

Legal Compliance Developments for Consumer Driven Health Care

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©Cheryl Risley Hughes, Esq.
Lincoln Weed, Esq.
Sanders, Schnabel & Brandenburg, P.C.
Washington, DC
202.638.2241
crhughes@ssblegal.com
lweed@ssblegal.com

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Background and Basic Concepts

- Three stages of evolution
 - “Provider-driven” traditional fee-for-service medicine
 - “Payer-driven” managed care
 - “Consumer-driven” health care (“CDHC”)
- CDHC plans have three basic elements:
 - High deductible insurance coverage
 - Health spending accounts (tax-sheltered)
 - Wellness/care management resources

Background and Basic Concepts

- Theory of CDHC plans is to change the role of employees from passive beneficiaries to active, informed consumers. To do so, CDHC plans provide employees with:
 - Greater financial stake in medical spending, including choice between spending and saving available funds
 - More choice in health care providers
 - More information about provider costs and quality
 - More information about their own health problems, treatment alternatives and lifestyle choices affecting their health

Background and Basic Concepts

- Health spending accounts under Internal Revenue Code
 - *Health Savings Account ("HSA")*
 - Introduced by 2003 Medicare reform legislation
 - Successor to Medical Savings Accounts under HIPAA
 - *Health Reimbursement Arrangement ("HRA")*
 - HRAs with carryovers confirmed by IRS guidance in 2002
 - HRAs available prior to 2002 under I.R.C. Section 105
- **HSAs and HRAs allow asset accumulation, unlike —**
 - *Health Flexible Spending Account ("health FSA")*
 - Permitted under I.R.C. for more than 25 years; precursor to CDHC
 - Usually offered as a component of cafeteria plans

Health Savings Accounts (HSAs): The Basics

- HSAs permit pre-tax employee and employer contributions (usually through cafeteria plans) and tax-free withdrawals for qualified medical expenses
- Assets are held and invested in separate account by outside custodian or trustee
- Assets are never forfeited to employer and unspent funds accumulate year-to-year; no use-it-or-lose-it rule
- No employer review and approval (adjudication) of account withdrawals; employees may withdraw for non-medical spending subject to paying taxes and (generally) 10% penalty

Health Savings Accounts (HSAs): The Basics

- Eligibility for contributions to HSA conditioned on employee coverage under high deductible health plan (HDHP) and only limited coverage under low deductible plans
- To qualify as HDHP, insurance coverage must satisfy minimum deductible and annual out-of-pocket maximum for single/family coverage (min/max limits apply for in-network expenses)
- Primarily regulated by IRS; HSAs are not subject to ERISA if certain requirements are met; other federal health laws generally not applicable

Health Savings Accounts (HSAs): The Basics

| <i>HSA/HDHP Limits 2009</i> | Single | Family |
|---|-----------------------------|-----------------------------|
| Contribution Limits + catch-up contributions (if age 55) | \$3,000 + \$1,000 | \$5,950 + \$1,000 |
| Minimum Deductible | \$1,150 | \$2,300 |
| Out-of-Pocket Maximum | \$5,800 | \$11,600 |

Health Reimbursement Arrangements (HRAs): The Basics

- HRAs permit tax-free employer contributions and tax-free withdrawals for qualified medical expenses
- Employee contributions not permitted; employer contributions must be outside cafeteria plan
- Usually unfunded; employer “contributions” are credited to bookkeeping reserves within employer general assets
- Use-it-or-lose-it rule is not required (but is permitted). Employees may thus accumulate unspent account assets from year to year, but employer may set limit on permitted carryover

Health Reimbursement Arrangements (HRAs): The Basics

- Employer or third party administrator reviews and approves (“adjudicates”) employee spending from HRA
- Forfeitures of unspent amounts permitted at termination of employment
- High deductible insurance coverage not required, but in practice most employers offer HRAs in conjunction with some form of high deductible plan
- Primarily regulated under Internal Revenue Code and ERISA; other applicable federal laws: ERISA, COBRA, HIPAA, NMHPA, MHPA, WHCRA, MSP, FMLA, USERRA

Health Flexible Spending Accounts (FSAs) – The Basics

- Health FSAs permit pre-tax employee contributions and tax-free reimbursements for qualified medical expenses
- Usually funded by crediting employee salary reductions under cafeteria plans to bookkeeping reserves within employer general assets
- Employer or third party administrator reviews and approves (“adjudicates”) employee spending from account

Health Flexible Spending Accounts (FSAs) – The Basics

- Use-it-or-lose-it rule applies: unspent funds are forfeited to employer at end of year; 2½ month grace period at year-end if plan so provides
- Uniform coverage rule applies: entire annual salary reduction available for employee to withdraw at beginning of year
- Primarily regulated under Internal Revenue Code and ERISA; other applicable federal laws: COBRA, HIPAA, NMHPA, MHPA, WHCRA, MSP, FMLA, USERRA

HSA/HRA/FSA Basics: Recent Developments

- IRS Notice 2008-82 providing guidance on HEART Act provision permitting distribution of unused benefits in health FSAs *9/29/08*
- DOL proposed regulations on investment advice *8/22/08*
- IRS proposed regulations on comparability rules and excise tax reporting *7/16/08*
- IRS Notice 2008-59 on “grab-bag” guidance on HSAs *6/25/08*
- IRS Notice 2008-52 on full contribution rule *6/04/08*
- IRS Notice 2008-51 on IRA to HSA transfers *6/04/08*
- IRS Rev. Proc. 2008-29 on HSA dollar limits for 2009 *5/13/08*
- IRS final regulations on delayed establishment of HSAs and accelerated contributions *4/17/08*
- IRS Announcement 2008-44 on direct deposits and withdrawals of economic stimulus payments *5/19/08*

Further Comparisons of HSAs, HRAs, and Health FSAs

- Eligibility
- HSA Eligibility
- Qualified Medical Expenses
- Adjudication Issues
- Dependent Expenses
- Funding
- HSA Funding
- Carryovers
- Nondiscrimination
 - HRAs and Health FSAs
 - Cafeteria Plans
 - HSA Comparability Rules
- Other Rules and Compliance Requirements

Comparison of HSAs, HRAs, and Health FSAs - Eligibility

- **HSAs** – Any individual (including self-employed) who satisfies Code definition of “eligible individual” (see next page) as of first day of month is eligible to make or receive HSA contributions for that month.
 - Withdrawals from HSA are permitted at any time, without regard to continued eligibility for HSA contributions
- **HRAs** – Any employee or retiree is eligible; self-employed individuals are not
- **Health FSAs** – Any employee or former employee under COBRA is eligible; retirees, self-employed individuals are not (self employed individuals include partners, more than 2% Sub S shareholders, independent contractors)

HSA Eligibility

- Requirements for eligibility to make or receive contributions to HSA:
 - Coverage under HDHP (no exceptions)
 - No coverage under non-HDHP (several exceptions)
 - Not enrolled in Medicare Part A-D (eligibility irrelevant)
 - Receiving social security benefits results in automatic Medicare Part A enrollment, which bars HSA eligibility. Delaying receipt of social security benefits and non-enrollment in Medicare Part A, B, C and D permits HSA eligibility to continue in retirement, including continued catch-up contributions
 - Not able to be claimed as another's tax dependent
- Note: HSA-eligible self-employed individuals may not make pre-tax contributions through cafeteria plan; instead they contribute outside cafeteria plan and take above-the-line income tax deduction

HSA Eligibility

- Exceptions permitting non-HDHP coverage
 - Preventive care
 - Disregarded coverage:
 - Insurance relating to worker's compensation, tort and property liabilities, specified disease or illnesses, hospital daily indemnity
 - Coverage for accidents, disability, dental, vision, long-term care
 - Non-overlapping HRA or health FSA
 - Limited purpose HRA or FSA (preventive, dental/vision care)
 - Post-deductible HRA or health FSA
 - Suspended HRA (no reimbursements available during plan year)
 - Retirement-only HRA (no reimbursements until retirement)
 - Coverage during health FSA grace period if account balance is exhausted or transferred to HSA

