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February 2006

Health Savings Accounts: Avoiding the Consumer Traps

What is a Health Savings Account (HSA) and what is a high deductible health plan?

An HSA is a tax-exempt savings account that you can open to save money for current and future health care costs. In order to open an HSA, you need to have a high deductible health plan, a type of insurance which only starts paying after you have paid for an initial amount of health care costs (see below). You may purchase a high deductible health plan from an insurance company and open an HSA with a bank on your own or your employer may offer such a plan in place of a more traditional health plan.

Why do some people like HSAs?

Money. HSAs coupled with a high deductible health plan fall under the umbrella category of “consumer-directed health plans.” The idea is that if consumers like you bear more of the financial burden in initial health care spending, market forces will work to lower health care costs. A high deductible health plan forces the consumer to consider the cost of health services when making health care decisions before the deductible has been met. In traditional insurance, patients pay the same copay regardless of what the doctor is really charging. It costs patients nothing more to go to a more expensive doctor. Often, the higher out-of-pocket cost with an HSA plan is exchanged for lower premiums than are available in more traditional plans. The money in your HSA rolls over from year to year, there is no use-it-or-lose-it rule, and the funds can be invested. Also, some individuals can save money with HSAs because contributions into an HSA are exempt from federal income taxes. Many small businesses are looking to HSAs to lower their health care costs by passing more of the cost burden onto employees.

How do I know if I am eligible for an HSA?

According to the federal government, you must meet the following requirements to qualify for an HSA:ⁱ

- You have a high deductible health plan (see below) on the first day of the month.
- You have no other health coverage (see exceptions below)
- You are not enrolled in Medicare.
- You cannot be claimed as a dependent on someone else’s tax return.

How does my spouse’s coverage affect my eligibility?

If your spouse has health insurance that is not a high deductible health plan, you may still qualify for an HSA if you meet the above conditions and if your spouse’s insurance does not cover you.ⁱⁱ For a more complete listing of potential interactions between multiple insurance plans and spouse or

family HSA eligibility, get IRS Publication 969 and the Treasury Department's HSA Frequently Asked Questions about HSAs by going to www.irs.gov or calling 1-800-829-1040.

How do I know if my high deductible health plan is HSA-eligible?

An HSA-eligible individual high deductible health plan provides coverage for health care expenses after you have met an annual deductible of \$1,050 or more.ⁱⁱⁱ For a family plan, an HSA-eligible high deductible health plan has a deductible of at least \$2,100, meaning you must spend at least \$2,100 before the plan's coverage kicks in.^{iv} Depending on the plan and the insurer, the deductible for your plan may be much more than these minimums. In fact, HSA-eligible individual plans could have deductibles over \$5,000 and family plans could have deductibles over \$10,000.^v

How do I know what expenses are qualified under my HSA?

This is a really gray area. The federal government provides no definite answer to this question; however, they have established some guidelines. The Treasury Department states that, "to be an expense for medical care, the expense has to be primarily for the prevention or alleviation of a physical or mental defect or illness."^{vi} The IRS provides a partial list of qualified expenses in IRS Publication 502. However, it is your responsibility to determine whether or not an expense is a qualified medical expense (as defined above or in IRS Publication 502). **Make sure you save your receipts to justify the itemized deductions on your tax return.**

Whose medical expenses can I pay using my HSA?

Tax-free payouts from an HSA can be used to pay for qualified medical expenses of:^{vii}

- the individual covered by the high deductible
- the spouse of the covered individual (even if not covered by the HDHP)
- any dependent of the covered individual (even if not covered by the HDHP)

What happens if I need to use money from my HSA for non-qualified expenses (food, the rent, childcare, etc)?

Payouts from an HSA that are not for qualified medical expenses are taxed as income on top of a 10% additional penalty. Individuals who are disabled or are over the age of 65 may take money out of their HSA for non-medical expenses without penalty. However, this money is still taxed as income.

What happens if I am wrong about the eligibility of a medical expense?

If you are audited, you may be asked to show receipts for the medical expenses paid out of your HSA. If the IRS determines that your expenses were not qualified, the amount of the unqualified expenditure will be taxed as income, and probably given the additional 10% penalty. Whether additional penalties will be assessed, and whether you have the right to appeal this decision are not clear. Please contact the IRS for more information about the penalties for an unqualified medical expense.

What tax forms do I have to file if I have an HSA? What forms do I receive from the bank issuing my HSA?

Each year, the bank issuing your HSA will send you the following two forms: Form 5498-SA and Form 1099-SA. Form 5498-SA shows what contributions you and/or your employer have made to the account. Form 1099-SA shows what money you have withdrawn from the account. You will use this information to fill out IRS Form 8889 which calculates the income tax deduction for your

HSA as well as any penalties to be paid for unqualified distributions. IRS Form 8889 is then attached to your U.S. Individual Income Tax Return, IRS Form 1040 -- the long form.^{viii} To find tax forms and instructions, go to <http://www.irs.gov> or call 1-800-829-1040.

