ABD Commentary

HSAs to Lead the Way After ACA

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The Republican ACA repeal/replace efforts are currently stalled in Congress. With no evident path to 50+ votes, the prospects currently look bleak for any imminent legislation.

However, a number of political and policy forces still place immense pressure on the GOP to fulfill their longtime pledge to put their stamp on health care reform. And there is one thing that nearly every proposal has included to date: a significant boost to health savings accounts (HSAs).

If President Trump signs into law any form of an ACA repeal/replace bill, it is likely to put HSAs in an even greater spotlight than they have already earned since their introduction roughly a decade ago.

Where will that new HSA path lead?

At a minimum, it will create a major new incentive to use HSAs as a long-term savings vehicle. But the possibilities are far larger than that. As discussed in this piece, the proposed HSA changes could be no less than the end of the employer-sponsored group health plan as we know it.

Admittedly, it's a radical theory. So let's start from the beginning.

I. What HSA Changes Have Been Proposed?

- ***Doubling the Contribution Limit:*** *Increasing the HSA annual contribution limit to match the high deductible health plan (HDHP) out-of-pocket maximum (OOPM). That would permit HSA-eligible individuals to contribute up to $6,650 for individuals and $13,300 for families in 2018.*
- **Return to 10% Additional Tax:** The additional tax for non-medical distributions prior to reaching age 65 would decrease from the 20% ACA level back to the 10% pre-ACA amount.
- **Spousal Catch-Up Contributions:** Currently, spouses who are catch-up eligible (age 55+) must contribute the up to $1,000 additional amount to their own HSA. The proposals would permit both catch-up eligible spouses to make the $1,000 additional contribution to the same HSA.
- **HSA Establishment Grace Period:** HSA distributions currently may be made on a tax-free basis If the medical expense was incurred on or after establishing the HSA (i.e., funding the HSA). The proposals would permit tax-free distributions incurred prior to HSA establishment, provided the account is funded within 60 days of HDHP enrollment.
- **OTC Drugs and Medicines:** The ACA required that an individual could take a tax-free HSA distribution (or FSA/HRA distribution) for a medicine or drug (other than insulin) only if provided pursuant to a physician prescription. Proposals would eliminate this requirement.
- **HSAs Grow Up (to Age 26):** One of the more popular provisions of the ACA permits adult children to remain on a parent's plan until reaching age 26. However, that provision did not extend to tax-free HSA distributions, which still follow the traditional tax-dependent determination (generally requiring the child be under age 19, or age 24 if a full-time student). More recent proposals have thankfully incorporated the age 26 provision to HSA distributions.
- ***HSAs for Premiums:*** *Current law permits tax-free HSA distributions to pay for premiums only in very limited situations (COBRA, federal unemployment, post-age 65, long-term care). More recent proposals have included a provision to permit tax-free HSA distributions for any individual market policy premium.*

I categorize the increased contribution limits and the ability to take tax-free distributions for premiums as the only major, paradigm-shifting changes in these proposals. We will take each in turn.

II. Who Would Contribute $13,000+ to an HSA without the Premium Option?

It's a fair question. Early proposals, including the AHCA bill that passed the House, did not include a provision permitting the use of HSAs to pay for premiums. This begged the question—what was the policy vision of doubling the contribution limit?

Cost-sharing (i.e., deductibles, copays, coinsurance) is a major expense in many plans. There is at least a theoretical reason to tie the HSA contribution limit to the HDHP OOPM. Individuals who fully fund the HSA will have effectively self-insured for their entire potential medical liability for the year.

But how many individuals purchasing a plan with a near-maximum OOPM (and therefore presumably a lower premium) will have sufficient discretionary income to allocate over $13,000 to an HSA? Even with unusually generous employer contributions, it seems likely that very few individuals in this position would do so.

