



EMPLOYERS COUNCIL ON FLEXIBLE COMPENSATION

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April 29, 2004

CC:DOM:CORP:R (Notice 2004-2)
Internal Revenue Service
Room 5226
PO Box 7604
Ben Franklin Station
Washington, DC 20004

Re: Health Savings Accounts Guidance (Notice 2004-2)

Dear Sir/Madam:

On behalf of the Employers Council on Flexible Compensation ("ECFC"), we express our sincere gratitude for the Health Savings Account ("HSA") guidance issued by Treasury and the Internal Revenue Service ("IRS"). Still, there are outstanding issues, the outcome of which greatly impact the viability of offering consumer driven health care through HSAs. We intend to submit a more comprehensive letter in the near future addressing several of the remaining issues of concern to our members, including the interaction of the Section 125 rules with HSAs, the ability to offer a disease management program along with an HDHP/HSA plan, and the other issues outlined in our letter of March, 2004.

The issue of most pressing concern is the interaction between HSAs and Health FSAs and/or HRAs. We are aware that this is an issue upon which further guidance is expected sooner than later. As discussed more fully below, HSAs, Health FSAs and HRAs are all essential components of an efficient consumer driven health care model. We believe that consumer driven health care works best when all three components are permitted to work together. Consequently, we request guidance that allows HSAs and Health FSAs and/or HRAs to exist side by side in a way that is both practical and meaningful to employees and employers.

ECFC is a non-profit membership association committed to the study and promotion of 401(k) plans, cafeteria plans, and other elective compensation plans. Approximately 14-18 million Americans receive flexible benefits from the more than 2800 members of ECFC. Members of ECFC are plan sponsors, corporations, governments, unions, universities, hospitals, and clinics as well as leading actuarial, insurance and accounting firms that design and administer flexible benefit plans. Founded in 1981, the Council has great experience in designing and administering compensation and benefit programs that offer flexibility for employers and employees.

We have outlined below the issues concerning interaction of Health FSAs/ HRAs and HSAs, including what we believe is a resolution that is consistent with the statute and previous Treasury/IRS guidance. .

Respectfully submitted,

Bonnie B. Whyte, CFCI, CAE
Executive Director

The relationship between HSAs and Health FSAs or HRAs.

Issue: To what extent can an individual maintain both an HSA and a Health FSA and/or HRA and continue to be an “eligible individual” for purposes of Code Section 223(c)(1)(A)(ii)?

Proposed Resolution: An individual will not fail or cease to be an “eligible individual” if he or she is covered both by an HSA and a Health FSA and/or HRA to the extent that coverage under the Health FSA and/or HRA is limited to one or more of the following:

- Services or treatments that are specifically excluded from coverage under the HDHP (such as over the counter drugs); or
- Code Section 213(d) expenses that may be reimbursed under permitted insurance or permitted coverage as defined in Section 223 (e.g., dental or vision benefits);
- Any otherwise reimbursable Code Section 213(d) expense to the extent that the benefits are not paid until the applicable deductible under the HDHP has been satisfied (e.g. Amounts that are otherwise covered under the HDHP above the deductible, but for a co-pay or R&C limitations); or
- Coverage for an individual once the individual retires or otherwise becomes entitled to Medicare and ceases to be an “eligible individual” as set forth Section 223(b)(7)).

Analysis

Code Section 223(c)(1)(A)(ii) indicates that an individual fails or ceases to be an eligible individual if the individual has other non-high deductible health coverage *that provides coverage for any benefit that is covered by the HDHP*. Under this provision, an individual could continue to be an “eligible individual” and be covered by a non-high deductible to the extent that the non-high deductible health plan covers benefits not covered by the HDHP. However, Rev. Ruling 2004-38 suggests that an individual fails or ceases to be an eligible individual if the individual has any other health coverage providing other than “permitted insurance” (as defined in Code Section 223(c)(3)) or “permitted coverage” (as defined in Code Section 223(c)(1)(B)) or that is not also a high deductible health plan (as defined in Code Section 223(c)(2)(A)). The holding in Rev. Ruling 2004-38 is based, in part, on statutory language and legislative history specifically allowing permitted insurance or coverage to be offered alongside an HSA, but that is silent as to other carve-out arrangements.

Services or treatments that are specifically excluded from coverage under the HDHP (such as over the counter drugs)

We understand the concern that allowing open-ended carve-outs from the HDHP could enable an abusive plan design whereby an employer could continue to offer low (or no deductible) coverage for comprehensive benefits through various “carve-outs” and yet rely on a “shell” HDHP to secure the tax benefits of Section 223. Clearly this would undermine the intent of the legislation and consumer-directed health care.

We believe, however, that individual account plans (FSAs and HRAs) are not subject to the same abusive practices. First, such arrangements are, by definition, consumer-centric since each individual maintains their own account (albeit notional). Thus, there is already a “built in” incentive to control health care

spending. Second, in practice, the amounts reimbursed under both health FSAs and HRAs tend to be rather small. Health FSAs are almost exclusively employee funded. Contributions (and thus coverage levels) are low due to the “uniform coverage” rule and “use-it-or-lose-it” rules imposed under Prop. Treas. Reg. 1.125-2 Q-7(b)(2). Likewise, the fact that employers must contribute the entire cost of funding an HRA results in relatively low coverage levels under such arrangements. Thus, as a practical matter, there is little practical risk of carving out substantial portions of the HDHP solely for the purpose of covering such benefits below the statutory deductible.

Moreover, allowing Health FSAs and/or HRAs to cover services or treatments that are specifically excluded by the HDHP will better enable employees to preserve HSA funds for expenses incurred under the HDHP that count toward the deductible. The FSA or HRA would be used for important, but somewhat ancillary medical expenses such as over the counter drugs and homeopathic or naturopathic treatments. This would better serve the intended purpose of Section 223 by preserving HSA funds for expenses that would otherwise be covered under the HDHP but for the deductible.

Permitted Insurance, Permitted Coverage, and Expenses Above the Deductible

Also, we believe that current guidance allows a health FSA or HRA to be established for expenses covered by permitted insurance or permitted coverage and/or any Section 213(d) expense above the HDHP’s deductible. Rev. Ruling 2004-38 states that “*if a prescription drug plan or rider does not provide benefits until the minimum annual deductible of the HDHP has been satisfied . . . Individual A is an eligible individual under section 223(c)(1)(A).*” However, some still question the viability of such arrangements. To address this confusion, we ask for guidance confirming that such arrangements are permissible in light of Rev. Ruling 2004-38.

HRAs for Retirees

Finally, as you are aware, post-retirement coverage is an issue of great concern to employers and retirees. Some employers are hesitant to put funds in an HSA for retiree medical that may be used for other non-medical purposes. Such employers may desire an HRA for retiree medical expenses to restrict health plan expenditures to medical expenses. Yet, during active employment, the employer may want to sponsor a combined HDHP/HSA arrangement for the employees. It would further the goals of Section 223 to allow a “retiree medical HRA” to accrue future benefits while an individual is covered under an HDHP/HSA arrangement. Given the fact that coverage does not commence until after an individual’s status as an “eligible individual” ceases, coverage under such an HRA should not be viewed as “other” non-high deductible health coverage referenced in Code Section 223(c)(1)(A)(ii). Confirmation of this conclusion would be helpful.