How much money do I need to have available to use a Health Savings Account?

The federal government has set limits on the “out-of-pocket” annual medical expenses that you can face under a high deductible health plan for it to be HSA-eligible. For 2006, these maximums are \$5,250 for an individual plan and \$10,500 for a family plan.^{ix}

So I won't have to pay any more than those maximums?

No, it is important for you to know that these out-of-pocket maximums apply only to the high deductible health plan, not the HSA. The out-of-pocket maximum includes payments towards the deductible and co-payments after the deductible has been reached.

The federal out-of-pocket maximum does not include the following:^x

- High deductible health plan premiums.
- Qualified medical expenses paid for using the HSA but not covered by the high deductible health plan. Because these expenses do not count towards the deductible, they do not count towards the out-of-pocket maximum. For example, if your health plan does not have dental coverage, you can pay for dental care out of your HSA. However, this expense does not count towards the deductible of your health plan or the out-of-pocket maximum.
- Non-qualified medical expenses. For example, teeth whitening is not a qualified medical expense. (See How do I know what expenses are qualified under my HSA? above for more information on which expenses are qualified.)

What happens if I go out of my HMO's provider network (list of doctors)?

Depending on your plan, services from doctors and practitioners outside of your HMO's provider network may not count towards your deductible or the out-of-pocket maximum. However, if the services you receive from an out-of-network doctor are qualified medical expenses, you can still use your HSA to pay.

How much money can I contribute to my HSA?

The total contribution to an HSA in any given year cannot be more than the smaller of 1) the amount of your health plan's deductible OR 2) \$2,700 for an individual plan and \$5,450 for a family plan.^{xi} These maximums include contributions to the HSA made by both you and your employer. If you are 55 or older, you are eligible to make additional “catch-up” contributions to your HSA (for more information on catch-up contributions, see http://www.treas.gov/offices/publicaffairs/hsa/faq_contributing.shtml#hsa1 or call 1-800-829-1040.) It is important to realize that these maximum annual contributions are not a maximum balance for the account. Even if you use all of the money in your HSA, you and your employer cannot put in more than \$2,700 for an individual or \$5,400 for a family in a year.

What happens if I contribute more money to my HSA than I am allowed?

As long as excess contributions and all income earned on those excess contributions are withdrawn from the HSA by the time you file your tax returns, the excess contributions and interest earned on them will be taxed as income without additional penalty. However, failure to withdraw excess contributions will result in those funds being taxed as income with an additional 6% penalty.

Will I benefit from the tax advantages of an HSA?

Maybe, maybe not. For many middle class and working families, the tax savings from an HSA are minimal. The higher your federal income tax bracket, the greater the savings. This is because your contributions to an HSA are subtracted from your total pre-tax income before calculating what income tax you owe the government (an “above-the-line” deduction). Contributions made by your employer or by you through your employer (and thus not reported as income) do not count as an above-the-line deduction, because they were not listed as income in the first place.

Does my employer have to contribute to my HSA?

No. While your employer does not have to contribute to your HSA, he or she may do so on a pre-tax basis. Employer contributions count toward the maximum annual contribution that you can make to your account. (see above)

What happens if I leave my job?

HSAs are portable, meaning that if you leave or lose your job, the HSA still belongs to you and is considered your money. You need to have a high deductible health plan to contribute to the HSA, but even without the health plan, you may withdraw funds from the account to pay for qualified medical expenses without penalty. If you have an HSA and have lost your high deductible health coverage, there are three important things to consider:

- Your HSA bank fees (see below) may be eating up the balance of your account.
- Your HSA withdrawals are not counting towards a deductible if you don’t have a high deductible health plan.
- You may use your HSA to pay for the premiums on COBRA plan continuation, and regain the ability to make tax-free contributions to your account.

What about paying for preventative care?

Preventative care coverage will vary from plan to plan. The federal government allows high deductible health plans to offer coverage of preventative care even before the deductible is reached (“first dollar preventative care coverage”). A partial list of preventative medical costs can be found in IRS Notice 2004-23, but a high deductible health plan doesn’t have to cover preventative care below the deductible. Some plans claim to offer first dollar preventative care coverage, but do not cover many preventative medical expenses listed by the government.

Can I purchase additional health coverage and keep my HSA?

As a general rule of thumb, if you are covered by a health insurance policy that is not a high deductible health plan, you are not eligible for an HSA (even if you also have a high deductible health plan). However, there are some exceptions.

Can I pay for insurance premiums using my HSA?

