

# Health-Based Accounts: Why Employers Need to Weigh All Options





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# Executive Summary

Account-based medical plans, such as medical savings accounts, health reimbursement accounts, and flexible spending accounts, have a strong future. They merit serious consideration by employers due to important benefits they confer to employers and employees alike. We believe this to be true regardless of whether essential provisions of the 2010 Patient Protection and Affordable Care Act will take effect as the law provides, or whether that law is significantly modified or diluted by the courts and Congress.

Our belief is rooted in the following four assumptions and key takeaways:

1. The tax advantages conferred upon account-based plans will remain intact, and plan designs will evolve around account-based plans or programs to maintain that tax-advantaged status in response to the Cadillac plan tax effective in 2018.
2. Employers will continue to need to place limits, and in many cases *greater* limits, on the level of their commitments to funding employee health care costs due to the strong likelihood that health care costs will rise at rates higher than inflation.
3. Ever-mounting fiscal pressure on the U.S. Government will continue well into the future, resulting in growing restrictions on Medicare and other federal entitlement programs. As this becomes clear to employees, they will seek convenient and tax-efficient opportunities to prepare themselves for their own financial and health futures.
4. Employees, who for many years have been accustomed to the defined contribution model for retirement income savings, seem to be gaining a comfort level with applying that approach to pre-funding short-term and post-retirement health costs.

It has been estimated that in 2010, some 21 million people were covered by either an HRA or HSA-eligible plan, representing about 12% of the privately insured market<sup>1</sup>. We expect the prevalence of health care accounts to grow substantially in the coming years—regardless of whether the U.S. system evolves into a 100% market-based policy, a 100% government (“single payer”) solution, or, most likely, something in between.

Through favorable tax treatment, accounts can enable employers to transform their strategies from the current cost shifting approach, which creates winners and losers, to a scenario where both employers and employees can come out ahead. Employers have multiple options for account-based solutions, each with its own advantages and limitations. The challenge now comes in how employers can creatively leverage the best combination of account-based solutions to drive innovative HR/benefits strategies to meet the short and longer-term needs of their evolving workforce.

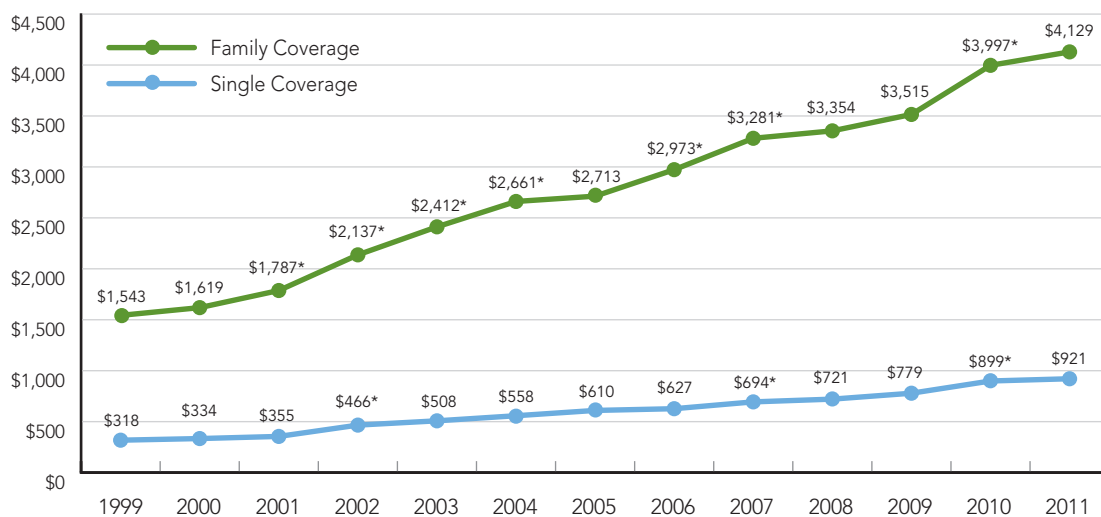
<sup>1</sup>Employee Benefits Research Institute Issue Brief, January 2011 #353, “Health Savings Accounts and Health Reimbursement Arrangements: Assets, Account Balances, and Rollovers, 2006–2010”



