The Pocket Guide to
Health Savings Accounts

by Liv S. Finne
Adjunct Scholar

Revised Edition edited by
Tanya E. Karwaki,
Director, WPC's Center for Health Care Reform

Introduction

Health Savings Accounts (HSAs) present a new opportunity for consumers to save for health care expenses and directly control more of their health care dollars. Under the current third-party payer system – whether the third-party payer is an employer, government program, or an insurance company – the consumer is removed from decisions of quality, cost, and necessity.[i] HSAs, financed with pre-tax contributions and available to anyone covered by a high deductible health plan, provide consumers with more control and responsibility for their health care decisions.

The Problem

The current system of employer-based health care coverage dates from the period of wage controls imposed by the federal government during World War II. Employers could not legally offer higher wages to attract workers, so they began offering non-monetary benefits such as free health care. A 1943 ruling by the IRS said the cost of these benefits was a legitimate business expense, making health coverage fully tax deductible for businesses, but not for individuals.

That ruling, later confirmed by Congress, created three interconnected economic distortions in the health care market:

1) It prevented patients from knowing the actual cost of the care they received.

2) It created the third-party payer problem, encouraging patients to demand care, regardless of whether it is necessary or cost beneficial. Most weekend warriors do not need a $1,000 MRI for their aches come Monday morning.

3) It undermined the true meaning of health insurance. People tend to see their health benefits as a pre-paid service, not as a way to mitigate risk. People reason, “It’s a free benefit. I’ll use as much of it as I want.”

The Solution

Health Savings Accounts address these basic economic distortions. Consumers with HSAs have a tax-free account for health care expenses, combined with an inexpensive, high deductible health plan (HDHP) to pay for medical care in case of major injury or serious illness. Consumers with HSAs have a financial incentive to spend their dollars wisely; unspent dollars accumulate tax-free in their own personal accounts, roll over from year to year, earn interest, and are not dependent on employment. Consumers can shop around, compare prices and providers, and select the medical services and treatments that are best for them. The resulting market competition puts urgently needed downward pressure on rising health care prices.

How Health Savings Accounts Work

Treasury Secretary John Snow describes an HSA as a "super-charged IRA [Individual Retirement Account] for health care."[ii] Here is how it works:

- Anyone under age 65 can get an HSA. The individual with the account owns it. It travels with the person from job to job. Money in an HSA can be inherited by heirs or a surviving spouse.

- Each HSA must be accompanied by a high deductible health plan. For 2006, this means an annual coverage deductible of at least $1,050 for an individual or $2,100 for families.

- High deductible health plans have a maximum limit to annual out-of-pocket expenses (including deductibles and co-pays). For 2006, the limit is $5,250 for individual coverage and $10,500 for family coverage.

- To participate in an HSA, you cannot be covered by any other health insurance plan.

- An HSA allows annual tax-free contributions equal to the amount of the insurance deductible <u>or</u> $2,700 for individuals and $5,450 for families, whichever is <u>less</u>. These amounts are for 2006, they will be adjusted for inflation in future years.[iii]

- Contributions to an HSA may come from any source: the HSA holder, a parent, a grandparent, spouse, employer or any other person or entity.

- HSA money may be spent tax-free on qualified medical expenses. [iv] Unspent funds in an HSA accumulate from year to year. There is no "use it or lose it" provision.

- Interest and investment earnings accumulate tax-free in an HSA.

- Money spent from an HSA on non-medical expenses before retirement are subject to federal income tax plus a 10% penalty. HSA money may be spent after retirement on non-medical purposes without penalty, subject only to income tax.

- HSA money spent for medical expenses after retirement is never taxed, and can be used to pay Medicare premiums or long-term care expenses.

As described above, to be eligible for an HSA you must have a high deductible health plan. You may, however, choose to have a high deductible health plan and not establish an HSA. For purposes of this document, the term HSA is used broadly to refer to an HSA-qualified high deductible health plan.