HSA Eligibility

- 6/08 guidance on permitted non-HDHP coverage and effect of statutory minimum deductible
 - An eligible individual with HDHP coverage may also have coverage under a plan that is not a qualifying HDHP provided that the deductible is at least the statutory minimum. Example is umbrella coverage with deductible of the HDHP's lifetime limit (Q&A-7)
 - Embedded individual deductible of at least the statutory minimum for family coverage within an umbrella family deductible does not affect HSA eligibility (Q&A-4(a))
 - If individual switches from family to self-only HDHP, expenses incurred during family coverage may be allocated in any reasonable manner, for satisfying self-only deductible (Q&A-12)

HSA Eligibility

- 6/08 guidance on permitted non-HDHP coverage
 - Where employee has HDHP family coverage, family members may have additional non-HDHP coverage (if it excludes the employee) (Q&A-11)
 - Post-deductible HRA or health FSA for employee with HDHP family coverage may not reimburse medical expenses of family member incurred before satisfying statutory minimum family deductible (\$2,300 for 2009) (Q&A-8)
 - Post-deductible HRA or health FSA may pay expenses above statutory minimum family deductible of individual with family HDHP coverage (Q&A-4(b))
 - Example: HDHP policy has family deductible of \$4,000. Post-deductible HRA may pay individual family member's expenses above \$2,300 (for 2009).

HSA Eligibility

- 6/08 guidance on permitted non-HDHP coverage
 - **Veterans Admin. medical benefits:** receipt of VA benefits within past 3 months bars HSA eligibility, but this rule does not apply if benefits received are limited to disregarded coverage or preventive care (Q&A-9)
 - **“Mini-med” plan** covering expenses below the statutory minimum deductible bars HSA eligibility unless mini-med plan is limited to preventive care or disregarded coverage (Q&A-2)

HSA Eligibility

- 6/08 guidance on permitted non-HDHP coverage: effect of employer payments
 - Employer payment of employee's share of HDHP premiums through HRA does not affect HSA eligibility (Q&A-1)
 - Employer payment of portion of expenses below minimum deductible bars HSA-eligibility (Q&A-3)
 - **Employer's onsite clinic:** Access to free or below-FMV care from employer's clinic does not bar HSA eligibility if clinic does not provide significant benefits in the nature of medical care (other than disregarded coverage or preventive care). E.g., clinic may provide allergy injections, non-prescription meds, treatment for workplace injuries (Q&A-10)

HSA Eligibility

- Spousal coverage and HSA eligibility: basic rules
 - If either spouse has family coverage, then both spouses are treated as having only that coverage
 - If both spouses have family coverage, then lower deductible applies for purposes of determining eligibility and combined contribution limit
 - Combined contribution limit may be divided between spouses as they choose; default is equal division
 - If one spouse has HDHP coverage and other spouse has non-HDHP family coverage that excludes first spouse, then first spouse is HSA-eligible
 - Contribution amount depends on whether first spouse's HDHP coverage is family or single) Rev. Rul. 2005-25

HSA Eligibility

Spousal coverage and HSA eligibility: examples

- Suppose husband has family non-HDHP coverage covering self and children; wife has self-only HDHP coverage
 - Husband is ineligible for HSA contributions
 - Wife is HSA-eligible and may contribute \$3,000 (for 2009)
- Suppose employee has HDHP coverage for himself and a same-sex domestic partner who does not qualify as tax dependent
 - This appears to constitute family coverage for HSA-eligibility purposes because it is not self-only coverage
 - Same-sex domestic partner may not be treated as spouse for federal law purposes. Therefore, HSA-eligibility rules on spousal coverage appear to be inapplicable to same-sex domestic partner relationships
 - Because domestic partner is not tax-dependent and has HDHP coverage, he apparently may contribute to his own HSA up to family coverage limit. Employee may do the same for his HSA. Their combined contributions are double what a married couple is permitted.

Comparison of HSAs, HRAs, and Health FSAs – Expenses Qualified for Payment or Reimbursement

- **HRAs and health FSAs** – Both may pay unreimbursed medical expenses under Section 213(d) of the Code, including expenses of spouse and dependents. Unlike HSAs, both may be designed to exclude payment of some 213(d) expenses.
- **HRAs**
 - Insurance premiums are payable – even for Medicare Part B or Medicare supplemental policies and long term care insurance (but no long term care services)
 - Expenses incurred post-employment are payable if HRA includes spend-down provisions (which are common for retirees)
- **Health FSAs** – Insurance premiums and payments for qualified long term care insurance or services may not be paid or reimbursed. Post-employment spend-down provisions are not permitted. Advance payment of orthodontia expenses is permitted.

Comparison of HSAs, HRAs, and Health FSAs – Expenses Qualified for Payment or Reimbursement

- **HSAs** – Unreimbursed medical expenses under Section 213(d) of the Code are payable, including expenses of spouse and dependents. Insurance premiums, including Medicare supplemental policy premiums, are not payable (except for COBRA coverage, long term care insurance, health insurance while unemployed, post-65 health insurance policy, Medicare Part D)
 - Notice 2008-59, Q&As 31-32 confirm that HSA may pay premiums for coverage *of spouse or dependent* during COBRA period or unemployment
- **HSA distributions** are allowed for non-medical purposes but will be taxable and subject to 10% excise tax unless exceptions are met (death, disability or post age 65)
- **Dependent status** — see below

Comparison of HSAs, HRAs, and Health FSAs – Dependent Expenses

- Dependents' medical expenses are payable on tax-free basis, if tax code definition of dependent is satisfied
 - HDHP, HRA or health FSA may define dependent differently than tax code definition. Defining dependent more broadly makes value of dependent coverage taxable to employee
 - Tax code definition of dependent controls for HSA purposes
- What is tax code definition of dependent?
 - Definition of dependent for group health plan purposes is slightly broader than definition for tax exemption purposes
 - New guidance clarifies dependent treatment in divorce situations
 - Custodial parent need not release claim to exemption
 - HSA may pay expenses of dependent claimed by former spouse

Comparison of HSAs, HRAs, and Health FSAs - Adjudication

- **Health FSAs** – Expenses must be substantiated and adjudicated (or auto-adjudicated)
- **HRAs** - Expenses must be substantiated and adjudicated (or auto-adjudicated)
- **HSAs** – No adjudication by employers is required or permitted. Upon audit, participant must be able to document that HSA withdrawals are for qualified medical expenses. For this purpose, HSA trustee/custodian may adjudicate expenses as a service to participant, or else participant must maintain documentation (“shoe box” recordkeeping). In either case, employer has no role.
 - Notice 2008-59, Q&A 28 clarifies that HSA account owner may authorize withdrawals by someone else

Comparison of HSAs, HRAs, and Health FSAs - Adjudication

■ Health FSAs & HRAs –

- *Debit cards* - can be used to auto-adjudicate (i.e. no further substantiation required) in certain circumstances defined by IRS notices 2006-69, 2007-2
- *EOB rollovers* – insurers send EOBs to TPAs who make automatic reimbursements from HRAs and health FSAs to participants.

■ HSAs –

- *Debit cards* - can be used (with medical filtering) but employee must have another method of obtaining money from account.
- *EOB rollovers* – permitted but undesirable to employee whose goal is saving money in an HSA.