# The Health Care Burden for Employees

A critical assumption in projecting growth in the adoption of health care accounts is the continued increase in individual responsibility for health care expenses. For more than a decade, individuals have seen this trend of increased responsibility in the form of higher premium contributions and cost sharing. Today, the average family with employer-sponsored coverage spends over \$4,000 annually for medical, prescription drug, and dental expenses (including premium contributions—see Figure 1).

**Figure 1: Average Annual Worker Premium Contributions Paid by Covered Workers for Single and Family Coverage, 1999–2011**



Source: Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 1999–2011.

\*Estimate is statistically different from estimate for the previous year shown ( $p < .05$ ).

In future years, with medical inflation rates that are likely to exceed wage inflation, the individual burden will increase both in terms of dollars, and as a percentage of income. This dynamic may impact employees both during their working careers and more dramatically, throughout their retirement. Medicare is not free and its cost-sharing provisions and substantial monthly premium contributions may be surprising to many retirees who need to plan for health care expenses in retirement.

In retirement, a family without dependent children will need the equivalent of \$235,000<sup>2</sup> in today's dollars to pay for medical expenses not covered by Medicare. (This estimate assumes a couple age 65, retiring in 2011, without employer-sponsored retiree health coverage.) If the couple is younger, the burden will be even greater, assuming medical inflation exceeds their retirement savings' investment returns.

<sup>2</sup>Fidelity Retiree Health Care Cost Estimate, 2011, Fidelity Benefits Consulting Report

## How Accounts Can Help

The cost of health care in retirement is difficult to estimate. Employees need to begin saving for retirement many years before they leave the workforce. To assist these efforts, health care accounts can be invaluable in helping individuals in this environment, especially given significant tax benefits available through account-based strategies. Specifically, we believe that individuals can significantly reduce their lifetime out-of-pocket medical expenses, net of taxes, through the effective use of account-based solutions.

## Developing a Strategy for Your Employees

For employers interested in the wealth, health, and productivity of their workforce, account-based solutions provide a key strategy to help employees with their increased financial responsibilities. Accounts can encourage individual discipline with regard to planning and saving for health care, drive consumer-oriented behavior where the need for and cost of procedures are questioned, provide individuals with the flexibility they'll demand as they are required to share more of the financial burden, and allow for other benefits such as linking participation in wellness programs to any employer funding of wellness rewards into a health care account.

Companies can design account-based strategies in a variety of ways to help manage their and their employees' needs. For example, a company may plan to offer a Health Reimbursement Arrangement (HRA) for individuals to use to purchase health care coverage through a Health Insurance Exchange (as provided for under the 2010 Patient Protection and Affordable Care Act, or PPACA), and a health care Flexible Spending Account (FSA) to help pay for out-of-pocket expenses. Another approach could involve offering an HDHP and HSA designed to encourage savings for retirement and to avoid the "Cadillac plan" excise tax mandated by PPACA. These are just two of many permutations involving account-based plans.

Regardless of the path an employer chooses, it is important that employers' strategic options be thought through, with both the macro environment (including the tax code and PPACA) and the micro environment (such as business needs and their employee demographic profile) taken into account. Given the generous government assistance being offered through tax incentives, it would be unfortunate to let such an opportunity pass from both the employer and employee perspective.

See *Appendix A: Simplifying the Evaluation: Plan Features of an Ideal Account* for considerations on constructing a health account structure for your organization, keeping in mind the pros and cons of each option.



# A Review of Account Alternatives

## Health Reimbursement Arrangements

One type of tax-advantaged account employers can consider using for active and/or retiree health savings is a Health Reimbursement Arrangement, or HRA. These accounts generally have a notional balance that is used for reimbursement of eligible medical expenses. Employees are not allowed to contribute to HRA accounts.