Frequently Asked Questions about Health Savings Accounts

1. Where can I get an HSA?

Nearly all insurance companies in Washington offer some type of HSA, whether for the individual, the employer, or both. As depicted in Figure 1, these companies include:

Figure 1

Insurance Companies Offering HSAs	**HSAs Available for Individuals**	**HSAs Available for Employers**
Asuris Northwest Health www.asurisnorthwesthealth.com		Yes
Cigna www.cigna.com		Yes
Group Health Cooperative www.ghc.org	Yes	Yes
KPS Health Plans www.kpshealthplans.com	Yes	Yes
Lifewise Health Plan of Washington www.lifewisewa.com	Yes	
Premera Blue Cross www.premera.com		Yes
Regence Blue Shield www.wa.regence.com	Yes	Yes

HSAInsider.com is one example of a website that lists companies selling HSAs with contact information by state. Another on-line resource is www.ehealthinsurance.com. The Office of the Insurance Commissioner also publishes a "Consumers Guide to: Individual Health Care Coverage," which is available at www.insurance.wa.gov or by calling 1-800-562-6900.

The first step in getting an HSA is to contact an insurance company or an insurance agent. An agent can compare plans, help you calculate costs and savings, and find the best available plan for your circumstances.

2. What information should I have on hand to apply?

When contacting an agent or insurance company, be prepared with the following information: your name, gender, age, whether you smoke, whether you have a spouse, whether you have dependents, and general information on your health history, such as whether you are diabetic, have had cancer, or any other pre-existing health condition. Finally, your agent will want to know what type of plan you have in mind, an individual or family plan, and what size deductible ($1,050 minimum for an individual and $2,100 minimum for a family in 2006) you prefer.

3. How do I open an HSA?

Once you have selected a high deductible health plan, you will need to choose a bank, credit union, investment company, or other financial institution to manage your HSA. Many insurers have teamed up with banks to provide Health Savings Accounts. The insurer who provides the insurance policy will probably refer you to a bank to manage your HSA, although you are free to choose your own bank (if they accept these accounts) or other HSA financial manager.

For example, Regence Blue Shield refers customers to either HSA Bank (www.hsabank.com; 1-800-357-6246) or Wells Fargo (www.wellsfargo.com; 1-800-869-3557) as financial institutions for Health Savings Accounts. Additionally, EvergreenBank offers an HSA Convenience Account (www.EvergreenBank.com; 1-800-331-7922).

4. Are there administrative fees associated with HSAs?

Yes. Banks and other entities that manage HSAs generally charge setup and monthly maintenance fees. The fees are usually nominal, but it pays to shop around and compare costs.

For example, HSA Bank charges a one-time setup fee between $18 and $25, depending on the type of application. HSA Bank then charges a monthly fee of $2.25, although the fee is waived for HSAs with balances of $3,000 or more. Thus, in this example, the fees for maintaining an HSA would be $27 a year.

Wells Fargo charges $3.75 a month, or $45 a year. Once the balance in the account reaches $2,500, no fee is charged. There is no setup, transaction, or closing fee.

See www.regence.com for a comparison of member experiences with HSA Bank and Wells Fargo.

5. How do I use my HSA money to pay medical bills?

Depending on your HSA account, you will receive a debit card or checks for your account. If the doctor requests payment at the time of the service, you may use the debit card or checks to pay the bill. Alternatively, you may pay the bill with your own funds and reimburse yourself from your HSA after the visit. If the physician does not ask for payment at the time of visit, he or she will probably bill your high deductible health plan. Just like with a traditional insurance policy, you will then receive a statement from your insurance company showing the amount that you are responsible for paying.

The bank or investment company handling the HSA will send you a monthly statement, just like a credit card or bank statement. Year-end statements will show all transactions made during the year, cash contributions into the account and total investment earnings. The statement will also show how much money is in the account on the last day of the year. This amount will roll over to the following year.

You can also use your HSA money to pay for medical care for a family member (spouse or dependent) without a tax penalty.

6. Can I earn interest or investment income on the money in my HSA?

Yes. The same types of investment options exist for HSAs as for Individual Retirement Accounts, including stocks, bonds, mutual funds, and certificates of deposit. (Some people maximize the tax savings and income they accrue in their HSA by using money from other sources to pay for routine medical expenses.) The year-end statement from your bank is used to report contributions, earnings and distributions on IRS Form 8889 when you file your income tax return.

7. If I get an HSA through my employer, how is it funded?

An employer sponsored HSA may be funded by you, your employer, or both. An employer may choose to match the monthly HSA contributions made by employees. If both you and your employer contribute, then the contributions are combined to determine whether you have reached the maximum contribution level. Employer contributions to an HSA are excluded from employees' taxable income.

