HSA Product Overview

Prepared by:
Mark J. Kinney
Kinney & Larson LLP

Published on www.lorman.com - February 2020

I. HSA Product Overview

A. A Brief Introduction to HSAs (and Why They're Terrific)

HSAs are stable, relationship-based deposits that may also generate monthly service fees, investment management fees, and interchange fees for banks, insurance companies and IRS-approved non-bank custodians. While many banks offer HSAs as a retail product to walk-in customers, they are less engaged in the market for employment-based HSA programs. Employer-based HSA programs are where the true potential lies for HSA custodians, but they present special challenges. This program is designed to help banks (and other HSA custodians) understand key issues related to offering employment-based HSA programs.

The market for HSAs has experienced rapid growth in recent years. Devenir Research reports that there were 25 million HSAs at the end of 2018, an increase of 13% over 2017.[1] According to the Kaiser Family Foundation, employees enrolled in high deductible health plans (HDHPs) with a savings option increased 50% from 2013 to 2018, and now encompass 29% of all employees with employer-based health insurance. [2] A new Executive Order from the Trump Administration is likely to make HSAs more consumer friendly, for example, by permitting first dollar health plan coverage for insulin and other preventive care for chronic conditions.[3] There is strong potential for continued growth of these products.

From the consumers' perspective, HSAs are the most tax efficient savings vehicle available under federal law. Employer and employee contributions are typically made with pre-tax dollars through employer-sponsored cafeteria plans. Once made, contributions may be invested in cash deposit accounts or mutual funds and grow tax-free. If used for qualified medical expenses, distributions are tax free. Forty-eight of fifty states provide the same tax advantages (California and New Jersey are the last two hold-outs). Most individuals with HSAs pay medical expenses as they are incurred using debit cards (which may generate interchange fees). But others pay medical expenses with after-tax dollars and leave their HSA funds to grow for retirement. Provided they maintain records of receipts for medical care expenses, they may reimburse themselves tax-free in retirement.

B. Guidelines for Employees.

Basic rules for employees are as follows:

- **Account Ownership**. The employee owns the account, with rights similar to ownership of a bank account. The HSA is portable, meaning they take it with them when they leave employment.

---

[1] Devenir Research. 2018 Year-End Devenir HSA Research Report, February 27, 2019. Accessible at: http://www.devenir.com/research/2018-year-end-devenir-hsa-research-report/.

[2] Kaiser Family Foundation & Health Research & Educational Trust. Employer Health Benefits 2018 Annual Survey. October 3, 2018. http://files.kff.org/attachment/Report-Employer-Health-Benefits-Annual-Survey-2018.

[3] Executive Order (EO) 13877 (June 24, 2019(

- **Contributions**. Employers and employees may both contribute to the annual maximum. Employer contributions are tax free and excluded from wages. The maximum contribution for 2019 is $3,500 for single and $7,000 for family. A "catch up" provision allows individuals who are 55 or older to contribute another $1,000. Excess contributions are subject to a 6% penalty tax unless distributed in the following year no later than the last day prescribed by law (including extensions of time) for filing an individual's return for that taxable year.

An employee who becomes eligible for an HSA part way through the year, and remains eligible on December 1st of that year, may make a contribution equal to the maximum amount permissible for the year as if he or she had been eligible for the entire year. But the employee must remain eligible for the HSA during a "testing period," or the excess contribution will be included in gross income and is subject to a 20% penalty tax. For a calendar year taxpayer, the testing period is from December 1 of the current year to December 31 of the following year

- **Eligibility.** Employees must be covered by a "high deductible health plan" as defined in Section 223 of the Code (HDHP). The minimum deductible is $1,350 for self-only coverage or $2,700 for family coverage, and the annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but not premiums) may not exceed $6,750 for self-only coverage or $13,500 for family coverage Employees may not have coverage (other than preventive care, certain permitted insurance, and vision and dental benefits) below the deductible, including coverage through a spouse. Disqualifying coverage includes Medicare Part A (for employees who turn age 65 and commence social security benefits) and coverage under a general-purpose health flexible spending account (FSA) of a spouse's employer.

