KANSAS INSURANCE DEPARTMENT
LEGISLATIVE COORDINATING COUNCIL
STUDIES #11 AND 12

HSAs, HDHPs, AND SECTION 125 PLANS

and

INSURER PROGRAMS PROMOTING WELLNESS, HEALTH, AND DISEASE PREVENTION

January 9, 2009

INTRODUCTION

<u>Public Health Studies</u>

In May 2008 the Conference Committee on H. Sub. for SB 81 requested studies on a number of topics initially considered as part of the legislation. On July 9, 2008 the Legislative Coordinating Council (LCC) approved a number of these studies to be conducted by the Kansas Health Policy Authority (KHPA) during the 2008 Interim period, with such studies to be provided to the Joint Committee on Health Policy Oversight on or before November 1, 2008. On August 29, 2008 KHPA confirmed, in a letter addressed to the LCC, that on August 14, 2008 the Joint Committee had approved an extension of the delivery date for the studies to the first day of the 2009 Legislative Session (on or before January 12, 2008). The LCC acknowledged this extension on October 13, 2008 and also approved KHPA's assignment of certain studies to various agencies. The following two studies were assigned to the Kansas Insurance Department:

1. **Study encouragement of HSAs, HDHPs, and Section 125 plans to expand affordable commercial insurance**

2. **Study allowing insurers to provide incentives in return for participation in programs promoting wellness, health, and disease prevention to expand affordable commercial insurance**

HEALTH SAVINGS ACCOUNTS, HIGH DEDUCTIBLE HEALTH PLANS & SECTION 125 PLANS

What is a Health Savings Account?

A health savings account (HSA) is a savings product that can be used as an alternative to traditional health insurance and which allows one to pay for current health expenses and save for future qualified medical and retiree health expenses on a tax-free basis. In order to take advantage of an HSA, you must also be covered by a high deductible health plan (HDHP) but must not be covered by other health insurance that is not an HDHP. In general, an HDHP will cost less than traditional health insurance, so the money saved on insurance can be put into the HSA. The money placed in the HSA is controlled by the owner and decisions regarding how the money is spent are made by the owner, without relying on a third party or a health insurer. The owner may also decide what types of investments to make with the money in the account in order to make it grow, including stocks, bonds, mutual funds, and certificates of deposit.

What is a High Deductible Health Plan?

As stated above, if you want to open an HSA you must also have a high deductible health plan. An HDHP, sometimes referred to as a "catastrophic" health insurance plan, is a less expensive health insurance plan with a high "deductible", which means it doesn't cover the first several thousand dollars of health care expenses you incur but will generally cover your expenses once that deductible is met. The intent is that the funds in the HSA will help pay for the expenses that your HDHP does not cover.

The HDHP policy does not have to be in the name of the owner of the HSA, as long as the HSA owner has coverage under the HDHP policy. This situation might arise in cases where the HSA owner has coverage under an HDHP in his or her spouse's name.

Setting Up an HSA

HSAs can be set up with banks, credit unions, insurance companies, and other approved companies. Employers are also permitted to set up plans for their employees. There are no income limitations that affect HSA eligibility. However, if you do not file a federal income tax return, you may not receive all the tax benefits that HSAs offer.

How Much Does It Cost?

An HSA is not something you purchase but is a savings account, similar to an IRA, into which you can deposit money on a tax-preferred basis. The only additional expense is the cost of purchasing an HDHP, which will cover you should your medical expenses exceed the funds available in your HSA. However, depending on where the HSA is established, there may be additional fees for administration of the account.

For 2008, in order to qualify to open an HSA, you were required to purchase an HDHP with a minimum deductible of $1,100 (for individual-only coverage) or $2,200 (for family coverage). The annual out-of-pocket expenses, including deductibles and co-payments, could not exceed $5,600 (individual-only coverage) or $11,200 (family coverage). HDHPs are permitted to have first dollar coverage (no deductible) for preventive care but may also apply higher out-of-pocket limits (co-payments and insurance) for non-network services.

Once funds are deposited into an HSA, they can be used to pay for qualified medical expenses tax free. The funds in the account roll over automatically each year and there is no time limit on using the funds. If your HDHP is cancelled or terminated, the funds in the HSA can still be used to pay for qualified medical expenses tax-free but no additional contributions can be made to the HSA account for the period you are not covered by an HDHP.