When you start a new job, find out if your new employer will contribute to your HSA. Employers are not obligated to contribute to your HSA, but if they do, they must make "comparable" dollar payments, meaning the employer must give the same dollar amount, or same percentage of the annual deductible, to all employees. Extra contributions to certain employees because of age or length of service are not allowed. Different treatment is allowed, however, for full-time compared to part-time employees, and for self-only (individual) insurance compared to family coverage.

8. If I use my high deductible health plan, who pays the deductible?

You pay the deductible with cash from your HSA. It generally takes about a year to build up enough money in the account to pay the annual deductible. In the event you need to pay the deductible before you have enough money in your HSA, you can use a loan, credit card, or other savings to make the payment, and then repay yourself from your HSA as money accumulates in the account. As long as you keep a record of the amount you paid and when you paid yourself back, all these transactions are tax-free.

9. What about preventive care?

High deductible health plans can offer "first dollar coverage" for preventive care. This means the insurance company pays for preventive care without a deductible or with a deductible below the minimum annual deductible. There is no requirement that high deductible health plans provide benefits for preventive care, it is an optional means of encouraging people to stay healthy and thus lower overall health care costs.

Many high deductible health plans pay for $300 of preventive care a year for each family member. Examples of preventive care include:

- Annual physical exams, including tests and diagnostic procedures.
- Routine prenatal and well-child care.
- Child and adult immunizations.
- Quit-smoking programs.
- Obesity weight loss programs.
- Screening tests for:

  a. cancer;
  b. heart disease;
  c. infectious diseases;
  d. mental health;
  e. substance abuse;
  f. metabolic, nutritional and endocrine conditions;
  g. musculoskeletal disorders;
  h. obstetric and gynecological conditions;
  i. pediatric conditions;
  j. vision and hearing disorders.

Preventive care generally does not include medical services to treat an existing illness, injury or condition, although certain medications may be considered part of preventive care.

10. What happens if I change jobs or stop working for a while?

With an HSA you do not lose your health coverage if you change jobs or decide to leave the workforce for a while. The money in your HSA belongs to you, not to your employer, insurance company, or government agency. Money contributed to your HSA account by your former employer is yours to keep. If you are on state or federal unemployment insurance, you can use money in your HSA to pay for COBRA coverage or other coverage. Once you have a new job, you may no longer use money in the account to pay health insurance premiums.

Even if your new employer offers only traditional health insurance benefits, you can ask the employer to give you the value of your benefit in cash, deposited each month into your HSA.

11. How many people are signing up for HSAs?

The first HSA was sold on January 1, 2004, the first day they became available. By January 2006, at least 3.2 million Americans purchased HSAs.[v] This number is more than triple the number reported in March 2005. In fact, the number of people purchasing HSAs in 2005 is reminiscent of the number of people investing in Individual Retirement Accounts in the early 1980s.

HSAs are being purchased by all categories of consumers. In the individual insurance market, half the people with HSAs are 40 years old or older and 31% of new enrollees were previously uninsured. Group coverage with HSAs is also growing dramatically; in September 2004 it accounted for about 20% of the market and by January 2006 this rose to approximately 60%. In fact, 20% of the largest U.S. employers offered HSA options to their employees in 2005.

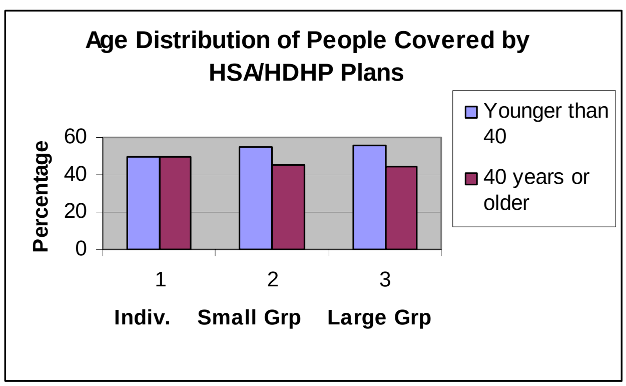
Washington state employees will soon have the option of signing up for an HSA as a result of state legislation enacted in 2006.

12. Who is signing up for HSAs?

Recent studies are providing more detail about who is signing up for Health Savings Accounts/high-deductible health plans (HSA/HDHPs). These studies have found that:

- Enrollees are not limited to the young and healthy. 50% of people covered by HSA/HDHPs in the individual market are aged 40 or older, 45% of people covered by HSA/HDHPs in the small group market are aged 40 or older, and 44% of people covered by HSA/HDHPs in the large group market are aged 40 or older.[vi] (See Figure 2).