- **FSA Grace Periods.** Many employers maintain a general-purpose health flexible spending account (FSA) with a grace period that permits employees to submit medical expenses for reimbursement until March 15th of the following year. The Code and IRS rules require that employees spend down their FSA account to zero on or before December 31 if they wish to establish and contribute to an HSA on January 1 of the following year. Employees who do not spend down their account may not establish or receive contributions to an HSA until the first day of the month following the end of the grace period April 1 in most cases). This is a common problems for employees who transition from other coverage options to an HSA-eligible HDHP.

Some general-purpose FSAs permits rollovers of up to $500 at the end of the plan year which may be used for the reimbursement of medical expenses in the following year. An employee who receives a rollover will not be eligible for an HSA for the balance of the following year, unless the rollover is to a "limited purpose" health FSA (more on that below).

Limited purpose FSAs and Health Reimbursement Arrangements (HRAs) may be used alongside HSAs. Reimbursements from FSAs and HRAs are limited to vision, dental, and post-HDHP deductible expenses.

- **Cash distributions permitted.** If the distribution is not used to reimburse eligible medical expenses, it is subject to income tax and a 20% penalty if the accountholder is younger than 65 (for individuals 65 and older, it is subject to ordinary income taxes). HSAs are not subject to "substantiation" requirements requiring proof of a medical expense before a distribution is made. It is a matter between the taxpayer, the IRS, and God (according to a cheeky IRS official).

- **Eligible expenses**. Eligible expenses include Medical expenses under § 213 (d) of the Internal Revenue Code (over the counter drugs other than insulin are generally not allowed unless prescribed). Generally, an HSA may not be used to pay health insurance premiums. HSAs may be used to reimburse premiums in the following limited circumstances:

a. health care continuation coverage (COBRA)
b. qualified long-term care insurance coverage
c. health care coverage while the individual is receiving unemployment compensation;
d. premiums for Medicare Part A or B, Medicare HMO, and after age 65, the employee's share of employer-sponsored retiree health care

- **Death.** If the employee designates his or her spouse as the beneficiary, the spouse may treat the HSA as their own and avoid taxation. If another beneficiary is assigned, the HSA terminates and the value is taxable. Many custodial agreements provide that, in the absence of a beneficiary designation, the estate is the beneficiary. Employees should always designate their spouse for this reason.

- **Divorce.** The parties to a divorce may agree to share an HSA at the time of divorce. Code Section 223(f)(7) provides that the transfer of an individual's interest in an HSA to the accountholder's spouse or former spouse under a divorce or separation instrument is not considered a taxable transfer, and the post transfer interest is treated as an HSA with respect to the spouse. The division of an HSA would not involve employers in any way.

C. Guidelines for Employers

HSAs represent a fairly radical shift from the traditional approach to employee benefits. Although they are usually offered in tandem with employer sponsored plans, HSAs are individual accounts that fall outside of the employment relationship. They are much more similar to ordinary checking accounts than to employer sponsored health or welfare plans. Once funds are contributed to an HSA, the employer relinquishes all control of those dollars. Too much involvement, in fact, may cause the arrangements to become subject to the Employee Retirement Income Security Act of 1974 (ERISA). The consequences of that result are beyond the scope of this summary, but take it from an ERISA lawyer, it's not a good result.

While the vast majority of employees will have few problems, a few will encounter complex issues relating to the loss of eligibility, excess contributions, prohibited transactions, or distributions for non-medical expenses. And unlike a retirement or health plan, where the employer sets relatively simple criteria for eligibility, eligibility for an HSA is often driven by factors outside of the employer's control, including coverage under a spouse's health plan. Some employees will face financial hardship, either because they fail to fully fund the HSA to meet the deductible, or because they spend down their HSA for non-medical purposes. Just as employers do not get involved in individual tax planning or supervise the use of checking accounts by employees, employers should avoid becoming entangled in these issues. Self-help can be found in IRS Form 969 and plenty of secondary sources online.