Absent the premium payment potential, supercharging the HSA contribution limits essentially becomes a long-term savings policy rather than a cost-sharing policy. Individuals would look to maximize HSA contributions primarily to save for future high health expenses as seniors (tax-free) or as a general retirement fund similar to an IRA (taxable, but no additional penalty for non-medical distributions after age 65).

a) The HSA as a Long-Term Savings Vehicle

If compound interest is the most powerful force in the universe, there is no better way to harness that power than in a tax-advantaged account. And no other account can match the triple-tax advantaged features of the HSA:

The Triple-Tax Advantage:

1) ***Pre-Tax Contributions***
   - *Employee contributions through payroll are made on a pre-tax basis through the Section 125 cafeteria plan. Contributions outside of payroll receive an above-the-line tax deduction.*
   - *Employer contributions are made on a tax-free basis.*
2) ***Tax-Free Growth***
   - *HSA gains are not subject to the interest, dividend, or capital gains investment taxes.*
3) ***Tax-Free Distributions***
   - *Distributions for qualifying medical expenses are not subject to taxation.*

In other words, HSA funds are never taxed at the federal level when used for qualifying medical expenses. That's unrivaled tax savings.

Furthermore, employer and employee contributions made through the Section 125 cafeteria avoid FICA taxes as well. That's up to an additional 7.65% savings on top of the income tax savings.

What's the catch? Not all states conform to this triple-tax advantaged treatment for HSAs. Individuals in California, New Jersey, and Alabama will need to make after-tax contributions to the HSA, and will not enjoy tax-free growth at the state income tax level. In California, most individuals pay taxes based on a 9.3% top income tax bracket, with rates as high as 13.3% for high earners.

b) What Happens When You Reach Age 65?

Prior to reaching age 65, HSA distributions for non-medical expenses are subject to both ordinary income tax and a 20% additional tax (proposed to reduce back to 10% in most ACA repeal/replace bills).

Upon reaching age 65, the additional tax is removed. This essentially converts the tax treatment of an HSA as identical to that of a traditional 401(k)/IRA where the (non-medical) distributions are taxable only at the ordinary income level.

The HSA bonus is that you are able to make both medical and non-medical distributions. Unlike a 401(k) or IRA, your medical distributions post-65 will continue to be tax-free. Furthermore, you can pay for premiums tax-free once you reach age 65 (more on that later).

This makes an HSA a dual-threat upon reaching age 65. You can use it with the same great tax advantage available with traditional retirement savings vehicles. Or you can use it for medical expenses and preserve that third leg of the triple-tax advantage. Most likely, you would use it for some combination of both if you saved large amounts in your HSA over your career—which is the best of both worlds.

Note: Upon enrollment in Medicare (not simply reaching age 65), you are no longer eligible to make or receive HSA *contributions*. However, you still have all the same *distribution* options available to HSA-eligible individuals.

c) Save It Forward

Perhaps the most powerful tax advantage of the HSA is one that is the least known and discussed. I call it the "save it forward" approach.

In almost any other context, you must take reimbursement of health expenses incurred within the plan year or a short run-out period following the end of the year. There is no option to defer income beyond that point.

With HSAs, you are free to take reimbursement of a current-year medical expense in year one, year two, or year 22. This means the HSA owner can delay taking a tax-free distribution for years while enjoying the tax-free growth.

The only requirements are:

a) The individual keep sufficient records to show that the distributions were made exclusively to pay or reimburse qualified medical expenses;
b) The expenses were not paid or reimbursed from another source; and
c) The individual did not claim the expenses as an itemized deduction in any prior taxable year.

For example, assume in 2017 you incur $1,300 in expenses for the deductible under your HDHP. You also pay $700 out-of-pocket (i.e., not covered by insurance or reimbursed by any account) for new prescription glasses and as the cost-share for a new dental crown.

You have $2,000 in health expenses for 2017, and you keep records of these expenses for life. You could take a $2,000 tax-free distribution from the HSA in 2017 to pay for those expenses without issue.

But why would you do so if you have $2,000 in funds available outside of the HSA? Why drain a triple-tax advantaged HSA only to preserve assets in taxable checking, savings, or brokerage accounts?

In other words, the HSA should become the payer of last resort. Save your receipts, and pay for the expenses outside the HSA *if you have the funds available*.

It may make you feel uncomfortable to drain your regular accounts to pay for health expenses, but it should not. Your HSA remains available at all times to reimburse yourself if you ever need the cash. This converts the HSA to a tax-free emergency account for some individuals.