Employers typically set up an HRA either to use as a vehicle for current year expenses or future retiree medical expenses. Though it is possible to have a single account for both purposes, retiree HRAs are almost always structured on a stand-alone basis because they are deemed excepted benefits exempt from provisions under several health care reform mandates, as well as provisions under HIPAA portability and nondiscrimination, and Mental Health Parity rules. Stand-alone HRAs that cover active employees are not presently exempt from these requirements or the restriction on annual limits imposed under health care reform.

HRA accounts are generally not portable. This may be attractive from an employer perspective in terms of retention, but less so from an employee viewpoint. Perhaps the most significant drawback of these accounts, for both employers and employees, is that employee contributions are not allowed. Still, with an extended accumulation period, the account balance can provide a significant means of helping to pay for premiums and/or out-of-pocket expenses, especially for those retiring before becoming eligible for Medicare.

The following table highlights key elements of both types of HRAs:

**Table 1: Attributes of Two Types of Health Reimbursement Arrangements**

HRA for Active Employees	HRA as Retiree Health Funding Tool
Typically offered with a PPO that includes a deductible and co-insurance	Use of employer-provided funds is typically used for either premiums and/or out-of-pocket expenses. Limiting such usage may ease the administrative burden for employers.
Can be used as a defined contribution vehicle for purchasing health insurance	Eligibility requirements are typically based on age and/or length of service and may be credited a fixed notional amount annually.
Can be funded by the employer to be used by employees to purchase insurance through the individual market or as part of a private or public insurance exchange	Vesting schedules may apply. Some employers may provide notional credits beginning at a certain age (e.g., age 40) and allow those credits and any accrued interest to accumulate during active employment. Other employers may choose to provide credits only upon retirement.
Carryover options, implications for midyear hires, and options after terminating the plan should also be considered.	Due to an aging population, employers may consider an HRA to replace their current retiree medical coverage with a defined contribution program where the employer contributes a fixed notional amount, based on each retiree's eligibility. Pre-funding options are limited for non-collectively bargained for-profit employers.
If an HRA is used by employees to help pay for deductibles, the vehicle may appear to remove the financial cost sharing that is needed to support health consumerism.	

## Health Savings Accounts

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 included a provision that created Health Savings Accounts (HSA). In the years since, adoption rates have been very high as the total number of HSA accounts rose to 6.3 million with assets totaling \$11.7 billion, a year-over-year increase of almost 28% for accounts and a 31% increase in assets for the period from June 30, 2010 to June 30, 2011<sup>3</sup>.

Further, according to the trade group America's Health Insurance Plans (AHIP), HSA account openings in conjunction with HDHP enrollment have continued to grow steadily since 2005 across all sectors including the individual, small group, and large group markets (see Table 2 below).

**Table 2: HSA/HDHP Enrollment (Covered Lives), March 2005 to January 2011**

	March 2005	January 2006	January 2007	January 2008	January 2009	January 2010	January 2011
Individual Market	556,000	855,000	1,106,000	1,502,000	1,832,000	2,053,000	2,358,497
Small-Group Market	147,000	510,000	1,057,000	1,816,000	2,429,000	2,970,000	2,779,208
Large-Group Market	162,000	679,000	2,044,000	2,777,000	3,752,000	4,986,000	6,299,460
Other Group*	88,000	247,000	291,000	13,000	*	*	*
Other**	77,000	878,000	34,000	10,000	**	**	**
Total	1,030,000	3,169,000	4,532,000	6,118,000	8,013,000	10,009,000	11,437,165

Sources: AHIP Center for Policy and Research, 2005–2011 HSA/HDHP Census reports.

\*For this census, companies reported enrollment in the large- and small-group markets according to their internal reporting standards, or by state-specific requirements for each state. The "other group" category contains enrollment data for companies that could not break down their group membership into large- and small-group categories within the deadline for reporting.