Eligibility

As state above, in order to be eligible for an HSA, an individual must be covered by a qualified HDHP and must not be covered by other health insurance that is not an HDHP. However, certain types of insurance, such as automobile, dental, vision, disability, and long-term care insurance do not jeopardize your eligibility for an HSA. You may also have health insurance coverage for a specific disease or illness, such as cancer, as long as that insurance pays a specific dollar amount when the policy is triggered. Wellness programs offered by your employer are also permitted if they do not pay significant medical benefits.

Individuals are not eligible for an HSA after they have enrolled in Medicare. However, if you had an HSA before you enrolled in Medicare you may keep it and continue to use it but may no longer make contributions to the account. Individuals who have received any health benefits from the Veterans Administration or one of their facilities, including prescription drugs, are also ineligible for an HSA.

HSA Funding

Contributions to HSAs can be made by individuals, their employers, or both. For 2008 the maximum annual HSA contribution was $2,900, for individual only HDHP coverage, and $5,800 for family coverage, regardless of the amount of the HDHP deductible. For 2009, these amounts increase to $3,000 for individual coverage and $5,950 for family coverage. If you are age 55 or older, you may also make additional "catch-up" contributions each year until you enroll in Medicare. For 2008, the catch-up contribution amount is $900 and for 2009 and after the catch-up amount is $1,000.

Contributions may be made to an HSA in a lump sum or in any amounts or frequency desired. However, the account trustee (bank, credit union, insurer, etc.) may have minimum deposit and balance requirements. Contributions made by employers are aggregated with those made by the HSA account holder to determine whether the maximum contribution has been made.

Tax Benefits

Personal contributions to an HSA provide an "above-the-line" deduction, which means the HSA account holder is permitted to reduce his or her taxable income by the amount contributed to the HSA. The account holder is not required to itemize deductions in order to qualify for this tax benefit. If an employer makes a contribution to the HSA, the contribution is not taxable to the employee.

If your employer offers a "salary reduction" plan, also known as a Section 125 plan or cafeteria plan, you may also make contributions to your HSA on a pre-tax basis but may not claim the "above-the-line" deduction for that same contribution.

Self-employed persons are not permitted to contribute to an HSA on a pre-tax basis but may contribution with after-tax dollars and take the above-the-line deduction.

Use of HSA Funds

HSA funds can be used to pay for any "qualified medical expense" for yourself, your spouse, or a dependent, even if the expense is not covered by your HDHP. For example, most health insurance plans do not cover the cost of over-the-counter medicines, but HSA funds can be used for these expenses. As long as HSA funds are used for qualified medical expenses, the money spent is tax-free.

When determining whether an expense qualifies as a "qualified medical expense," HSA account holders can refer to IRS Publication 502, available at the Internal Revenue Service website (www.irs.gov). However, in general, the expense has to primarily for the prevention or alleviation of a physical defect or illness. If HSA funds are used for other than qualified medical expense, the expenditure will be taxed and, for individuals who are not disabled or over age 65, subject to a 10% tax penalty.

The HSA account holder is responsible for keeping track of contributions made to the account and expenditures. If you have not met your HDHP policy deductible you will be expected to pay for 100% of the amount agreed to be paid by your insurance policy to the physician, either at the time services are provided or when you receive a bill from your physician.

What Are Section 125 Cafeteria Plans?

Section 125 cafeteria plans, also referred to as flexible benefit plans or Section 125 plans, are employer sponsored employee benefit plans that allow employees to obtain benefits on a pre-tax basis. Congress provided for cafeteria plans in 1978 under IRS Code Section 125.

The primary benefit for employers is a potential savings in payroll taxes. For employees, the benefits include income tax savings, increased take-home pay, and increased morale. In general, the administrative costs of establishing and maintaining a Section 125 plan are minimal compared to the potential tax savings.

Premium Only (POP) Section 125 Cafeteria Plans

A premium only plan, also known as a POP, is a popular type of Section 125 plan. A POP plan helps reduce a company's costs by allowing its employees to pay for qualified health care premiums with pre-tax dollars.

POP Benefits

For employers, the benefits include:

- Savings on payroll taxes when employees make pre-tax contributions, which ultimately decrease the amount of taxable pay

- Ability to deduct POP fees as a business expense

For employees, the benefits include:

- Savings on cost of qualified insurance premiums since employee contributions are made with pre-tax dollars

- Increased take-home pay as a result of reduced taxes

How Can Employers Be Encouraged to Use HSAs, HDHPs, and Section 125 Cafeteria Plans?