Comparison of HSAs, HRAs, and Health FSAs - Adjudication

- Debit Card Guidance
 - IRS Notice 2006-69 allows auto-adjudication at merchants (without health care MCCs) with inventory information approval systems (IIAS) and permits multiples of co-pays, in addition to original auto-adjudication methods (co-pays, recurring expenses, and real-time adjudication charges at merchants with health care MCCs).
 - IIAS must have recordkeeping and allow split transactions.
 - Also permits automatic adjudication based on EOB

Comparison of HSAs, HRAs, and Health FSAs - Adjudication

- Debit Card Guidance (con't)
 - IRS Notice 2007-2 provides transitional relief to merchants without health care MCCs until 12/31/2007 — allows use of cards to continue until IIAS in place
 - IRS Notice 2007-2 also imposes new rule on drug stores and pharmacies – must have IIAS or 90% of gross sales must be qualified medical expenses
 - Notice 2008-59, Q&A 26 clarifies that HSA may be administered through debit card restricted to medical expenses, but only if access to HSA funds is otherwise available, e.g. through online transfers, ATM withdrawals or checkwriting

Comparison of HSAs, HRAs, and Health FSAs – Funding

- Contributions –
 - **Health FSAs** – Salary reductions or employer contributions
 - **HRAs** - Employer contributions only (but not under the cafeteria plan)
 - **HSAs** – Salary reductions or employer contributions through a cafeteria plan, other employer contributions, after-tax contributions of individual

Comparison of HSAs, HRAs, and Health FSAs – Funding

- Contribution limits –
 - Health FSAs – None, if non-discriminatory
 - HRAs – None, if non-discriminatory
 - HSAs – \$3,000 for self-only coverage and \$5,950 for family coverage (2009 indexed amounts). Additional “catch-up” contributions (\$900 for 2008 and \$1,000 thereafter) permitted for individuals who attain age 55 before end of taxable year.
 - Each spouse must contribute catch-up amount to own HSA (Q&A-22)
 - Contribution limits are also tax deduction limits
 - Dec. '06 legislation removed policy deductible as alternative limit, permitted full year contribution when eligibility begins mid-year, and allowed one-time “qualified HSA funding distribution” from traditional and Roth IRAs to HSAs (see Notice 2008-51 for detailed guidance on distributions from IRAs)

HSA Funding

Applying the family HSA contribution limit

- Family contribution limit applies even if spouse or dependents have coverage by non-HDHP, Medicare or Medicaid, but no portion of contribution is allocable to spouse's HSA
- If both spouses are HSA-eligible with one having self-only and the other family coverage, then the family limit applies, regardless of whether family HDHP covers spouse with self-only coverage; contribution is allocated between spouses by agreement
- If both spouses have family HDHP coverage, then family limit applies, regardless of whether each spouse's family coverage covers other spouse

HSA Funding

Timing rules

- Individual who becomes eligible mid-year may contribute full-year amount, based on Dec. 1 coverage status (this may increase, not decrease, contribution limit)
 - But failure to remain eligible throughout following year (testing period) for reasons other than disability or death means that contributions attributable to pre-eligibility period (but not earnings) are included in gross income, and penalty is imposed of 10% of that amount, for following year.
 - Penalty applies regardless of age or applicability of 10% penalty for non-medical
 - Pre-eligibility contributions are not distributable as excess contributions
- Individual losing eligibility during year may only contribute pro-rated amount, but still has until next 4/15 to make that contribution
- Contributions made between Jan. 1 and April 15 are allocable to prior year, but Form W-2 Box 12 should show actual contributions for calendar year.

HSA Funding

Timing rules

- Date HSA established is determined by state trust law
 - Most state laws require holding assets for a trust to exist
 - State laws vary as to signature requirement
 - HSA may not be treated as existing prior to date established under state law; e.g., HDHP coverage date does not begin HSA
- If HSA receives funds by rollover or transfer from other HSA, then establishment date of other HSA carries over to transferee HSA. No such effect for qualified HSA distributions under § 106(e) or qualified HSA funding distribution from IRA
- If account owner had previously established an HSA, and later establishes a new HSA, the original establishment date of the prior HSA carries over to new HSA if prior HSA had positive balance within 18 months before new HSA is established

HSA Funding

Correction rules

- 6% penalty on excess contributions, unless excess + earnings are distributed to individual by tax return extended due date
- Erroneous contributions to HSA are returnable to employer —
 - If employee was never HSA-eligible—then no HSA existed, or
 - If amount exceeded statutory limit—then excess is returnable
- Employer may ask HSA custodian to return erroneous contributions + earnings to employer. If not returned by end of taxable year, then employer must include the amount in employee's gross income and report on W-2.
- Erroneous contributions to HSA *not* returnable to employer —
 - If contribution exceeds employer's intent but not statutory limit
 - If employee ceased to be eligible mid-year and employer seeks to recoup subsequent contributions (employee is responsible for withdrawing excess + earnings and including both in income)

Comparison of HSAs, HRAs, and Health FSAs - Carryovers

- **HSAs** – carryovers required
- **HRAs** – carryovers permitted, not required
- **Health FSAs** – no carryover (except for 2½ month grace period, if plan provides for it)
 - HEART Act (6/17/08) and Notice 2008-82 (9/29/08): unused amounts may be distributed to military reservists called to active duty for 180 days (or indefinite period)
- Carryover is fundamental to CDHC; it is intended to change employee focus from annual spending and forfeiture to long-term medical and financial benefits resulting from careful attention to health care and spending

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- **Health FSAs** - Cannot discriminate in favor of highly compensated individuals as to eligibility to participate or benefits—Code § 105(h); also subject to proposed cafeteria plan nondiscrimination rules under Code § 125
- **HRAs** - Cannot discriminate in favor of highly compensated individuals as to eligibility to participate or benefits—Code § 105(h); Code § 125 rules do not apply
- **HSAs** – Employer contributions must satisfy comparability rules under Code § 4980G unless offered through cafeteria plan—then must satisfy cafeteria plan proposed non-discrimination rules under Code § 125

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Nondiscrimination rules for HRAs and health FSAs under Code § 105(h)*:
 - HRAs and health FSAs are treated as self-insured health plans, which are not permitted to discriminate in favor of “highly compensated individuals” as to eligibility or benefits
 - Regulations under § 105(h) are more than 25 years old; IRS does not currently issue rulings; little enforcement activity. It may be reasonable to apply certain elements of new § 125 regulations for § 105(h) purposes
 - Both § 105(h) and § 125 use term “highly compensated individuals” but term is defined differently in each section

* These rules also apply to self-insured major medical plans, including HDHPs. Discrimination under § 105(h) have adverse tax consequences under Code § 409A rules governing nonqualified deferred compensation.

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Nondiscrimination rules for HRAs and health FSAs under Code § 105(h) (cont'd):
 - HRAs and health FSAs are nondiscriminatory because when they cover most employees and provide the same benefits to all, as commonly occurs
 - Other situations may require careful consideration of discrimination rules. Examples:
 - Health FSA where limit on annual contributions is so high as to be used only by highly compensated employees
 - HRA offered only to a limited group consisting substantially of top paid 25% and/or certain officers/shareholders
 - HRAs with provisions for vesting or basing maximum reimbursement amount on age, years of service or compensation

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Nondiscrimination rules for HRAs and health FSAs under Code § 105(h) (cont'd):
 - Definition of “highly compensated individual” under § 105(h):
 - five highest officers
 - 10% shareholders
 - highest paid 25% of all employees
 - In determining the highest paid 25%, certain categories of “excludable employees”—employees who are part-time, seasonal, collectively bargained, less than age 25, with less than 3 years of service, or non-resident aliens with no U.S. source income—are not considered, if the HRA or FSA excludes them from participation. These exclusions are also applied in determining whether eligibility and benefits are discriminatory.