\*\*The "other" category was necessary to accommodate companies that were able to provide information on the total number of people covered by HSA/HDHP policies but were not able to provide a breakdown by market category within the deadline for reporting.

Employees are eligible to fund an HSA if they participate in a high-deductible health plan (HDHP) meeting certain design requirements as defined by the Internal Revenue Service each year. An individual generally is ineligible to contribute to an HSA if he or she has health care coverage other than the HDHP plan, or a limited purpose or post-deductible health FSA. Both the employer and the employee are eligible to make contributions to the employee's HSA, up to the maximum amounts permitted.

The HSA is always owned by the individual and is portable. As such, it may be accessed by the individual at any time, including post-employment or during retirement. Distributions from the account are tax free if used for qualified medical expenses or for certain insurance premiums (e.g., COBRA premiums and Medicare Part B and Part D premiums). Distributions used for anything other than qualified medical expenses are considered taxable income and are subject to a 20% penalty tax. The tax penalty is not applicable in certain cases, notably when the account owner is age 65 or over. An HSA may be transferred to a surviving spouse federal income tax free.

HSAs are receiving renewed attention as employer costs continue to escalate, the tax-favored nature of the accounts is better understood, and the excise tax under health care reform approaches (effective in 2018). Larger employers still typically offer HDHP plans alongside traditional options (e.g., an HMO or PPO) and achieving greater enrollment in the HDHP plans is an ongoing challenge for many. Various approaches including contribution strategy and communication and education efforts can help improve enrollment.

<sup>3</sup>Midyear 2011 Devenir Health Savings Account Survey Report; August 2011, Devenir Group LLC



Still, there is debate over the extent to which HSAs mitigate cost increases. In any discussion of potential impact, it is important to isolate the impact of the HDHP versus the HSA itself. Many studies indicate that with their higher cost-sharing features, HDHPs reduce employee utilization of health services. Analyzing the impact of the HSA itself should focus on the impact of having an account that can build over time. The greater benefit for employees stems from tax savings; HSAs allow individuals to pay for expenses on a pre-tax basis, saving an average of 30% in a calendar year, versus paying on an after-tax basis.

### **Flexible Spending Accounts (including “Limited Scope” or “Limited Purpose” FSAs)**

Health care Flexible Spending Accounts (FSAs), allowed under a cafeteria plan, enable individuals to pay out-of-pocket expenses on a pre-tax basis. Contribution amounts are generally elected during annual enrollment for the following year. Any amounts not used to pay for eligible health care expenses are forfeited at the end of the plan year, or following the 2½ month grace period if the employer has adopted that feature.

Though employers are allowed to set the maximum contribution amount today, they will be subject to a cap of \$2,500 beginning in 2013.

Full-scope FSAs can be used alongside traditional offerings such as an HMO or PPO plan. However, they cannot be used in conjunction with an HSA, where only a limited purpose or post-deductible health FSA can be employed. The limited purpose FSA can be designed to reimburse dental, vision, and preventive care expenses not covered by a health plan, and the post-deductible health FSA may reimburse out-of-pocket expenses in excess of the medical plan deductible.

### **Section 401(h) Retiree Medical Accounts**

Although this option has not been popular with plan sponsors, Section 401(h) of the Internal Revenue Code allows employers to establish a separate fund inside a defined benefit retirement plan (i.e., a pension plan) to pay retiree health benefits. These accounts can be funded by employer contributions, which are deductible to the employer, and by employee after-tax contributions. The 401(h) account is intended primarily as a vehicle for employers to fund their retiree health care benefit obligation. For recordkeeping purposes only, a separate account must be established and maintained for contributions used to fund 401(h) benefits in the pension trust. In addition, separate accounts must be established for key employees and benefits are only payable to them from such accounts.