Figure 2



- HSA-eligible plans are attractive to individuals and families. As of December 2005, about 63% of purchasers were individuals and 37% were families.[vii]

- HSA-eligible plans are being adopted by all income levels; 45% of HSA-eligible plans were purchased by people with incomes of $50,000 a year or less.[viii]

- About 41% of new enrollees in HSA/HDHP plans were previously uninsured.[ix]

- HSA/HDHP plans are affordable. Over 71% of HSA-eligible plan purchasers in 2005 paid $100 or less per month.[x]

- Over 79% of HSA-eligible plans purchased in 2005 paid 100% of hospitalization and lab or X-ray services after the HDHP deductible was met.[xi]

- Nearly 71% of HSA-eligible plans purchased in 2005 included prescription drug benefits.[xii]

13. What about people with pre-existing health conditions?

HSAs may be less effective if you have a significant pre-existing health condition because the high deductible health plan may not be available or may be more expensive than other options. However, some people with chronic illness prefer the individual control that an HSA gives them in managing their disease.

Consumers are eligible for an HSA even if they have other coverage for a specific disease or illness, as long as the coverage pays a specific dollar amount when the policy is triggered. Thus, consumers with a pre-existing condition may choose to have insurance for their condition and still purchase an HSA to pay for their other medical expenses. Additionally, you can own an HSA and still have dental, vision, disability, and long-term care insurance policies.

14. Are HSAs for everyone?

Not necessarily. An HSA increases personal responsibility for health care decisions. This self reliant approach is not always appropriate for or desired by everyone, including those who are more comfortable with traditional insurance policies. HSAs are designed to encourage efficiency and cut waste in health care. But this also means it is possible that people could decide to bypass some medical testing or treatment in order to save money. With an HSA you and your doctor are in charge of your medical care, so individuals must accept responsibility for maintaining good health.

Two Examples of How HSAs Work

(These examples are based on real events but the names and minor details have been changed to protect privacy.)

A Small Business with 12 Employees

Mr. Jones, the owner of a motor sports and sales repair business in Wenatchee, Washington adopted an HSA plan recently as a way to increase benefits for his twelve employees. Mr. Jones had been struggling to provide traditional health coverage as costs climbed steeply each year. In 2006, the cost of the premium for the company's old policy would have risen to $225 a month for single employees and $750 a month for married workers, and it would have carried a $500 deductible.

Mr. Jones looked into the cost of an HSA, and discovered that the premium for an HSA for each of his nine unmarried employees would be only $150 a month, a savings of $75 per person. The premium for an HSA for his three married employees would be $500 per employee, a savings of $250 a month per family. The deductible for the HSA plan would be $1,050 for unmarried employees and $2,100 for the married employees.

Mr. Jones and his employees decided to switch to the HSA plan. The business pays $150 of the cost of each employee's premium. Today each employee has an HSA with a debit card to use for medical expenses. The unmarried employees have decided to put the $75 they previously paid each month for traditional insurance into their tax-free HSA. By the end of the first year each of them will accumulate $900 to use for medical expenses. In addition, depending on their income, they will save from $100 to $250 in lower income taxes each year.

The decisions of the three married people at this company show how HSAs allow people to pay for health coverage in the way that works best for them. One employee decided to deposit only $10 a month into his account and to use his $250 in monthly savings in other ways. Another married employee decided to deposit the entire $250 in monthly savings into his HSA, up to the $2,100 limit (based on the deductible). If some of these HSA funds are used to pay for routine health services, whatever money remains will roll over to the following year.

This small-business owner and his employees are convinced HSAs are the best way to pay for present medical needs and save for future ones. The accounts provide financial security from ever-increasing premiums and medical expenses. As an added benefit, each employee now has his or her own account accumulating dollars tax-free for medical expenses regardless of where he or she works in the future, or to supplement retirement after leaving the workforce. This is a "win-win" arrangement for both Mr. Jones and his employees.

Self-employed Family of Two

Mr. and Mrs. Smith live and work in Everett, Washington. They are self-employed marketing professionals. They have no children and their company has no employees. In May of 2006, they faced a large increase in the cost of their health insurance, jumping 13% to $642 a month.