If you have more assets, this converts your HSA to a tax-free forever account. When paired with the ability to invest your HSA funds in long-term equity strategies, you have just harnessed long-term tax-free growth in a manner that no other investment or retirement vehicle can match.

Summary: Save it forward. Consider not taking any HSA distributions unless you need the funds. If you have sufficient assets outside the HSA to cover your health expenses, you probably do not need the funds. If you ever do need the funds, you can reimburse yourself tax-free from the savings in the HSA at any point in the future.

The longer you follow this strategy, the more you save tax-free, and the more you have available for tax-free distributions at any point when needed.

d) Morningstar Weighs In: Room for HSA Investment Option Improvement

The most comprehensive study of HSA investment options in the market today was recently released by Morningstar. The full 46-page report is available here.

With respect to HSAs as an investment vehicle (as opposed to a basic funds in/out spending plan), the study reviews HSA vendors based on investment menu design (exposure to core asset classes), investment quality (likelihood of outperforming benchmarks/peers), price (fees), and performance (based on Morningstar's proprietary rating system). Only one HSA vendor of the ten reviewed (HealthEquity) received a positive review in all categories.

Here is the basic conundrum anyone with access to HSA contributions through an employer will generally face:

- For many good reasons unrelated to investment opportunities, the employer will permit the employee to make and receive HSA contributions through payroll only if the employee establishes an HSA through the employer's chosen vendor.

- The investment options are typically mediocre at best. Very often they are poor. Most employers have never reviewed the options, have no interest in doing so, and are unable to make changes to the menu (without changing vendors) regardless.
- The employee wishes to use the HSA as a long-term savings vehicle, and therefore plans to invest some or all of the account balance.
- The HSA vendor requires that some amount be held in the regular savings component of the HSA (generally $2,000 - $5,000) in order to avoid additional fees.
- The employee is disappointed by the investment options, and therefore considers rolling some or all of the HSA balance to a different vendor with better investment choices. HSAs may be rolled at any point (there is no "distributable event" requirement as with 401(k) plans).
- Other vendors require that a similar amount (generally $2,000 - $5,000) be held in savings to avoid additional fees.
- It is administratively burdensome for the employee to complete paperwork to transfer HSA amounts on some semi-regular basis (and additional rollover fees may apply).
- Facing the prospect of holding $2,000 - $5,000 in cash reserves in two HSAs, and the need to roll amounts over to the second HSA on a regular basis, the employee concedes that it may make more sense to utilize the poor investment options in the employer's chosen HSA vendor than to keep extra funds on the sidelines and deal with constant paperwork.

The result is that a) HSA investment options are typically average to poor, and b) employees who wish to save long-term through an HSA usually do not have a practical ability to escape the employer's chosen HSA vendor investment options (again typically average to poor) unless they build up a very large balance to make the cost, hassle, and reserve requirements worthwhile.

e) HSAs and ERISA Fiduciary Duties: The Missing Link

HSAs are in almost all scenarios not an employer-sponsored group health plan subject to ERISA. While it is theoretically possible for an employer to make an HSA subject to ERISA, it is extraordinarily rare. The DOL's FAB 2006-02 (and earlier guidance) sets the groundwork for exempting HSAs from ERISA except in the most unusual of circumstances.

Yet in almost all scenarios, employers will not permit employer or employee HSA contributions through payroll outside of the employer's chosen HSA vendor. This creates the common predicament described above.

In the 401(k) world, ERISA addresses this problem by imposing fiduciary duties on employers with respect to the plan. Most significantly, employers have a duty of loyalty to act solely in the interests of participants and beneficiary (the "exclusive benefit rule), and a duty of prudence to create the plan menu with the skill, prudence, and diligence of a prudent person acting in a like capacity (an expert standard). Where employers fail to adhere to these standards, employees can bring a claim for breach of fiduciary duty under ERISA.

In the HSA world, no such fiduciary obligations exist. Employers frequently do not think of the HSA as an investment vehicle, nor do they have a fiduciary duty to prudently select and monitor the investment alternatives offered. This provides little incentive to the employer to address the issue (other than a rare employee complaint), and no recourse for employees who are left with poor investment options.