Earnings on contributions, which must be allocated on a reasonable basis, accumulate tax free in the defined benefit trust. Distributions—principal and earnings—from the 401(h) account are not taxable to the retiree as long as they are used to pay for eligible retiree out-of-pocket health care expenses.

## Defined Contribution Retirement Plans

Although not explicitly designed for this purpose, defined contribution plan (DC) accounts, such as 401(k) and 403(b) accounts, can be a significant source of funds to defray health care expenses in retirement. DC plans provide flexibility since they can be used for non-health care-related expenses in retirement. Also, their contribution limits are quite high relative to the HSA. However, DC plans are not as tax effective as other vehicles because disbursements of pre-tax contributions and earnings are taxable to the individual, regardless of their use.

It may make sense for individuals to earmark a portion of their DC plan savings for health care expenses. For most individuals, any balances in other health care accounts will likely not be sufficient to pay for all of their health care expenses. If a multi-account strategy is available to employees, education and planning tools are especially useful to help navigate this complex planning process.

## Employee-Pay-All Voluntary Employee Benefit Associations (VEBAs)

Voluntary Employee Benefit Association (VEBAs) accounts allow employees to save for retiree health care expenses, with some tax advantages. They are established under Section 501(c)(9) of the Internal Revenue Code, which establishes a trust for the payment of life, health, or other benefits.

Employees can make contributions only on an after-tax basis, but there are no limits on those contributions. Earnings on contributions grow tax free, and account disbursements are not taxed as long as they are used for qualified health care expenses.

Employee-pay-all VEBAs have not received much interest, due in part to the after-tax contribution structure. Despite the limited tax advantages, the employee-pay-all VEBA may provide one of the few vehicles for employees to specifically fund retiree health care.

VEBAs may be attractive to employers who choose not to contribute towards retiree health care, but to only provide employees access to a savings vehicle. When evaluating the merits of these accounts, employers will have to take into consideration whether lower-paid employees are able to contribute enough on their own to meet their health care expenses in retirement and whether the VEBA would meet applicable nondiscrimination requirements under the Code.

## Employer-Funded Voluntary Employee Benefit Associations (VEBAs)

Employer-funded VEBAs are tax-favored welfare benefit trusts that allow for the payment of life, health, and other benefits to members and their dependents and beneficiaries. This VEBA trust is strictly a funding mechanism for employers. Neither individual employee accounts nor contributions from employees are permitted.

Becoming eligible for and then calculating the tax deduction on the employer contribution to VEBAs is a complex undertaking. For example, the reserve for post-retirement medical benefits must be funded over the working lives of employees, with no allowances for medical inflation factored in. The employer's deduction for contributions to the VEBA may be limited under Code Section 419A. Also, for many employers, earnings on fund reserves are subject to unrelated business income tax (UBIT).

As a result, this type of VEBA may not be tax efficient unless the underlying assets are themselves tax efficient. For these reasons, relatively few employers find value in using VEBAs for funding benefits.

See *Appendix B: Comparison of Health Care Accounts* for additional details.



# Strategic Options, with Employer and Employee Implications

Account-based solutions address the core issue facing employers today: how to add a greater element of defined contribution funding (implicitly addressing their budget challenges) into a program that has been largely a “defined benefit” design in the past. By moving in this direction, employers will be able to better manage their year-to-year liabilities while providing employees with the funding mechanism needed to efficiently support the broader movement towards consumerism and increased accountability. Increasing the proportion of funding that is defined contribution in nature can be accomplished through a number of strategies, with varying degrees of impact and change from the status quo. Options to consider are summarized in Table 3 below:

**Table 3: Strategic Options for Account-based Solutions**

Strategy	Considerations
1. Fixed-dollar subsidies	Limiting company contributions can result in significant year-over-year increases to employee costs, especially in the first year. Special attention should be paid to best communicate this kind of change to employees.
2. HSA with generous employer contribution	One approach provides relatively generous HSA funding in exchange for premium contributions that are higher. This method may help offset the transition to HDHP.
3. HRA with fixed-dollar contributions	An HRA can be used as a vehicle for delivering credits towards health care costs in conjunction with a plan provided through an employer or an exchange. Carryover and interest credit features can put a true defined contribution framework in place.
4. No health care benefits, offset with increased compensation	The loss of tax efficiency may be offset by tax credits for select employees with specific earning limits in the Exchanges in 2014; employer penalties may apply.
5. Other, including retiree medical accounts and flexible spending accounts	As more account options are made available, careful coordination and education become more critical to employee understanding, engagement, and utilization.