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Nondiscrimination rules for HRAs and health FSAs under Code § 105(h) (cont'd):
 - **§ 105(h) eligibility test**—current law is unclear
 - 1981 regulations under § 105(h) apply obsolete version of test applicable to qualified retirement plans, which involves alternative percentage tests or a subjective, “reasonable classification.” Percentage tests require that plan benefit at least 70% of all employees, or benefit 80% of eligibles where 70% of all employees are eligible. Plan aggregation permitted, not required.
 - Above tests were revised by 1986 tax reform act. Current tests are partially incorporated in proposed § 125 regulations (see below), which use retirement plan definition of “highly compensated employee,” not § 105(h) definition of “highly compensated individual.” The highly compensated employee definition is based on compensation for the preceding year above \$100,000 for 2007 and \$105,000 for 2008.

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Nondiscrimination rules for HRAs and health FSAs under Code § 105(h) (cont'd):
 - **§ 105(h) eligibility test**—current law is unclear (cont'd):
 - No guidance exists on whether current § 125 tests may be applied for § 105(h) purposes
 - Current tests may require counting most “excludable employees” — a problem for HRAs or FSAs excluding large groups, e.g. part-time employees
 - Including such an HRA or FSA as part of non-discriminatory major medical plan would make that plan discriminatory unless HRA or FSA is given the same eligibility provisions as major medical benefits

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Nondiscrimination rules for HRAs and health FSAs under Code § 105(h) (cont'd):
 - **§ 105(h) benefits test:** all benefits provided to highly compensated individuals must be provided to non-highly compensated individuals, in both plan terms and plan operation
 - Greater utilization by highly compensated individuals is not treated as discrimination.
 - Different waiting periods apply to different groups has been treated as discrimination in benefits rather than eligibility (lesser tax consequences apply to the latter)
 - IRS has informally allowed differences in benefit provisions for different groups if each group satisfied eligibility testing. It remains to be seen whether IRS will continue this position after § 125 regs

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125
 - Rules applicable to HSAs or health FSAs provided through cafeteria plans. Not applicable to HRAs, which may not be provided through cafeteria plans
 - IRS issued proposed cafeteria plan regulations in Aug. 2007 (expected to be finalized by end of 2008)
 - New discrimination regulation is one of seven proposed rules consolidating, updating and expanding limited prior guidance on cafeteria plans
 - Proposed effective date is plan years beginning on or after Jan. 1, 2009. This date is expected to be deferred by one year. The proposed regulations may be relied upon pending final regulations.

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125 (cont'd)
 - Cafeteria plans may not discriminate in favor of “highly compensated individuals” as to eligibility, contributions and benefits
 - Cafeteria plans may not provide more than 25% of non-taxable benefits (including HSA contributions) to “key employees”
 - Cafeteria plan rules are more flexible than comparability rules; e.g., employers may contribute more to HSAs of persons with chronic disease

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125 (cont'd)
 - Basic elements of proposed regulation:
 - Definitions
 - Eligibility Test
 - Contributions and Benefits Test
 - Key Employee Concentration Test
 - Safe Harbor for Health Benefits
 - Plan Aggregation/Disaggregation
 - Additional Rules
 - Tax Consequences of Discriminatory Cafeteria Plan

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125 (cont'd)
 - Definition of highly compensated individual:
 - Officer in the preceding plan year (or current year for new hires), based on all facts and circumstances; or
 - More than 5% shareholder in voting power or value determined w/out attribution, in either preceding or current plan year; or
 - Compensation exceeded Code § 414(q)(1)(B) amount, i.e. \$105,000 for 2008, and (if employer elects) in top-paid 20%, for preceding plan year (or current year for new hires); or
 - Spouse or dependent of the above

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125 (cont'd)
 - Definition of compensation
 - Includes elective deferrals
 - Excludes amounts above qualified plan comp limit (\$230,000 for 2008)
 - Definition of statutory non-taxable benefits: qualified cafeteria plan benefits that are excluded from gross income (e.g. group health coverage, HSA and FSA contributions, dependent care benefits) plus taxable group term life in excess of the \$50,000 limit

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125 (cont'd)
 - **Eligibility test:** Disregarding “excludable employees,” plan must satisfy either
 - Numerical safe harbor percentage test for qualified plans, or
 - Numerical unsafe harbor percentage component of facts and circumstances test for qualified retirement plans **and** a reasonable classification test
 - Excludable employees:** Collectively-bargained employees, non-resident aliens with no U.S.-source income from employer, COBRA participants. If plan requires 3 years of employment to participate, then employees with less than 3 years may also be excluded.
 - This does not permit excluding ineligible employees such as part-timers, which makes some current plans discriminatory

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125 — Eligibility (cont'd)
 - Reasonable classification test: objective business criteria required for eligibility exclusions, such as job category, geographic location, salaried versus hourly compensation
 - Safe harbor percentage test and unsafe harbor percentage test both require computing plan's ratio percentage, which is % of HCIs divided by % of non-highly compensated individuals benefiting from plan

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125 — Eligibility (cont'd)
 - Safe harbor percentage test: ratio percentage must be at least equal to 50% reduced by 0.75% for each 1% by which non-HCIs % of total employees exceeds 60%
 - Unsafe harbor percentage test: ratio percentage must be at least equal to 40% reduced by 0.75% for each 1% by which % of non-HCIs of total employees exceeds 60%, but in no case less than 20%, after certain exclusions applied; reasonable classification test must also be satisfied

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125 — Eligibility (cont'd)
 - Calculation of ratio percentage:

$$\frac{\frac{\text{Non-HCIs who benefit}}{\text{All Non-HCIs}}}{\frac{\text{HCIs who benefit}}{\text{All HCIs}}}$$

- Persons “who benefit” appears to mean eligible participants, regardless of whether they elect to participate

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125—Contributions and Benefits (cont'd)
 - Cafeteria plan may not discriminate in favor of highly compensated participants as to either...
 - Qualified benefits and total benefits; or
 - Employer contributions allocable to statutory nontaxable benefits and to total benefits
 - Non-discrimination must be satisfied for both benefit availability and benefit utilization

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125—Contributions and Benefits (cont'd)
 - **Benefit availability:** Plan must give each similarly situated participant a uniform election opportunity with respect to qualified benefits and employer contributions
 - “Similarly situated” appears to allow reasonable differences in plan benefits e.g., for employees working in different geographical locations or single v. family coverage.
 - **Benefit utilization:** Aggregate qualified benefits elected, or aggregate employer contributions utilized, by highly compensated participants as % of their compensation may not exceed that % for non-highly compensated participants

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125—Contributions and Benefits (cont'd)
 - Example of contribution/benefit utilization test—facts
 - Plan covers all employees, providing health coverage plus employee-funded HSAs and limited-purpose health FSAs
 - Employer pays entire \$100 monthly health premium; employees elect that or \$50 monthly cash payment
 - 3 of 4 HCPs and 5 of 20 non-HCPs elect health coverage and contribute \$20/mo to HSAs/FSAs; HCPs earn \$120K/yr and non-HCPs earn \$30K/year
 - Does this pass utilization test? ...