While it is true the DOL's new investment advice fiduciary rule extends to HSAs, employers generally do not provide investment advice under the HSA. It is also rare for an employer to solicit the investment advice services of a financial advisory firm that would be providing fiduciary investment advice for a fee. Again, this is because employer is not subject to ERISA fiduciary standards that would require it to act prudently in providing the HSA investment options.

Summary: HSAs currently struggle to compete with 401(k) plans with respect to the cost and quality of their investment options. However, a much higher HSA contribution limit could be the impetus for the DOL to re-visit its prior HSA guidance and consider applying some level of fiduciary obligations on employers with respect to its HSA investment options.

Even absent DOL involvement, the market may move to push better and more competitive investment offerings that are in line with 401(k) plans. Employers and employees may demand those improvements once they are able to build significant assets within an HSA. Those companies that utilize an investment advisory firm will receive fiduciary advice that would go a long way to improving the current landscape.

III. HSAs for Premiums: Unlocking a Broad Base of Individuals Who Would Contribute $13,000+ to an HSA

Opening up the use of HSAs for premiums is the policy world's new kid on the block. Most early ACA repeal/replace proposals did not include this option. Now that it seems to have entered the mainstream in Republican proposals (to the extent there is such a thing), it's worth considering the doors it would unlock not just for individuals—*but also for employers*.

The key to this analysis lies first in the historical dichotomy that has defined the individual vs. group markets since the wage controls of the World War II era, and more recently in the ACA's strong push to preserve those distinct spheres.

a) Why the Individual Market Did Not Thrive Pre-ACA

Pre-Existing Condition Exclusions: Employers needed to establish a group health plan to ensure employees (or their dependents) with significant health conditions could access full coverage. On the individual market, insurance carriers were able to medically underwrite and/or deny coverage to individuals with costly health conditions. This gave employer-sponsored coverage an enormous advantage—particularly after the 1996 enactment of HIPAA's portability provisions that prohibited most pre-existing condition exclusions and individual medical underwriting *in the group market only*.

Taxes: World War II-era wage controls did not apply to employer-sponsored group health plans. Employers looked to compete with benefit offerings as a manner of increasing compensation without increasing wages beyond the caps. Congress also enacted §106 to exclude the cost of coverage from employees' gross income. Individuals could deduct medical expenses (including premiums) outside of an employer only to the extent those costs exceeded 7.5% of their adjusted gross income. This confluence is sometimes referred to a "historical accident," but regardless it has ever since provided powerful incentives to receive health coverage through an employer-sponsored group health plan.

Adverse Selection: Leaving employees to fend for themselves in the individual market generally was not competitive because of these major coverage and tax disadvantages. The result was nearly all the "good" risk (i.e., the full-time employee demographic) was in the employer-sponsored group health plan market. This also diminished the quality and quantity of individual market offerings.

b) Why the Individual Market Has Not Thrived Under the ACA

This topic is far too large to adequately address in this piece. There are many factors to address in the individual market's shortcomings under the ACA.

As of 2014, the U.S. Census Bureau reports 55.4% of the population covered by employment-based insurance, compared to just 14.6% under an individual policy. Here are the primary issues that relate to employer-sponsored coverage that have negatively affected the individual market in the ACA era:

Stand-Alone HRAs and Employer Payment Plans Prohibited: Back when the ACA passed in 2010, there was significant concern that employers would engage in a practice typically referred to as "Exchange dumping." There was a theory that with the ACA prohibition of pre-existing condition exclusions, and the potential for a robust individual marketplace via state exchanges, employers would terminate their plans and "dump" employees onto the exchange.

One major reason this never occurred in any significant numbers stems from the notorious Friday the 13th guidance. The DOL and IRS issued guidance on September 13, 2013 that slashed employer opportunities to foster individual marketplace enrollment. (DOL Technical Release 2013-3, IRS Notice 2013-54)

In short, the Friday the 13th guidance prohibits employers from subsidizing individual market coverage. Employers can no longer directly pay for or reimburse an individual policy (referred to as an "Employer Payment Plan"). Nor may employers establish a health reimbursement arrangement (HRA) for employees who are not enrolled in a group health plan (referred to as a "stand-alone HRA"). HRAs must meet complex integration requirements to avoid violating this requirement. Any failure in this area could trigger §4980D excise taxes of $100/day/employee—or $36,500/employee/year!