While HSAs can be complex, individuals are capable of understanding the rules and applying them to their personal circumstances. The key for employers is to find the right balance between assisting its employees in understanding the arrangements and letting them take responsibility for their own affairs. Over time, employees will adjust to the new arrangements; hopefully, they will become excellent stewards of their own health care resources. As employees learn to be better consumers of health care, the rate of inflation in an employer's health plan should also decline.

Once HSAs are established, an employer's role is limited to forwarding contributions. But implementing an HSA arrangement can be a major undertaking. It requires integration with existing benefit programs and careful planning for certain classes of employees. Employers have an affirmative obligation under the Internal Revenue Code to make certain that its health plan qualifies as an HSA-qualified HDHP under Section 223 of the Internal Revenue Code (though most will rely on brokers, consultants or insurance company for that assurance). Employers must also make certain that they do not provide other coverage that disqualifies employees in the HDHP from eligibility for an HSA. Employers must ensure that payroll deduction and employer contributions flow to HSAs through a section 125 cafeteria plan (if paid directly by the employer, they are subject to byzantine "comparable contribution" rules which may subject the employer to penalties).

Although employers are not required to educate employees on the nuances of HSAs, they should provide clear communications to its employees on how the HSA arrangement interacts with other welfare benefit plans, including general-purpose and limited-purpose health FSAs and HRAs. Special issues of interest to employers include the following:

- **Employer Establishment of HSAs**. Medical expenses that are incurred before an HSA is established may not be reimbursed from an HSA. The establishment date also governs how much an employee may contribute to an HSA in a given year. Many employers have experienced difficulty in encouraging employees who enroll in an HSA-qualified HDHP to execute custodial agreements in a timely manner. Employees are disappointed when an expense they incur cannot be reimbursed from the HSA because they have not executed the agreement.

Department of Labor Guidance in Field Assistance Bulletin (FAB) 2006-02 clarifies that an employer may unilaterally open an HSA for an employee and deposits employer funds into the HSA without causing the arrangement to be subject to ERISA, provided that HSA accountholders have sole control and are exclusively responsible for expending HSA funds and generally may move the funds to another HSA or otherwise withdraw the funds. IRS Notice 2008-59, Q&A-38, provides that state law determines when an HSA is established. Most state trust laws require that for a trust to exist, an asset must be held in trust; thus, most state trust laws require that a trust must be funded to be established.

Employers that work with more sophisticated HSA custodians are typically advised to establish the HSA on behalf of its employees and contribute a penny to each account on the first day of the plan year for an HSA-qualified HDHP.

The custodian typically freezes access to the HSA until it completes consumer identification procedures (CIP) with respect to the individual accountholders.

- **Maximum contributions to HSAs.** Although employers have relatively few responsibilities with regard to the HSA arrangement, it is required to limit contributions made through its cafeteria plan to certain statutory maximums. A simplified version of those limits in 2019 is set forth below:

Age	Self Only Coverage	Family Coverage
less than 55	$3,500	$7,000
55 or greater	$4,500	$8,000

- **Changes to Other Benefit Plans.** To implement the program, it may be necessary to amend or modify certain other programs so that they do not disqualify employees from establishing and contributing to HSAs. If an employer maintains an on-site medical clinic, for example, it may not provide "significant benefits in the nature of medical care" below the statutory deductible for an HSA-qualified HDHP to employees enrolled in an HSA unless the employee pays for the fair market value of that care. Employers that offer "teledocs" or similar programs will also have to charge employees enrolled in an HSA for that service until they reach the deductible.