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125—Contributions and Benefits (cont'd)
 - Example of contribution utilization test—analysis
 - Aggregate employer contributions:
 - HCPs = \$3,600 Non-HCPs = \$6,000
(no. of employees x total employer contributions)
 - Aggregate comp. of each employee group:
 - HCPs = \$480K Non-HCPs = \$600K
 - Aggregate employer contributions as % of comp.
 - HCPs = 0.75% Non-HCPs = 1.0%
 - Test is passed because HCPs elect lower %

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125—Contributions and Benefits (cont'd)
 - Example of benefit utilization test—analysis
 - Aggregate qualified benefits earned:
 - HCPs = \$4,320 Non-HCPs = \$7,200
(no. of employees x total contributions)
 - Aggregate comp. of each employee group:
 - HCPs = \$480K Non-HCPs = \$600K
 - Aggregate qualified benefits as % of comp.
 - HCPs = 0.90% Non-HCPs = 1.2%
 - Test is passed because HCPs elect lower %

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125—Key Employee Concentration Test
 - Key Employees: 25% limit
 - If statutory non-taxable benefits for key employees exceed 25% of aggregate statutory non-taxable benefits for all employees electing non-taxable benefits, then ...
 - Maximum taxable benefits that key employees could have elected are includable in their gross income
 - Key employee definition (based on preceding plan year):
 - Officers with compensation above \$150,000 (2008 amount)
 - 5% owners
 - 1% owners with compensation above \$150,000 (no indexing)

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125—Key Employee Concentration Test (cont'd)
- **Example:** Employees pay 30% of insurance premium for single (\$3,600) or family (\$7,200) coverage, and contribute to HSAs with no employer contribution. One key employee elects family coverage and contributes \$1,000 to HSA; three non-key employees elect single coverage and one of them contributes \$1,000 to HSA.
 - Key employee's non-taxable benefits = $\$1,000 + (30\% \times \$7,200) + (70\% \times \$7,200) = \$8,200$.
 - Non-key employees' non-taxable benefits = $\$1,000 + (30\% \times \$3,600 \times 3) + (70\% \times \$3,600 \times 3) = \$11,800$
 - $\$8,200 / (\$8,200 + \$11,800) = 41\%$. **Exceeds 25% limit.**

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125—Safe Harbor
 - Cafeteria plans providing major medical benefits are nondiscriminatory if:
 - Contributions for each participant equal 100% of cost of health coverage of majority of highly compensated participants similarly situated, or equal or exceed 75% of cost of health coverage of the participant (similarly situated) with the highest cost health coverage, and
 - Contributions or benefits in excess of the foregoing bear a uniform relationship to compensation
- “Similarly situated” permits reasonable differences in benefits, e.g. for different locations or single v. family coverage

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125—Plan Aggregation
 - Permissive disaggregation for testing purposes:
 - If plan benefits employees with less than 3 years of employment, then...
 - For testing purposes the plan may be disaggregated into 2 separate plans, one covering employees with less than 3 years, and one covering employees with 3 or more years
 - Both eligibility and contributions/benefits testing must be disaggregated

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125—Plan Aggregation (cont'd)
 - Queries: Is additional permissive disaggregation available? Does plan-by-plan analysis work with permissive disaggregation?
 - Optional aggregation for testing purposes:
 - If employer aggregates 2 or more plans, the combined plan must satisfy both eligibility and contributions/benefits testing as if it were a single plan
 - Aggregation is not permitted if a principal purpose is to manipulate testing requirements or otherwise discriminate in favor of highly compensated individuals or participants

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

■ Cafeteria plan nondiscrimination rules under Code § 125—Additional Rules

- Employer aggregation: controlled group affiliates treated as single employer. Query whether separate lines of business may be treated separately
- Timing: Nondiscrimination testing is done as of the last day of the plan year, taking into account all non-excludable current and former employees who were employed on any day during the plan year
- Discriminatory operation prohibited: e.g. offering a benefit only for period when used by highly compensated employees
- Anti-abuse rule: Nondiscrimination rules must be interpreted reasonably. Violation occurs if testing procedures or plan provisions are changed repeatedly, where doing so has the effect and a principal purpose of manipulating tests
- Transactions: No guidance yet on how rules apply to corporate mergers, acquisitions, divestitures

Comparison of HSAs, HRAs, and Health FSAs – Nondiscrimination

- Cafeteria plan nondiscrimination rules under Code § 125—Tax Consequences of Discrimination
 - Highly compensated and key employee participants' gross income includes the value of the taxable benefit with the greatest value that employee could have elected, even if only nontaxable benefits are actually elected.
 - The year of income inclusion is the participant's taxable year within which ends the plan year for which the election was or could have been made.

HSAs – Nondiscrimination

Comparability Rule for HSAs

Final regs on comparable contributions issued 7/06;
modified by 12/06 legislation and 4/08 final regs;
further regs proposed in 7/08

- **General Rule:** All employees in same coverage category must receive same employer contribution amount (either same dollar amount or same percent of HDHP deductible)
- **Exception:** Employer contributions made “through” a cafeteria plan are not subject to comparability rule
 - Exception usually applies
- **Penalty:** 35% excise tax on all employer contributions to HSAs for the year—file Form 8928

HSA – Nondiscrimination

HSA Comparability—Exception

- When are employer contributions to HSAs made *“through” a cafeteria plan?*
 - If employees can make contributions to their HSA by salary reduction through the cafeteria plan, then any additional employer contributions are also “through” the cafeteria plan
 - Even if some employees do not make salary reductions
 - No need to offer a cash-out option for employer contribution
 - If cashable flex credits are available for HSA contributions, then would be considered “through” the cafeteria plan, even without salary reductions.
 - Non-cashable flex credits?

HSA – Nondiscrimination

HSA Comparability—General Rule

- **Categories of coverage:** For purposes of making comparable contributions to employees in same coverage category, the following categories apply:
 - Statutory categories of coverage are self-only and family
 - 2006 regulations also permit categories of family coverage: self+1, self+2 and self+3 or more
 - Exclude collectively bargained, self-employed, and employees ineligible for HSAs
- **Permitted discrimination in favor of non-highly compensated employees:** Dec. '06 legislation modified comparability rule: non-highly compensated employees may now receive higher contributions than highly compensated employees in same coverage category. See 7/08 proposed regs

HSA – Nondiscrimination

HSA Comparability—General Rule

- The 2006 final regulations do not completely address how to satisfy the basic comparability requirement in two situations:
 - When an employee has not established an HSA at the end of the calendar year
 - When an employer wishes to accelerate HSA contributions for employees who incur large medical expenses during the year
- These two situations are addressed in April 2008 supplementary final regulations (adding Q&As 14 and 15, respectively), effective for employer contributions made for calendar years beginning in 2009 or later.
- See also 7/08 proposed regulations permitting maximum contributions for employees who are eligible mid-year

HSAs – Nondiscrimination

HSA Comparability—General Rule

- Employer contributions for employees who have not established HSAs or informed the employer
 - 2006 final regulations addressed how an employer complies with the comparability rules if an employee has not established an HSA at the time the employer contributes to its employees' HSAs but does establish an HSA later in the calendar year
 - 2006 regulations reserved question of how to comply when employee does not establish an HSA by the end of the calendar year

HSAs – Nondiscrimination

HSA Comparability—General Rule

- Employer contributions for employees who have not established HSAs or informed the employer (cont'd)
 - If an employee does not establish an HSA when employer contributes to HSAs but does establish an HSA later in the calendar year, or the employer does not know that the employee established an HSA when the employer contributes to HSAs, then ...
 - 2006 regulations require that employer make the contribution plus reasonable interest once the employee later establishes an HSA.
 - Reasonable interest safe harbor is Federal short-term rate under Code § 1274(d). The rate for September, 2008 was 2.36%.

HSAs – Nondiscrimination

HSA Comparability—General Rule

- Employer contributions for employees who have not established HSAs or informed the employer (cont'd)
 - Under new regulations, where an HSA-eligible employee has not established an HSA by the end of the calendar year (Year 1), or the employer does not know whether the employee has done so, the employer may satisfy the comparability rules by taking two steps in the following year (Year 2):
 - Employer must give notice to employees by January 15 of Year 2, and
 - Employer must make comparable contributions plus reasonable interest by April 15 of Year 2 — required for each HSA-eligible employee who follows instructions in notice
 - Employer notice to employees: Notice must state that employer will contribute to HSAs for Year 1 of employees who, by the last day of February of Year 2, establish an HSA and notify the employer. Employer notice must be issued no later than January 15 of Year 2 and no earlier than 90 days before first HSA contribution for Year 1. Notice may be issued either to all employees or only to those not identified as having established an HSA.