The Kansas Insurance Department (KID) provides a number of resources for small employers that contain information regarding HSAs. Such information is included in KID's Small Business Packet, which is distributed to small businesses seeking information about the different types of insurance needed for their companies. This information is also provided on KID's public website at 222.ksinsurance.org/consumers/hsa.htm. The KID website also provides a regularly updated list of banks that offer HSAs. Periodically Commissioner Praeger has discussed HSAs in articles provided to media throughout the State, which are published in local newspapers. Finally, KID recently completed an insurance Primer that will be available for distribution in early 2009. This Primer contains information about the various types of insurance regulated at both the state and federal level and provides specific information regarding HSAs and tax credits available to employers who make contributions to HSAs on behalf of their employees.

House Substitute for Senate Bill 81, which was passed during the 2007-2009 Legislative Session, included a number of provisions to expand the use of Premium Only Section 125 Plans by Kansas employers. In New Section 1, insurers doing business in Kansas are now required to provide employers with the option of establishing a premium only cafeteria plan and amended the definition of "health benefit plan" to include Section 125 cafeteria plans. In New Section 2, the Legislature also encouraged employers to "offer the option of paying all or any portion of the health insurance premium or the option of receiving health insurance coverage through a high deductible health plan and the establishment of a health savings account." Finally, in Section 16 of SB 81, the Legislature authorized the Kansas Health Policy Authority to provide grants to small employers "for the purpose of establishing a cafeteria plan" and directed the Authority to develop and implement a program to ensure that small employers are aware of the grant program and understand the benefits of establishing cafeteria plans.

Recommendation

Although there is abundant information available from the Kansas Insurance Department and through the Internet regarding health savings accounts, high deductible health plans, and Section 125 cafeteria plans, many small employers may still be unaware of the existence and benefits of such plans. Greater promotion in the media or education for small employers regarding the costs and benefits of HSAs, HDHPs, and Section 125 Plans through small business associations or a state-sponsored clearinghouse, like the development program described in SB 81, may result in expanded use of these benefits. However, small employers may still be reluctant to establish such programs for their employees for a number of reasons.

First, small employers, that typically do not have human resource departments or a human resource person on staff, may feel overwhelmed or unprepared to take on the responsibility of establishing and maintaining these types of benefit plans for their employees. In some cases there may be misunderstandings regarding the cost of establishing such programs or concerns regarding the amount of time necessary to administer these programs.

Second, although HSAs, HDHPs, and Section 125 Plans provide significant benefits to both employers and employees, either the employees or the employer must be willing and able to make the necessary monetary contributions to establish and maintain these plans. In the case of HSAs, both the employee and the employer are permitted to make contributions to the employee's HSA, but the contributions needed to provide sufficient funds to cover the deductible of the employee's HDHP, generally in excess of $1,000, may be difficult or impossible for both parties. In these cases, expanded use of such plans might be possible if subsidies were provided to small employers or individuals to reduce the costs associated with HSAs, HDHPs, and Section 125 Cafeteria Plans for their employees.

WELLNESS, HEALTH AND DISEASE PREVENTION PROGRAMS

In general, Kansas insurance law does not prohibit insurers from providing incentives to their insureds for participation in wellness or disease prevention programs and the inclusion of such programs in contracts of health insurance issued to Kansas insureds is routinely approved by the Kansas Insurance Department. However, under K.S.A. 40-2404(8)(a), insurers are prohibited from knowingly permitting, offering or making any contract of accident and health insurance that contains any inducement to purchase, discounted premiums, special favor or advantage, or any "valuable consideration or inducement" unless it is "plainly expressed in the insurance contract."

When reviewing and approving contracts of insurance that contain these types of programs, KID's policy examiners review the type of incentives or special benefits that an insurer is proposing to offer to Kansas insureds to determine whether the incentives or special benefits are clearly described in the policy and apply to all insureds in a non-discriminatory fashion. In cases where the policy examiner asks for additional clarification or language to be included in the policy form or an associated rider, insurers regularly modify the contracts to provide the clarity needed to insure that the incentives and benefits are clearly described.

In the past KID has approved wellness and disease prevention programs that include:

- Health risk assessments
- Personalized health living action plans
- Healthy weight or weight management programs, including dietitian services
- 24 hour nurse access
- Wellness counseling
- Discounts for fitness club memberships and home exercise equipment
- Complementary "natural" health care services, such as acupuncture, chiropractic care, and massage therapy
- Reduced deductibles and co-payments for preventive care services, such as annual physical, eye, and hearing exams, routine dental visits, flu shots and other vaccinations.