After investigating alternatives, Mr. and Mrs. Smith purchased a family HSA from LifeWise Health Plan of Washington. They pay $212 a month for their premium. Their annual deductible is $5,000. Each of them has $300 worth of preventive care, meaning they may get annual physicals, flu shots, cancer and heart screenings, and other routine preventive care each year without paying the deductible.

By switching to an HSA, Mr. and Mrs. Smith are saving $5,160 a year in premium payments, which is more than enough to fully fund their tax-deductible HSA and have money left over. In addition, their HSA contributions save them money each year by lowering their taxable income.

Assuming Mr. and Mrs. Smith spend about $1,000 a year from their HSA for routine medical expenses (about the national average for families[xiii]), they will accumulate $20,000 plus interest over the next five years. If they put their additional tax savings in a retirement investment account such as an Individual Retirement Account, they will accumulate additional thousands of dollars over the same five year period.

Over the five years of this example, Mr. and Mrs. Smith will save over $20,000 of tax-free financial security to pay for health care and retirement, due to their decision to buy an HSA.

How HSAs Can Reduce the Cost of Medical Care

HSAs can encourage consumers to alter their behavior regarding health care services, becoming more prudent consumers. For example, think about someone who could be your neighbor, Jane Joyce. Jane is a 35 year old woman, in reasonable health, who normally receives care from her allergist and family practitioner. Let's follow Jane's health care decisions over a one year time period and see how HSAs could reduce medical costs as patients become more involved in their own care.

- When visiting her allergist, Jane offered to pay cash and received a discount in return, equivalent to about 15% of the fee for an office visit.

- She filled a prescription her allergist gave her for an antihistamine, choosing the generic brand and saving several hundred dollars a year.

- Jane chose not to go to her family practitioner in the winter when she came down with a cold that was prevalent in her office.

- Worried about her cholesterol levels, and working with her family practitioner, Jane shopped around and chose to have her cholesterol checked at Preventive Labs, a direct to consumer seller of laboratory services. By doing this, Jane saved about $10 each time she had her cholesterol checked.

- Finally, when Jane's back began hurting her one Saturday after gardening, she applied heat, took some aspirin, and decided to wait until Monday to see her family practitioner rather than making an expensive visit to the emergency room.

In all of the above health care decisions, Jane was an active participant, making choices that allowed her to meet her health care needs while controlling costs.

Regulatory Barriers to HSAs in Washington State

High deductible health plans that accompany HSAs are more expensive in Washington than in states where health insurance is less regulated. Washington requires insurance companies to cover or offer coverage for 50 different medical conditions and services.[xiv] This is much higher than the number of mandates in neighboring states; for example, Oregon has 31 mandates and Idaho has 13. Mandating such comprehensive coverage works against the cost-cutting purpose of HSAs and artificially inflates the cost of health insurance.

State mandates require every insurance policy to pay for podiatry, reconstructive breast surgery, acupuncture, and chemical dependency, among other things, even if the person buying the coverage has no need for such services. A recent national study by the Council for Affordable Health Insurance found that mandated benefits make health insurance much more expensive, adding some 20% to 50% to the cost of coverage, depending on the state.[xv] Economists Gail Jensen and Michael Morrisey also report that as many as one in four individuals who are without coverage are uninsured because of the cost of state health insurance mandates.[xvi]

Community rating laws also drive up the cost of health insurance in Washington. These laws require insurers to treat everyone purchasing health insurance as if they were among the costliest population of the insured, even though Washington has a separate high risk pool intended to cover those at greatest risk of illness. This system limits insurers' ability to price a policy accurately reflecting the risk an applicant brings to the pool. Though these laws are intended to help people gain access to affordable health insurance, they actually have the opposite effect. When insurance companies cannot adjust rates based on risk, they have to charge higher prices to everyone.

Ways Washington Policymakers Can Improve Access to HSAs

1. **Authorize mandate-free health insurance.** Currently, all high deductible health plans with HSA eligibility sold in Washington must bear the full burden of the 50 mandates enacted by the legislature over the last four decades. This policy means that HSAs cost more in this state than they need to, which puts Washington consumers at a significant disadvantage compared to citizens in other states.

2. **Exempt high deductible health plans from state community rating requirements.** This would allow fair and accurate pricing of HSA health coverage because the cost of the insurance policy would then be based on the actual health risk a person brings to the insurance pool. As a good first step toward reducing the number of uninsured, the exemption could be limited to people who had no health coverage in the previous six months. Extending the exemption to small businesses buying first-time HSAs for their employees would further reduce the uninsured population.