HSA – Nondiscrimination

HSA Comparability—General Rule

- Accelerating employer HSA contributions for employees who incur large medical expenses during the year
 - April 2008 regulations permit employer to accelerate all or part of its contributions for the calendar year to the HSAs of employees who incur, during the year, qualified medical expenses exceeding the employer's cumulative HSA contributions at that time
 - If contributions are accelerated for any employee, then same opportunity must be available to all employees throughout the calendar year on an equal and uniform basis
 - Employers must establish reasonable, uniform methods and requirements for acceleration and for determination of medical expenses

HSAs – Nondiscrimination

HSA Comparability—General Rule

- Accelerating employer HSA contributions for employees who incur large medical expenses during the year (cont'd)
 - Accelerated contributions are permissible —
 - With respect to employees who terminate employment before the end of the year and who thus receive more employer contributions per month than employees who do not terminate
 - Without paying interest on either accelerated or non-accelerated contributions
 - Acceleration rules take effect January 1, 2009

Comparison of HSAs, HRAs, and Health FSAs – Other Rules

- Retiree coverage — both HRAs and HSAs are suitable
- Employer involvement in retiree coverage
 - HRA withdrawals continue to be administered by employer after retirement
 - HSA withdrawals are never administered by employer
- Reimbursable expenses for retirees
 - HRAs may pay health insurance premiums, including for Medicare Part B, Medicare supplement policies, long term care insurance. Paying premiums for individual insurance presents HIPAA nondiscrimination issues
 - HSAs may pay costs of qualified long term care insurance contracts and, after age 65, may pay for any health insurance other than Medicare supplement policies

Comparison of HSAs, HRAs, and Health FSAs – Other Rules

- Sick or vacation leave contributions –
 - **Health FSAs** – can sell time under cafeteria plan and put money in Health FSA
 - **HRA** – can contribute unused sick or vacation time to HRA, either when active or retiring, but only if non-elective!
 - **HSAs** – can sell time under cafeteria plan and put money in HSA

Comparison of HSAs, HRAs, and Health FSAs – Other Rules

- Uniform Coverage Rule or Pay As Funded?
 - **Health FSAs** – Uniform Coverage Rule applies (i.e., the entire annual salary reduction amount must be available for withdrawal from beginning of year)
 - **HRAs** – can pay as funded or advance funds
 - **HSAs** – can pay as funded – be careful in advancing funds

Comparison of HSAs, HRAs, and Health FSAs – Other Rules

- Election Changes
 - **Health FSAs** – Subject to strict rules regarding changes of elections
 - **HRAs** – No change of election rules
 - **HSAs** – Can change election as often as you want, as long as it is prospective (no election changes between general purpose health FSA and limited purpose health FSA)

Comparison of HSAs, HRAs, and Health FSAs – Other Rules

- COBRA
 - Health FSAs – COBRA rules apply, with a special limitation
 - HRAs – COBRA rules apply (sometimes unclear how)
 - HSAs – no COBRA (but this account is portable and non-forfeitable)

Comparison of HSAs, HRAs, and Health FSAs – Other Rules

- Ordering Rules
 - **Health FSAs** – generally the payor of last resort. If Health FSA and HRA offered together, can draft so that HRA is payor of last resort.
 - **HRAs** – can be payor of last resort or pay before the Health FSA
 - **HSAs** – no ordering rules

Comparison of HSAs, HRAs, and Health FSAs – Other Rules

- Earnings
 - Health FSAs – typically no earnings; if in trust, then non-taxable
 - HRAs – typically no earnings; if in trust, then non-taxable
 - HSAs – typically will be earnings, which will be tax-free

Comparison of HSAs, HRAs, and Health FSAs – Other Rules

- HIPAA and ERISA
 - **Health FSAs** – HIPAA and ERISA will apply to most employers
 - **HRAs** – HIPAA and ERISA will apply to most employers
 - **HSAs** – HIPAA and ERISA typically will NOT apply (see DOL Field Assistance Bulletin 2004-1 regarding application of ERISA).

Comparison of HSAs, HRAs, and Health FSAs – Other Rules

- Medicare Part D
 - **Health FSAs** – No notices required; reimbursements for prescription drugs count toward out-of-pocket limit for retirees but are not eligible for subsidy
 - **HSAs** – No notices required; reimbursements for prescription drugs count toward out-of-pocket limit for retirees but are not eligible for subsidy
 - **HRAs** – Notices required each November 15; reimbursements do not count toward out-of-pocket limit for retirees but may qualify for subsidy!

HSAs – Special Issues

- **Preventive Care Definition for HSAs:**
Unlike high deductible plans associated with HRAs, the HDHPs associated with HSAs must conform to regulatory definition of preventive care exception to high deductible requirement. IRS guidance permits:
 - Periodic health evaluations, well-baby/child care, immunizations for children and adults
 - Smoking cessation and weight-loss programs
 - Listed screening devices and tests
 - Service or screening for prevention that also includes treatment for related condition or incidental treatment
 - Drugs to prevent condition for which person has risk factors or is asymptomatic, or to prevent recurrence, or as part of preventive programs such as smoking cessation

HSAs – Special Issues

- Exclusions from IRS definition of preventive care:
 - Definition is independent of state insurance law mandates that certain services be provided below deductible, which may preclude insured HDHPs in some states
 - Drugs etc. taken for general health purposes may be preventive but are not reimbursable because they are not qualified medical expenses under I.R.C. § 213(d)
- IRS definition is only a safe harbor, and does not rule out additional items as preventive care

HSA – Special Issues

- **Coordination Issues** – Should you combine an HRA, a health FSA, and/or an HSA?
- **Coordinating HRAs with health FSAs**
 - **Design options and limitations**
 - Contributions – no direct or indirect funding of HRA with salary reduction money
 - Limit allowable expenses?
 - Allow carryovers or spend-downs?
 - How should withdrawals be ordered?
 - Transitional issues – plan documents and forms

HSAs – Special Issues

- Coordination Issues – Rollovers: IRS Notice 2007-22 provides guidance on implementation of rollovers from FSAs and HRAs to HSAs
 - Must complete rollover by 2012
 - Must not exceed balance on 9/21/06 or date of distribution
 - Do not count against annual limit on contributions to HSAs
 - Employees must elect by last day of the Plan Year to make rollover

HSAs – Special Issues

- Coordination Issues – Rollovers: IRS Notice 2007-22 guidance on implementation of rollovers from FSAs and HRAs to HSAs (con't)
 - Employees must have high deductible health plan coverage as of first of month during which rollover occurs and must be HSA-eligible
 - Must have a blackout period – no reimbursements from health FSA or HRA after last day of Plan Year
 - Rollover must be directly to Trustee by March 15 (for calendar year plan)
 - Rollover must result in zero balance or employer could convert general purpose health FSA or HRA into HSA compatible plan

HSAs - Special Issues

Coordination Issues — Summary of Permitted Non-HDHP Coverage/Insurance for HSAs

- Preventive care
- Dental
- Vision
- Disease-specific insurance*
- Fixed periodic payment for hospitalization*
- AD&D
- Disability
- Long term care
- Wellness, disease management, EAP
- Liability and worker's comp insurance
- High deductible HRA or health FSA
- Suspended or retiree HRA
- Drug testing
- Business travel accident

* See PLR 200704010

HSAs – Special Issues

- Coordinating HSAs with health FSAs
 - Design options
 - Limited purpose health FSA
 - Vision, dental, preventive care, mix and match
 - Problems: How do you administer preventive care FSA?
 - High deductible health FSA
 - Limited use

HSAs – Special Issues

- Coordinating HSAs with health FSAs
 - Transitional issues – mid-year implementation of HSA and limited purpose health FSA
 - Mid-year change in election not permitted between general purpose health FSA and limited purpose health FSA
 - Could adopt limited purpose health FSA mid-year, merge general purpose health FSA balances for all employees

HSAs – Special Issues

- Coordinating HSAs with health FSAs
 - Transitional issue arising from 2½ month grace period for health FSAs
 - Dec. 06 legislation reverses IRS guidance making employee ineligible for HSAs during grace period; now HSA-eligibility is permitted if participant exhausts FSA balance by end of plan year or transfers balance under new rollover provisions
 - Employees cannot voluntarily restrict coverage during grace period to a limited purpose health FSA to avoid this problem.
 - Employers can transfer all general purpose health FSA participants to the limited purpose health FSA during the grace period.