Some. Long-term care insurance, Medicare, and COBRA premiums can be paid from an HSA. Also, health insurance premiums paid while receiving unemployment compensation may be paid from the HSA. All other premiums cannot be paid for using an HSA, including the premium for your high deductible health plan.

Do I need to use the bank suggested by the insurer of my high deductible health plan for my HSA?

The Department of the Treasury says that you can control which company holds your HSA.^{xii} However, it is unclear if employers can set up a health benefits program that specifies an HSA custodian for you.

What sorts of fees are charged by the bank issuing my HSA?

Fees and regulations vary from one HSA bank to another, so if you have the opportunity to choose your own bank, it's in your favor to shop around. Here are some questions to ask a potential HSA bank:

- Do you have a minimum start up deposit?
- Is there a start up fee?
- What monthly, annual, transaction, and closing fees are associated with this account?
- Is there a monthly or annual minimum contribution that I must make?
- Will I receive checks, a debit card, or a credit card with this account to pay for qualified medical expenses? (If not, how can I get reimbursed for the expenses I pay out?)
- What fees and interest rates are associated with these payment options?
- What minimum balance is required for my account to earn interest?

Who is there to help me make health care decisions and find the best value for my money?

One of the common criticisms of consumer-directed health plans is that they don't give you enough help making very complex, very important decisions about your health and your money.^{xiii}

Insurance providers have been criticized for not providing information on cost efficiency or quality to consumers. Specifics vary from plan to plan, so don't be afraid to ask what support an insurer can provide you. Moreover, there are some free Internet sites (such as www.familyhealthbudget.com and www.subimo.com) that can help you estimate your annual health care costs.

Are other consumers satisfied with their HSAs and other consumer-directed health plans?

A study by the Employee Benefit Research Institute found that consumers with consumer-directed and high deductible health plans were more likely than consumers with comprehensive health plans to be:^{xiv}

- dissatisfied with their plan
- pay higher out of pocket costs (despite similar use of care)
- put off health care because of cost
- more cost-conscious health care consumers

Bottom Line:

Do your homework and don't be afraid to ask questions. **HSAs aren't for everybody.** Before choosing an HSA, it's important to understand exactly what your high deductible health plan will cover, what your estimated annual health costs are, how much financial risk you can handle, how it affects your taxes, and what the HSA's fees and restrictions will be.

Helpful Links:

US Treasury Dept. – Health Savings Accounts Resources

<http://www.treas.gov/offices/public-affairs/hsa/>

US Treasury Dept. – HSAs: Frequently Asked Questions

<http://www.treas.gov/offices/public-affairs/hsa/faq.shtml>

CT State Insurance Dept. list of High-Deductible Health Insurance Policies for Use with Tax-Qualified Savings Accounts (scroll down the page a bit)

<http://www.ct.gov/cid/cwp/view.asp?a=1267&q=254440>

February 2006

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ⁱ IRS Publication 969.

ⁱⁱ IRS Publication 969.

ⁱⁱⁱ Minimum deductible for an individual plan to be HSA eligible in 2006. (www.treas.gov/offices/public-affairs/hsa/faq_basics.shtml)

^{iv} Minimum deductible for a family plan to be HSA eligible in 2006. (www.treas.gov/offices/public-affairs/hsa/faq_basics.shtml)

^v IRS Publication 969.

^{vi} http://www.treas.gov/offices/public-affairs/hsa/faq_using.shtml#hsa2

^{vii} U.S. Treasury Department. (2005) All About HSAs. available at <http://www.treas.gov/offices/public-affairs/hsa/pdf/hsa-basics.pdf>

^{viii} Courtesy of First HSA, Inc. www.1hsa.com.

^{ix} IRS Publication 969.

^x IRS Publication 969.

^{xi} Maximums are for 2006. http://www.treas.gov/offices/public-affairs/hsa/faq_contributing.shtml#hsa1

^{xii} U.S. Treasury Department. HSA Basics (tri-fold brochure) – for use in 2006. available at <http://www.treas.gov/offices/public-affairs/hsa/pdf/HSA-Tri-fold-english-06.pdf>.

Also, U.S. Treasury Department. (2005) All About HSAs. available at <http://www.treas.gov/offices/public-affairs/hsa/pdf/hsa-basics.pdf>

^{xiii} Rosenthal et al. (2005) A Report Card On The Freshman Class Of Consumer-Directed Health Plans. *Health Affairs* 24, 6: 1592-1599.

Also, Frostin et al. (2005) Early Experience With High-Deductible and Consumer-Driven Health Plans: Findings From the EBRI/Commonwealth Fund Consumerism in Health Care Survey. EBRI Issue Brief No. 288.

^{xiv} Frostin et al. (2005) Early Experience With High-Deductible and Consumer-Driven Health Plans: Findings From the EBRI/Commonwealth Fund Consumerism in Health Care Survey. EBRI Issue Brief No. 288.