Strategies that focus on the five options outlined in Table 3 will be relevant and valid regardless of how health care reform plays out in the States, the courts, or elsewhere. Understanding of health care account options and workforce strategies is critical to ensuring that an employer’s time in developing a health care strategy is well spent.

There is no one strategy that fits all employers. During the planning process, it is important to list and then consider the variables that should impact any decision. These variables will include, but not be limited to, the following:

1. Company's risk and volatility tolerance (P&L flexibility)
2. Competitive employment environment
3. Employee demographics
4. Corporate culture and philosophy
5. Business and political climate

Analyses performed by companies when evaluating any strategy must take into consideration the impact of taxation of the dollars spent on health care. This consideration can result in real benefits for both the employer and employee, thus leading to wider adoption of account-based strategies. Figure 4 shows five possible account scenarios for employers seeking to increase defined contribution funding of health care. Approaches range from a traditional approach where an employer facilitates contributions to an HSA with a limited purpose FSA, to a radical approach of no longer providing health insurance for employees.

**Figure 4: Five Scenarios for Moving Towards a Defined Contribution Model for Health Benefit**

	HRA	HSA	FSA*	Underlying Health Plan**	Comments
1. Traditional, Focus on Employee Spend		●	●	●	Employer provides access to an HSA with limited purpose FSA and access to underlying plan. Objectives may include cost management and desire to stay below excise tax limits.
2. DC Strategy Adoption	●	●	●	●	Employer provides HRA and employee can purchase insurance on a private or public exchange, including HSA and limited purpose FSA.
3. Traditional, Focus on Employer Spend	●		●	●	Employer provides HRA and accompanying plan, perhaps for a population with high turnover.
4. Efficient Funding, No Access	●			●	Funds provided in HRA for individual to spend on a public exchange. Unclear whether "play-or-pay" penalty would apply.
5. Complete Exit			●		Employer provides no health insurance but can provide an FSA to help ease out-of-pocket costs.

Note: Circles in Figure 4 indicate options included in the overall plan design

\*FSA must be "limited" type if offered alongside an HSA

\*\*Plan may be through employer channel or via exchanges (public or private)

For illustrative purposes only.



## Study: HSAs Can Show a Significant Savings Difference Over Traditional Paths

A Fidelity analysis has found that both single people and those with families may be able to increase their retirement savings, including the portion needed for medical expenses, by utilizing a combination of a workplace savings plan, such as a 401(k) or 403(b) plan, and an HSA in conjunction with an HDHP.<sup>4</sup>

The analysis, described below, found that it may make more financial sense to switch from an HMO or PPO to an HDHP with an HSA. HDHPs may generally have lower premiums than HMO and PPO plans, which help to offset the cost of the higher deductible.

The analysis indicated that there may be an overall savings benefit by switching to an HDHP with an HSA, regardless of whether the participants had annual incomes of \$50,000, \$150,000, or \$250,000. This is generally true whether the participants utilized a low, medium, or high level of health care services.

Fidelity developed nine case studies tracking the traditional HMO path and the HSA/HDHP path over 20 years, based on three hypothetical families in the three different income brackets. Each family was shown using low, medium, and high amounts of health care. The families were assumed to be single earner households, had no other income except for salary, and had contributed to their HSA\* and their 401(k) plan at age 45 and had let the savings grow to age 65. A 7% average annual return was assumed.