HSAs – Special Issues

- Coordinating HSAs and HRAs
 - HSAs are compatible with restricted HRAs:
 - High deductible HRA
 - If deductible of HRA is lower than HDHP, then lower deductible will determine contribution limit to HSA
 - Limited purpose HRA
 - Reimburse expenses of dental, vision or preventive care
 - Reimburse expenses of permitted insurance

HSAs – Special Issues

- Coordinating HSAs and HRAs
 - HSAs are compatible with restricted HRAs:
 - Retirement HRA (medical expenses reimbursed only after the individual retires even if contributions made currently)
 - Suspended HRA (employee elects prior to HRA coverage period to forgo payment or reimbursement by HRA for medical expenses incurred during the coverage period)

HSAs – Special Issues

- Coordinating HSAs, health FSAs and HRAs
 - Examples of design options:
 - HDHP + Limited purpose health FSA + High deductible HRA for prescription drug coverage + HSA
 - HDHP + Limited purpose health FSA + Suspended HRA + HSA
 - HDHP + Limited purpose health FSA + Retirement HRA funded with cash-outs of vacation time + HSA

HSAs – Special Issues

- **Applicability of ERISA to HSAs:** Initial DOL guidance (April 2004) provides that ERISA does not cover HSA (even if there are employer contributions) if establishment of HSA is completely voluntary by employees and employer does not:
 - Restrict employee from moving funds to another HSA custodian or trustee
 - Restrict use of HSA funds other than as permitted by Internal Revenue Code
 - Influence investment of HSA funds
 - Represent that HSA is an employee welfare benefit plan established by employer
 - Receive any payment or compensation in connection with HSA

HSAs – Special Issues

- **Applicability of ERISA to HSAs:** Oct. 2006 DOL guidance clarifies that employer may do the following without giving rise to ERISA-covered HSAs:
 - Employer permitted to open HSA and deposit employer funds without violating requirement that establishment of HSA be completely voluntary
 - Employer may limit HSA providers who are allowed to market HSA products in workplace or to which HSA contributions will be forwarded
 - Employer may select HSA provider that offers some or all investment options in employer's 401(k) plan (but just one fund is not good enough)

HSAs – Special Issues

- **Applicability of ERISA to HSAs:** Oct. 2006 DOL guidance clarifies that employer may do the following without giving rise to ERISA-covered HSAs:
 - Employer may pay HSA account fees otherwise payable by employees
 - Cash incentives for selecting an HSA provider are permitted if payment is deposited directly into HSA
 - Line of credit may be OK if HSA accountholder directs payment of HSA funds to credit line vendor in reimbursement for expenses paid with credit card

HSAs – Special Issues

- **Applicability of ERISA to HSAs:** Oct. 2006 DOL guidance also identifies actions by employer or HSA provider that could violate prohibited transaction rules under Internal Revenue Code:
 - Employer may not receive discount on product from HSA provider selected by employer
 - An employer's failure to promptly remit employee contributions to HSA custodian may trigger prohibited transaction penalties under Code

HSAs – Special Issues

- **Prohibited transaction rules under IRC:** prohibited transaction occurs (regardless of ERISA) if —
 - Account owner borrows from HSA or pledges HSA to secure a loan
 - Trustee lends money to HSA (e.g. bank line of credit). But bank may lend to HSA account owner if HSA funds are not collateral and not available for repayment
- Consequences of prohibited transaction: HSA is disqualified as of first day of the taxable year of the transaction, assets are deemed distributed and taxes apply, including 10% tax for non-medical expenses

HSAs – Special Issues

- **Prohibited transaction exemption:** In August 2008 DOL proposed relief from ERISA and IRC prohibited transaction restrictions on investment advice provided to participants in plans with individually-directed investment arrangements (including HSAs)
- DOL proposal would implement statutory exemption added by Pension Protection Act of 2006 (PPA), and would provide further administrative exemption

HSA – Special Issues

- **Prohibited transaction exemption (cont'd):** No prohibited transaction is deemed to occur if
 - Fees do not vary depending on investment option selected (fee leveling), or
 - Fiduciary adviser uses only a computer model satisfying DOL procedural requirements (where computer model is not feasible, adviser must furnish asset allocation guidance that takes into account the beneficiary's age or time horizon and risk profile)
- Statutory exemption allows revenue of investment adviser's affiliates to vary based on participants' investment decisions, provided the affiliate does not itself provide investment advice to them
- Administrative exemption would allow revenue of investment adviser itself to vary based on participants' investment decisions

Wellness Programs

- Wellness and similar programs may include such elements as:
 - Health risk assessment (HRA) questionnaires
 - Screening (lab tests etc.)
 - Preventive care
 - ID and follow-up of employees with health risks
 - Disease management and health “coaching” for chronic disease
 - Smoking cessation programs
 - Weight control and exercise programs
 - Maternal/newborn programs for high-risk pregnancies
 - Employee assistance and stress reduction programs
 - Information/educational resources
 - Health club membership subsidies
 - Financial incentives to participate
 - Financial rewards for improving health status

Wellness Programs

- Legal issues to consider
 - HIPAA prohibition against discriminating adversely based on health factors
 - Relation to ERISA group health plan
 - Americans with Disabilities Act (ADA)
 - HIPAA privacy
 - Tax treatment of incentives; tax non-discrimination
 - Genetic Information Nondiscrimination Act (GINA)
 - ERISA § 510 prohibition of interference with benefits
 - COBRA continuation coverage
 - Fair Labor Standards Act and mandatory programs
 - State laws relating to insurance, discrimination, etc.

Wellness Programs

- Recent guidance:
 - Final DOL Regulations issued Dec. 2006*
 - DOL FAB 2008-02 issued Feb. 2008*
 - *Rodrigues v. Scotts Co. LLC*, 43 EBC 1835 (D.Mass. Jan. 30, 2008) (denying employer's motion to dismiss employee's claim that his discharge for failure to satisfy smoking cessation program violated state law privacy rights and interfered with health plan participation in violation of ERISA § 510)

* DOL guidance relates to HIPAA non-discrimination based on health factors.