- **FSA Grace Periods**. General purpose health FSAs have often have a grace period that permits employees to submit medical expenses for reimbursement until March 15th of the year following the plan year. If employees are enrolled in a general purpose FSA and do not spend it down to zero on or before December 31, they may not establish an HSA until April 1st (the first day of the month following the end of the grace period). This is a rookie mistake for employers that make HSAs available for the first time, but even sophisticated health care companies have made it. Communication needs to go out well in advance so employees can spend down their accounts, or at least understand that medical expenses they incur between January one and April 1 will not be reimbursable from an HSA established on April 1.

A more recent rule change allows employers to permit employees to roll over up to $500 in a health FSA from year to year. If a rollover occurs from a general purpose FSA, it will disqualify the employee for an HSA for the entire year that follows. Employers can avoid this amount by adopting a rule in their cafeteria plan which requires that rollovers for employees that select an HSA-qualified HDHP will be made to a limited-purpose and/or post-deductible FSA.

- **Transfer of Contributions.** Employers must transfer contributions made through salary reduction to the HSA custodian via wire or ACH as soon as administratively feasible consistent with the plan asset rule set forth by the Department of Labor in 29 C.F.R. Sec. 2510.3-102.

- **Start Early.** Employers need to select an HSA custodian and must typically negotiate an employer contribution agreement. It will be necessary to send test files from payroll and establish contribution protocols. This should be completed before open enrollment so employees may be fully briefed on the new arrangement.

D. Guidelines for HSA Custodians

- **Omnibus Accounts**. To simplify administration, most banks that offer HSAs to large groups of employees do not record individual HSA balances on their primary deposit accounting system. Instead, they establish one or more omnibus deposit accounts for the HSAs for which they act as custodian. Each omnibus account is titled in the name of the bank as custodian and contains funds from multiple accountholders. Within the omnibus account, the bank (or a third party recordkeeper) tracks contributions, distributions and balances at the individual HSA level. The balance of the omnibus accounts is reconciled daily against the balance on the recordkeeper's records. This approach should satisfy FDIC "pass-through" requirements if the custodial relationship is shown in the bank's records, so that the maximum deposit insurance amount is available for each accountholder. See, e.g., 12 C.F.R. § 330.5(b)(1). We also think that separate recordkeeping of each individual's accounts satisfies prohibition on "commingling" of HSA funds in Section 223 of the Code.

- **ESIGN.** The ESIGN Act generally requires that consumers express their consent electronically, or confirm their consent electronically, in a manner that reasonably demonstrates that the consumer will be able to access required notices or disclosures electronically. See OCC Advisory Letter 2004-11. Most HSA custodians require that employees open an online account and execute the custodial agreement electronically. Custodial agreements typically require consent to electronic delivery of all required notices including enrollment forms, custodial agreement updates, disclosures related to the Truth in Savings (Reg. DD) and Funds Availability (Reg. E), bank privacy policies, documents issued by mutual funds, including prospectuses and trade confirmations, IRS tax return forms 1099-SA and 5498-SA (though some custodians prefer to mail these documents), account summaries, and confirmation of online or telephonic instructions or elections. ESIGN permits withdrawal of consent and paper workarounds are available for most HSA custodian functions. But the ability to access investments is typically reserved solely for accountholders who agree to electronic delivery or related disclosures.

- **Recordkeeping**. Banks may conduct recordkeeping internally or hire third party HSA recordkeepers. In addition to tracking contributions, distributions and balances, the recordkeeper typically settles debit card transactions; calculates interest earned on HSA balances, processes charges for account fees, and produces and distributes periodic account statements. The recordkeeper perform a daily reconciliation of contribution and distribution accounts.

- **Uncashed Checks and Escheatment**. The recordkeeper monitor and tracks outstanding checks or other payments that have not been presented for payment by accountholders, and returned to the account after a fixed period. Indefinite retention of "float" in a distribution account may be treated as a prohibited transaction and should be avoided. HSAs that are deemed abandoned under the laws of the state of an accountholder's residence must be escheated to the state by the bank (consistent with the rules that apply to other abandoned accounts).

