an account and expressly providing in the Cafeteria Plan document and in enrollment materials that the employer has no obligation to make contributions for employees who fail to act. **Specifically, where employers fund employee HSAs, plan documents and employee communications should state that any employer funds are forfeited if employees do not timely open HSAs.** For more information on notice requirements under the Comparability Rules see our Alliant Insight.

HSA and H- FSA Transition: When is the Employee HSA Eligible?

Employers introducing an HSA–HDHP often already have a general purpose H- FSA in place as an option under their Cafeteria Plan. As noted above a general purpose H- FSA is incompatible coverage that prevents HSA eligibility for the entire coverage period or plan year. This is the case even if the H- FSA is exhausted or has a zero balance prior to the end of the coverage period. Many if not all H- FSAs also offer either a grace period or a carryover option. Both of these options create issues in implementing a HSA so employers will need a transition plan with respect to these accounts.

FSA Grace Periods

A grace period allows participants to access unused FSA amounts after the end of a plan year to reimburse expenses incurred for up to 2 ½ months after the end of the plan year. This is

different from a run-out period, which only provides additional time to submit expenses incurred during the coverage period or plan year. If an employee has a balance in a general purpose H- FSA with a grace period, the grace period extends the time the employee is not eligible to contribute to an HSA. S/he is not HSA eligible until the first calendar month after the grace period ends (April in the case of calendar year plan with a 2 ½ month grace period). However, an employee with a zero balance at the end of the plan year can disregard H- FSA coverage and will be HSA-eligible during the grace period. The zero balance is determined on a cash basis which means that pending claims that have not been paid are still reflected as an H-FSA balance.

When implementing an HSA into a plan with a general purpose H- FSA and grace period employers should communicate well in advance of the start of the plan year that any employee that wants to be HSA eligible as of the first day of the plan year must have a zero balance in the H- FSA as of the last day of the coverage period. Otherwise, they will have to wait to make and receive contributions until the first month after the grade period ends—April, for most plans.

Carryovers

IRS guidance now allows H- FSAs to offer carryovers of unused balances of up to $500 remaining at the end of a plan year to be used for qualified medical expenses incurred in subsequent plan years. General purpose H- FSA carryovers raise similar HSA eligibility issues as H- FSA grace periods. A H- FSA carryover makes the employee ineligible to contribute an HSA for the *entire subsequent plan year, even after the carryover is exhausted and even if the employee does not make or receive new H- FSA contributions*.

Solutions to Carryovers

In order to address this, the rules now provide that a Cafeteria Plan with an H- FSA carryover can allow employees to decline or waive their carryover prior to the beginning of the next plan year so that they can contribute to an HSA. A plan can also allow participants to elect on an individual by individual basis to carryover unused general purpose FSA amounts into an HSA compatible limited purpose H- FSA.

Lastly, the Cafeteria Plan could provide that employees who elect HDHP coverage for the next year automatically carryover health FSA funds into an HSA compatible limited purpose health FSA. This strategy may not be ideal because not all enrollees in an HDHP are HSA eligible. This would be the case with a high Medicare or Tricare entitled population. A better approach is for employers to take advantage of the unprecedented flexibility that allows each individual to elect to carryover H-FSA balances to either a general purpose H- FSA or an HSA compatible H-FSA. That way individuals can make choices that are most beneficial based on their respective HSA eligibility.

Employer Contributions: the Full Contribution Rule

Employers that elect to fund employee HSAs often struggle with when to make contributions. Common funding options are annually at the start of the plan year, quarterly, semi-annually, and monthly. The best option may depend on the employer's tolerance for administrative tasks and the amount of employer funding at issue, but generally we recommend monthly funding as the most flexible for employers and employees.

Annual HSA contribution limits are tied to the tier of HDHP coverage elected (individual or family coverage). For 2020, the individual only limit is $3,550 and the family coverage limit is $7,200. These annualized limits actually apply monthly or are prorated for the number of months an individual is HSA eligible. This means that if an individual enrolls in individual only coverage in January but then acquires incompatible coverage in March they are technically only HSA eligible for 3 months of the year and their maximum HSA contribution would be $875.00. If their employer made an annual $1,000 HSA contribution at the start of the plan year the employee must withdraw the excess amount to avoid penalties. The employer cannot recoup that amount and may also need to account for payroll taxes on the excess contribution.

Employees that join the HDHP-HSA benefit option mid-year also raise HSA contribution and funding issues. As noted above, HSA annualized limits are calculated monthly or are prorated for the number of months an individual is HSA eligible. For a new employee that enrolls mid-year, the easiest approach is to limit employer funding and employee Cafeteria Plan salary reductions to the prorated HSA contribution limit reflecting the total number of HSA eligible months remaining in the calendar year, rather than allow for the individual to receive the full annual employer contribution. This is our recommended approach.

There is, however, another option called the "full-contribution rule." Under the full contribution rule, if an employee is HSA eligible on December 1, the full annual HSA contribution can be made even where the individual is only HSA eligible for a small part of the year. Those who take advantage of this rule must remain HSA eligible for a 13-month testing period (i.e., from December 1 through the end of the next calendar year) or the excess contributions loses tax favored status. Neither employer nor the HSA custodian (bank) is responsible for tracking or reporting whether an HSA-eligible individual remains HSA eligible during the testing period.

The full contribution rule is complicated to communicate to employees and is likely to create tax issues for at least some individuals who seek to take advantage of it, especially given the frequency with which employees and spouses change employers or change benefit options.

Conclusion

We will likely continue to see increased movement to HDHP-HSA plan designs in all types of industries and employee populations. This is a move that can be unsettling for employees

and their families. The transition will be much smoother if you address the potential issues discussed here before the transition begins, and provide employees clear and direct guidance about how these plans operate.