The hypothetical results are striking. The HSA option led to greater potential savings in every case, even though each family had budgeted equal amounts. But the HSA option hypothetically made more money available to be invested for retirement savings, and the HSA served as a powerful supplemental savings account for future qualified medical expenses.

However, for each family, the potential savings advantage of the HSA option over the traditional one declines as health care costs rise and more money is taken out of the HSA to pay for qualified medical expenses. Nonetheless, the potential benefits of the HSA path were shown to be greater in all hypothetical cases, thanks to the impact of the HSA on savings.

**For more information on HSAs as a tax-advantaged savings vehicle, visit: <https://guidance.fidelity.com/viewpoints/personal-finance>**

\*In each of these cases the participant contributes \$5,150 to the HSA, which is the maximum allowed amount given the employer contribution of \$1,000 and an overall limit in 2011 of \$6,150. As healthcare utilization increases from low, to medium, to high, the amount to withdraw from the HSA increases from \$320, to \$2,050, to \$3,200 in these case studies.

<sup>4</sup>"Benefits Optimization: Maximizing the Value of Retirement & Health Care Plans," Strategic Advisers white paper, Feb. 25, 2011

# Employee Budgeting and Cash Management Considerations

The features of different types of health care accounts have implications for employee budgeting and cash management. For example, the entire amount of the employee's annual election in a health Flexible Spending Account is available to participants on the first day of the plan year. This is a valuable feature to employees from a cash management perspective, should they incur high health care expenses at the beginning of the year.

In contrast, with the Health Savings Account, cash flow can be an issue as employee (and sometimes employer) contributions are generally deposited on a *pro rata* basis each month; a major expense early in the year might exceed the HSA balance. However, over time, many employees will have accumulated sufficient funds to cover their share of medical expenses as those expenses are incurred.

A related issue from the employee perspective is the tax treatment of the different account types. The tax benefits associated with health care accounts—particularly Health Savings Accounts—can be very significant.

## Helping Employees Make the Transition

As most employers learned long ago when first introducing account-based retirement income savings vehicles, offering account-based vehicles for funding health care expenses necessitates a set of strategic initiatives to enable employees to make full use of the new benefit. The following are three key efforts employers need to make:

- 1. Brand the new program and “sell” its value.** Developing a longer-term approach to saving for health care expenses with account-based solutions requires creativity, consistency, and coaching. Companies are embracing account-based health savings programs that are aligned with their organization's identity and HR brand, supported by an engaged and visible leadership, and offering meaningful incentives to employees.
- 2. Take advantage of personalized technology solutions.** As in the 401(k)/403(b) world, highly sophisticated and individualized Web-based tools have been developed to show employees how they will be impacted financially under different saving and spending scenarios.
- 3. Provide prescriptive tools and guidance.** Many employees will not be inclined to engage in modeling exercises, and prefer—or need—appropriate guidance that addresses the common request, “Just tell me what to do.”

Developing a successful health care saving program involves a long-term commitment and a sound business strategy. Senior management need to play a role in creating a “culture of savings” and a “culture of health.” The HR/Benefits team needs to develop innovative communications programs that empower the company's unique employee population to take more responsibility for planning their financial future, save more for health care expenses in retirement, and certainly, better manage their own health today.



## The Impact of Health Care Reform

Health care accounts were addressed within the Patient Protection and Affordable Care Act of 2010 (PPACA). The direct impacts, which many had feared would make accounts less attractive, did so only in a narrow sense. The changes included the following:

- Beginning in 2013, the maximum contribution into a health FSA will be \$2,500. Until then, the maximum is set at the employer's discretion, subject to certain limitations.
- Non-qualified distributions from HSAs incur a 20% penalty. Prior to 2011, the penalty was 10%.
- Over-the-counter (OTC) drugs are no longer eligible, reimbursable health care expenses unless accompanied by a prescription (with the exception of insulin).