- **Customer Identification Process (CIP).** Banks must perform CIP on newly established HSAs, including follow-up documenting information when electronic procedures cannot verify identity (i.e., social security card when wrong social security number is provided).

- **Debit Cards.** The bank or a third party recordkeeper settles debit card transactions. Debit cards are typically co-branded. Interchange fees may be shared with debit card vendors and other third parties including recordkeepers. HSAs are exempt from the entire scope of the Federal Reserve's Regulation II (REG II) on interchange fees and network exclusivity and routing because bona fide trust accounts (including all HSA accounts) are not included in the definitions of the types of accounts governed by the regulation.

- **Investments.** To compete with other HSA custodians targeting the employer market, custodians must offer an array of investments, typically mutual funds. IRS rules prohibit investments in life insurance contracts or collectibles.

- **Banking Regulations.** We've addressed the applicability of various banking regulations on HSA and concluded as follows:

a. **Reg. V.** Regulation V implements the Fair Credit Reporting Act, 15 U.S.C.1681 et. seq. These rules apply if banks require credit reports on applicants or shared credit information with consumer reporting agencies. While some HSA providers engage in these activities, most do not share data on accountholders with credit reporting agencies or other third parties, and Reg. V would not apply.

b. **Reg. E**. Regulation E implements the Electronic Fund Transfer Act, 15 U.S.C. 1693 et. seq. The Act generally applies to any electronic fund transfers that authorizes a financial institution to debit or credit a consumer's "account." 12 C.F.R. Sec. 205.3(a). 12 C.F.R. Sec. 205.2(b)(1) defines an "account" subject to Regulation E as "demand deposit (checking), savings, or other consumer asset account . . . held directly or indirectly by a financial institution and established primarily for personal, family, or household purposes." The term does not include "an account held by a financial institution under a bona fide trust agreement." 12 C.F.R. Sec. 205.2(b)(3). Although Regulation E may not apply to HSAs, it continues to apply to preauthorized transfers from an employer's account to make HSA contributions. See, e.g.. 205.10(b) & (d).

When Regulation E was amended to apply to "payroll card accounts," the Federal Reserve Board clarified that HSAs are not subject to the rule. In the preamble to the final rule under 12 C.F.R. part 205, the Board stated that "cards used solely for health-related expenses – such as cards linked to flexible spending accounts, health savings accounts or health reimbursement arrangements – are not covered by the regulation, whether funded by the employer or not."

c. **Reg. Z.** Regulation Z implements the Truth in Lending, 15 USC 1601 et. seq. A bank is a party in interest with respect to an HSA, and an extension of credit is a prohibited transaction. Accordingly, it does not appear that Reg. Z would apply to HSAs. Although it is possible to have an extension of credit in the form of a force post on a debit card transaction, the Board of Governors of the Federal Reserve System (the "Board") has indicated in related guidance that the term "overdraft services" is specifically defined to not include credit features subject to Regulation Z. 12 C.F.R. 205.12(a)(3).

d. **Reg. CC.** Regulation CC implements the Expedited Funds Availability Act, 12 U.S.C. 4001 et. seq. It requires banks to disclose their funds availability policies in a manner that allows customers to determine when funds from a deposit will be available for withdrawal. Banks typically provide this information in their custodial agreements.

e. **Reg. DD**. Regulation DD Truth in Savings Act ("TISA") disclosures are typically provided electronically in the online enrollment process (which must be activated prior to opening the account). Monthly summary reports with TISA disclosures may be pushed out to accountholders via email with a hyperlink back to the individual's online account, or the agreement may provide that they are delivered to an accountholders online account. Regulations issued by the Board of Governors of the Federal Reserve (the "Board") expressly authorize disclosures under TISA to be made in electronic form, subject to compliance with the E-Sign Act.