Numerous additional forms of IRS guidance have clarified these requirements further, but the result is any employer payment amount intended to assist an employee with the cost of individual market coverage would need to be a simple increase in the employee's taxable compensation with no conditions. The employee must have an unrestricted right to receive the cash, not be required to use the cash to purchase health coverage, have

no health-plan related conditions on receiving the additional cash, and never be required to substantiate the purchase of any individual market coverage.

Employers generally have not liked the idea of providing an unrestricted taxable bonus or raise to employees intended to cover the cost of an individual policy. The lack of control and adverse tax consequences do not make this approach desirable.

The Employer Mandate: Employers with 50 or more full-time employees (including full-time equivalents) in the prior calendar year are referred to under the ACA as "Applicable Large Employers," or "ALEs." ALEs must offer minimum essential coverage to all full-time employees that is affordable and provides minimum value to avoid large potential employer mandate penalties (frequently referred to as "pay or play" penalties).

The larger §4980H(a) penalty, commonly referred to as the "A Penalty" or the "sledge hammer" penalty, applies where an ALE fails to offer coverage to at least 95% of its full-time employees (generally those working at least an average of 30 hours of service per week). Where at least one of those full-time employees who is not offered coverage receives subsidized coverage on the Exchange, the employer is subject to a 2017 annualized penalty of $2,260 multiplied by all full-time employees (minus the first 30).

ALEs have been very reluctant to drop their health plans because not only would they likely need to offer a significant boost in taxable wages (and potentially a gross-up) to be competitive, but they would also face the large sledge hammer penalty under the employer mandate. While it is possible that total cost could be less than the cost of offering a fully compliant employer-sponsored group health plan, it has generally proven undesirable.

ACA Increases Deductibility Threshold to 10%: The ACA increased the threshold that permits individuals to deduct health care expenditures from amounts in excess of 7.5% of adjusted gross income to amounts in excess of 10% of adjusted gross income. This increase makes it even more unlikely that employees paying for individual market coverage would have the ability to pay for some portion of health expenses on a tax-advantaged basis.

Limited Choices and Narrow Networks: In many areas of the country, there have been relatively few choices available in the individual market for consumers. The Exchanges simply did not develop into the robust marketplace that was intended in these areas. In some extreme cases, all carriers have left the region, leaving no individual market options.

In areas where the Exchanges have provided some reasonable level of choice, there is still a common issue of narrow networks. Most Exchange policies do not have as broad a network of providers and hospitals as a typical employer-sponsored group health plan. This has caused many to view Exchange coverage as closer to Medicaid (which has long had much more narrow provider offerings) than an employer plan, and therefore less desirable.

Employers facing the need to retain and recruit labor have found the prospect of moving employees to Exchange coverage as a non-starter in many cases because of the sub-standard offerings compared to a typical employer plan.

Adverse Selection: This has not changed since the pre-ACA era. There are still strong incentives for employers to offer group health plan coverage, and strong incentives for employees to receive employer-sponsored group health plan coverage. These tax, coverage, and competitive incentives have in many ways been exacerbated by the ACA.

The result continues to be that nearly all of the "good" risk (i.e., the full-time employee demographic) remains in the employer-sponsored group health plan market, and the individual market continues to struggle to retain sufficient good risk to maintain reasonable premium and cost-sharing levels.

c) <u>HSA Changes Make the Individual Market a Viable Alternative</u>

Imagine a post-ACA world where the following factors all line up in favor of creating an individual market that can truly compete with the employer-sponsored group health plan:

- HSA contribution limits double to $13,000+ for family coverage;
- Tax-free HSA distributions are permitted to pay for premiums on the individual market (regardless of age/circumstances);
- The individual market prohibits pre-existing condition exclusions and medical underwriting (the AHCA bill that passed the House did permit medical underwriting in certain states and under certain circumstances where the individual fails to maintain continuous coverage);

- There is no employer mandate (every version of the ACA repeal/replace proposals, even the so-called "skinny bill," would remove all pay or play penalties under §4980H); and
- The individual market is not limited to Qualified Health Plans (QHPs) meeting strict benefit and metal tier standards on the Exchange, so low-premium plans (with less rich benefits) are readily available.