3. **Encourage insurance companies to enter Washington's HSA/HDHP market.** Over the years private insurers have steadily left the state, leaving consumers with fewer choices. The advent of HSAs offers an opportunity to reverse this disturbing trend. State lawmakers and the Insurance Commissioner should adopt rules that encourage more insurance companies to start doing business in Washington, in order to promote choice and price competition that benefit consumers.

Conclusion

HSAs are attractive to a wide variety of people because they are tax favored accounts that provide consumers with more control and responsibility for their health care decisions. These plans do not require pre-authorization from medical gatekeepers, insurance bureaucrats, or government regulators before using the benefits. HSAs are flexible and portable, and their tax advantages help consumers save for future health care needs. The low premium payments for the high deductible health plans are attractive to people who are currently not covered by health insurance, and to small employers who otherwise could not offer coverage to workers. All in all, HSAs offer a practical solution to many of the ills that now plague our health care system.

Further resources

For additional information, go to the U.S. Treasury's website, at www.ustreas.gov/offices/public-affairs/hsa/. This site has a detailed frequently asked questions section and an overview of HSAs.

The Internal Revenue Service has a useful publication on its website, *Health Savings Accounts and Other Tax-Favored Plans*, Publication 969 (2005), available at www.irs.gov/publications/p969/index.html.

Other useful resources are:

- The Council for Affordable Health Insurance at www.cahi.org.
- Americans for Free Choice in Medicine at www.afcm.org.
- The Galen Institute at www.galen.org.
- National Association for Alternative Benefits Consultants, at www.naabc.com.
- Health Savings Account Official Web Portal at www.hsadecisions.org.

---

[i] In contrast, cosmetic surgery, which is normally not covered by health insurance, has a competitive marketplace. As a result, the inflation-adjusted price of cosmetic surgery fell over the past decade, despite a huge increase in demand and considerable innovation. See "Why Are Health Costs Rising?" by Devon Herrick, National Center for Policy Analysis, May 7, 2003.

Through the 1990s, Lasik eye surgery, another medical service purchased directly by consumers, improved in quality as the price fell. Now new wavefront-guided Lasik has improved vision to such an extent that a new "eagle vision" line is being added to the standard 20/20 eye chart. See "Why Settle for 20/20?" by Adam Aston, *Business Week*, May 17, 2003.

[ii] "Town Hall Meeting on HSAs," Office of Public Affairs, Press Release, June 25, 2004.

[iii] See "HSA Frequently Asked Questions," U.S. Treasury Department, at http://www.treas.gov/offices/public-affairs/hsa/faq.shtml.

[iv] See "Health Savings Accounts," Department of the Treasury, at www.treas.gov/offices/public-affairs/hsa/pdf/hsa_tri-fold_brochure.pdf.

[v] "January 2006 Census Shows 3.2 Million People Covered By HSA Plans," survey of 96 AHIP member companies, Center for Policy and Research, America's Health Insurance Plans, March 2006, at www.ahip.org/content/default.aspx?docid=15302.

[vi] *Id.*

[vii] "Health Savings Accounts: January 2005-December 2005," eHealth Insurance, May 10, 2006, at http://image.ehealthinsurance.com/content/ReportNews/2005HSAFullYearReport-05-10-06F.pdf. eHealth Insurance is the largest source of health insurance in the United States for individuals and families representing over 140 of the leading health insurance carriers across all 50 states.

[viii] *Id.*

[ix] *Id.*

[x] *Id.*

[xi] *Id.*

[xii] *Id.*

[xiii] "Health Savings Accounts," JPLG Health, February 15, 2005, at www.jlbghealth.com/hsaquotes.php.
Claims statistics for 2003 compiled by Assurant Health indicate that families of all sizes, from two to eight members, incur an average of $1100 a year in claims, most of which are being applied to copays.

[xiv] In the 2006 legislative session, Washington lawmakers added the 50th health care mandate: prostate cancer screening.

[xv] "The Cost of Health Insurance Mandates in Washington," by Victoria Craig Bunce and J.P. Wieske, Policy Brief, Washington Policy Center and Council for Affordable Health Insurance, January 2005, at www.washingtonpolicy.org/Misc/HealthMandates02-2005.html.

[xvi] "Mandated Benefit Laws and Employer Sponsored Health Insurance," by Gail Jensen and Michael Morrisey, Health Insurance Association of America, 1999.