Wellness Programs

HIPAA Nondiscrimination

- HIPAA prohibits adverse discrimination based on health factors
 - Health factors mean: health status, medical conditions (physical and mental), claims experience, receipt of care, medical history, genetic information, evidence of insurability, disability
 - “Benign discrimination” in favor of employees with health problems is permitted
 - Regulations define when wellness programs are subject to the nondiscrimination requirement and establish permitted exceptions to the requirement
 - DOL Field Assistance Bulletin 2008-02 provides compliance checklist

Wellness Programs

HIPAA Nondiscrimination

- Compliance with HIPAA nondiscrimination regulations is required only if —
 - There a wellness program,
 - The program is (or part of) group health plan,
 - The program discriminates based on a health factor, and
 - The discrimination is adverse, not favorable, to individuals with health factor

Wellness Programs

HIPAA Nondiscrimination

- Is there a wellness program, and is it part of a group health plan?
 - If program is not part of a group health plan, then HIPAA non-discrimination regulations do not apply
 - E.g. conditioning employment on non-smoking status is an employment policy, not a group health plan requirement
 - Wellness program operated outside health plan is not subject to HIPAA non-discrimination, but may be subject to other laws such as ADA or state law

Wellness Programs

HIPAA Nondiscrimination

- Is there a wellness program, and is it part of a group health plan? (cont'd)
 - Wellness program may itself be ERISA group health plan
 - Informal 2008 DOL staff guidance approves applying opinion letters on employee assistance programs (EAPs) to analyze whether wellness program is a group health plan under ERISA. Contrast:
 - Referrals to medical providers
 - Counseling services for substance abuse or personal problems
 - But group health plan may be “excepted benefit” not subject to HIPAA portability requirements such as nondiscrimination
 - Dental/vision plans are excepted benefits

Wellness Programs

HIPAA Nondiscrimination

- A wellness program discriminates based on a health factor if it conditions a reward on meeting a standard related to a health factor (e.g., premium reduction conditioned on low cholesterol level)
- Examples of rewards:
 - Discount or rebate of premium or contribution
 - Waiver of deductible, coinsurance or co-payment in whole or part
 - Absence of surcharge
 - Benefit not otherwise provided by plan

Wellness Programs

HIPAA Nondiscrimination

- Examples of wellness programs that do *not* discriminate based on health factors
 - Reimbursing health club membership costs
 - Reward for undergoing diagnostic testing or completing health risk assessment, if reward is not based on results
 - Waiver of copayments or deductibles for obtaining preventive care or participating in pre-natal program
 - Reimbursement for cost of smoking cessation programs if reward not based on results
 - Reward for attending monthly health education seminar

Wellness Programs

HIPAA Nondiscrimination

- Permitted discrimination based on health factors
 - *Example:* waiver of deductible for diabetics who enroll in disease management program involving educational classes and following doctor recommendations on exercise and drugs—this is benign discrimination, not subject to regulation
 - *Contrary Example:* Same facts, but diabetics are also required to meet health factor-related standards such as BMI or blood glucose level—this is adverse discrimination, and must comply with regulation

Wellness Programs

HIPAA Nondiscrimination

- Compliance by discriminatory wellness programs
 - Wellness programs may condition rewards on satisfying health factor-related standards if —
 - Reward amount does not exceed 20% of cost of coverage
 - Program is reasonably designed to promote health or prevent disease
 - Program offers opportunity to qualify at least once a year
 - Reward is available to all similarly situated individuals, and a reasonable alternative to satisfying health-related standard is available to any individual whose medical condition makes it unreasonably difficult or inadvisable to satisfy the standard
 - Availability of reasonable alternative is disclosed in all plan materials (see sample disclosures in regulation)

Wellness Programs

HIPAA Nondiscrimination

- Compliance by discriminatory wellness programs
 - When does a reward exceed the 20% limit?
 - Limit is 20% of combined employer and employee contributions for applicable coverage category
 - Applicable coverage category depends on (i) whether wellness program is open only to employee, and (ii) coverage category in which employee and any dependents are enrolled. For example—
 - If participant and spouse are enrolled in self+1 coverage, but wellness program is open only to employees, then reward is limited to 20% of cost of single coverage
 - If wellness program is open to both employees and dependents and employee enrolls in family coverage, then maximum reward is 20% of cost of family coverage
 - 20% limit applies collectively to all of a plan's wellness programs that require meeting a standard related to a health factor

Wellness Programs

HIPAA Nondiscrimination

- Compliance by discriminatory wellness programs
 - What is a reasonable alternative to satisfying a health-related standard?
 - Reasonable alternative may be determined on a case-by-case basis
 - Plan may seek verification, e.g. from person's physician, that a reasonable alternative is needed
 - Alternative should be reasonable in the burden it imposes and reasonable taking into account the person's medical condition
 - Waiver of the standard is a reasonable alternative

Wellness Programs

- Other Compliance Issues - ADA
 - Wellness and disease management programs, including medical examinations and health risk assessments, must be “voluntary” under the ADA.
 - Current law not clear
 - Recent EEOC staff informal discussion of issue suggests that requiring health risk assessment as a condition for health coverage is problematic

Wellness Programs

- Other Compliance Issues – HIPAA Privacy
 - HIPAA privacy regulations require group health plans to maintain confidentiality of “protected health information” (PHI)
 - Informal HHS guidance from 2006 states that TPA may use PHI from claims processing to identify and contact employees who may benefit from plan wellness programs
 - Permissible without individual authorization, if plan document and business associate agreement provide for this use and disclosure
 - Either TPA and employer may contact employees, but HHS expressed “less concern” if employer is not involved. Employer involvement requires plan provision, and does not permit employer to use wellness information for employment-related purposes
 - Consider effect of recent non-HIPAA “Red Flag” rules concerning medical identity theft, applicable to entities that extend credit

Wellness Programs

■ Other Compliance Issues – IRC

- Incentive-based contributions must meet nondiscrimination rules under IRC § 105(h) and § 125 (if made to health FSA or HRA) or comparability rules (if made to HSA that is NOT through a cafeteria plan). Incentive-based contributions are unlikely to meet comparability rules.
- Wellness program benefits do not constitute medical care qualifying for tax benefits if they merely promote general health. E.g.
 - Weight reduction programs not limited to obesity
 - Gym membership
 - General nutrition (e.g., education, vitamin supplements)

The value of these benefits may be taxable and subject to withholding

- Cash rewards and gift cards are taxable and subject to withholding. 2008 informal guidance states that gift card value should be included in W-2 by employer, not Form 1009-MISC by TPA

Wellness Programs

- Other compliance issues – state law
 - Some states have “smoker’s rights” statutes providing that smoking out of work may not be prohibited as a condition of employment
 - Some state statutes prohibit discrimination in employment based on employee use of lawful products or engaging in lawful conduct
 - State privacy statutes may restrict employer non-smoking and other wellness requirements

Additional Resources

- Employee Benefits Institute of America, Consumer-Driven Health Care and Fringe Benefits Manual (updated quarterly). Ms. Hughes is a contributing author to this Manual.
- National Business Group on Health, *Purchaser's Guide to Clinical Preventive Services: Moving Science Into Coverage* (Nov. 2006), available at <http://www.businessgrouphealth.org/benefitstopics/topics/purchasers/index.cfm>
- Cheryl Risley Hughes, "Crackdown on "Elective" Health Reimbursement Arrangements (HRAs): IRS Issues Private Letter Ruling 200704005," March 2007, available at <http://www.ssblegal.com/files/Elective%20Health%20Reimbursement.pdf>
- Lincoln Weed and Cheryl Risley Hughes, "Bankruptcy Developments Affecting Cafeteria Plans and Consumer-Driven Health Benefits," ECFC Flex Reporter, Sept. 2005, available at <http://www.ssblegal.com/files/Bankruptcy.pdf>.
- Lincoln Weed, Cheryl Risley Hughes and Dan S. Brandenburg, "Evaluating Alternatives for Consumer-Driven Health Care" (January 2006), available at <http://www.ssblegal.com/files/ConsumerDrivenHealthCare2006.pdf>.
- "Designing Consumer-Driven Plans," pp. 59-81 from Hughes/Weed presentation at Consumer-Driven Care Web Summit, March 2007, available at <http://www.ssblegal.com/files/Evaluation%20Alternatives%20for%20Consumer%20Driven%20Care.pdf>

Thank you!

Cheryl Risley Hughes, Esq.
Lincoln Weed, Esq.
Sanders, Schnabel & Brandenburg, P.C.
Washington, D.C.
202.638.2241
crhughes@ssblegal.com
lweed@ssblegal.com