The Large HSA Opt-Out Approach: It is fairly common now for employers to offer a small opt-out credit to employees with access to other coverage (e.g., through a spouse, domestic partner, or parent) to avoid the cost of coverage where possible.

However, what if the opt-out credit becomes an enticement to join the individual market?

For example, assume an employer offers three medical plan options. The employer offers an opt-out credit equal to the employer-share of the premium for the lowest-cost plan option for employees who verify HDHP enrollment in the individual market. This opt-out credit is deposited directly in an HSA—not as taxable cash.

The employee uses this large HSA deposit to pay the premium for the individual market HDHP coverage on a tax-free basis. Employees may choose a lower actuarial value plan (e.g., 58% based on previous proposals) that comes with a much lower premium. Where the opt-out credit is more than the cost of the premium, the employee can save the balance for cost-sharing amounts or long-term savings.

The employer likes this approach because the opt-out amount is tied to the employer-share of the premium for the lowest-cost plan. It therefore could reduce costs.

The employee likes this approach because it provides ultimate flexibility, tax-advantaged contributions/distributions, and the ability to save the balance in the HSA.

Short-Term Implications of the Large HSA Opt-Out Approach: The approach is likely attractive only to smaller employers at the outset. Competitive forces still require robust benefit offerings for large employers. As more and more small employers test the waters, the approach gains momentum slowly over a period of years.

This drives a significant portion of "good" risk (i.e., full-time employees) into the individual market for the first time in generations. As a result, premium costs in the individual market stabilize as the risk pool improves.

Intermediate to Long-Term Implications of the Large HSA Opt-Out Approach: Mid-sized and large employers begin to offer the large HSA opt-out to respond to competitive forces from employees who have experienced the option and create market demand.

Over time, more and more employees with low to average health risk flock toward the large HSA opt-out alternative. These employees see the ability to pay a low premium (albeit for less rich benefits) and save the balance in the HSA as a more compelling option than the traditional employer-sponsored group health plan. Employees with higher than normal health risk remain in the employer plan for the cost/comfort advantages.

The long-term implications of this are a move away from the predominance of the employer-sponsored group health plan industry to a more attractive, stable, tax-efficient, and affordable individual market than we have had in the past century. Decades into the future as the "good" risk migrates more and more to the individual market, employer plans see cost increases over time that could become unsustainable. That could be the recipe of an eventual individual market takeover driven by large employer HSA contributions.

IV. Summary

HSAs in a post-ACA world have the potential to radically change our savings and health care approach.

With respect to savings, a $13,000+ HSA contribution limit will drive major increases in the use of HSAs as a long-term savings vehicle. As this use becomes commonplace, there will be both regulatory and market pressures to ensure employees have access to low-cost, quality HSA investment options.

This will move employers, HSA vendors, and investment advisory firms to select, monitor, and communicate HSAs in ways that have largely been ignored to date. Furthermore, it will drive educational pushes to better understand HSAs, their unique triple-tax advantaged structure, and the powerful "save it forward" ability to ensure these large contribution amounts are put to their best possible use.

The ability to take tax-free HSA distributions to pay for health premiums, when paired with the much higher contribution limit, could be the spark for nothing less than a legitimate individual market alternative to the current

employer-sponsored group health plan predominance. By offering large HSA opt-out credits, small employers could start the trend that slowly moves up the chain.

Once the HSA contribution approach becomes a real competitor for employer and employee dollars, employer-sponsored group health plans could start to fade as the risk profiles shift. While it may be unlikely that anything but the very long-term future would see the end of the group health plan as we know it, it is likely that over time the individual market would take significant market share from group health plans.

In the face of real competition from tax-advantaged individual market coverage, made possible by increased HSA contributions and tax-free premium distributions, the employer-sponsored group health plan industry faces an interesting challenge ahead.

You can contract Brian at brian.gilmore@theabdteam.com. He will likely ask to show you a picture of his license plate. You should probably humor him.

For more information on the current state of HSAs, please see our Office Hours webinar "Go All the Way with HSA: Everything HDHP/HSA You Need to Know."