While these may represent modest takeaways from an employee perspective, other parts of the legislation support account-based solutions. For example, the excise ("Cadillac plan") tax is very likely to speed up the adoption of HDHPs and HSAs. A 40% excise tax, effective in 2018, applies if the value of an individual's coverage exceeds certain thresholds, generally, \$10,200 for single coverage, \$27,500 for family coverage. Employers will naturally work hard at managing their costs in an attempt to stay below these thresholds. Given the limited means available to ensure that costs stay below the excise tax threshold, the accelerated migration to high-deductible health plans (often with HSAs) will likely continue, in part due to an HDHP's typically lower cost structure.

Health care reform has also spurred renewed employer interest in HRAs. Specifically, the use of HRAs as a defined contribution vehicle is being contemplated by a number of employers. The employer would provide employees a fixed dollar amount inside an HRA, where the funds can be used to purchase insurance from the individual market, private exchange, or other access channels. The individual market channel may be a more viable option in the near future as medical underwriting and pre-existing condition exclusions will not be allowable beginning January 1, 2014.

A health-based account approach may be a viable option for some employers; however, penalties related to health care reform may be an ongoing concern as they may play a role in determining health care strategies for your organization.

# Conclusions

Given current economic, political, and medical cost trends, it is clear that employers and employees need to promptly weigh their options for helping employees have adequate resources to cover their out-of-pocket medical costs, particularly in retirement. As noted in this report, in retirement a family without dependent children is projected to need the equivalent of \$235,000<sup>5</sup> in today's dollars to cover expenses not covered by Medicare—a sobering sum. In 20 years, with an average medical inflation rate of 5%, that sum would nearly triple, to \$624,000.

Health-based accounts, in their varied forms, merit serious consideration. The philosophical acceptance of account-based programs is already well established in employers' embrace of defined contribution plans, such as 401(k) plans, as a means of allowing for adequate retirement income. The viability and advantages of health-based accounts are unlikely to be negatively impacted by the future course of health care reform. Formulating a benefits strategy that incorporates health-based accounts requires time and careful analysis. It is our hope that this report provides a useful starting point for that process.

## Fidelity Can Help

To better understand how to navigate the changing health care landscape, contact your Fidelity Representative to arrange a meeting with Fidelity Benefits Consulting as you continue to explore:

- How to optimize your investment in health improvement programs
- Best practices for employee engagement
- How to measure the effectiveness of tools and technology designed to help employees make the right health care decisions
- How to design and implement health care cost containment efforts while still serving the needs of your changing employee population
- The impact of health care reform on your benefits strategy

<sup>5</sup>Fidelity Retiree Health Care Cost Estimate, 2011, Fidelity Benefits Consulting Report



# Appendix A

## Simplifying the Evaluation: Which account-based options are best for my workforce?

While the idea of health care accounts is conceptually simple, plan design features can be complex. In Fidelity’s view, health care accounts provide a meaningful opportunity for employers to help manage their business needs while providing employees access to a significant source of savings options and potentially beneficial tax treatment.

Several account structures exist today, providing both design benefits and challenges. The following table presents Fidelity’s perspective on ten features employers may want to consider as they evaluate potential account-based strategies.

### Ten Plan Features of an Ideal Health Care Account to Consider

Plan Elements and Ideal Design Features	Employer and Employee Considerations
<p><b>1. Funding of Accounts</b> Ideally, flexibility is provided to allow employee and employer contributions and investment control for account holders (employees and retirees).</p>	<ul style="list-style-type: none"> <li>• For-profit private companies with non-collectively bargained plans currently have limited options for pre-funding future health care benefits on a tax-favored basis outside of an HSA, 401(h) account, or employee-pay-all VEBA.</li> <li>• When available, employer and employee funding maximizes flexibility for both plan sponsors and participants.</li> <li>• Funded accounts create greater administrative burdens than notional (unfunded) accounts. Additional responsibilities may include account maintenance, transaction processing, and investment processing.</li> <li>• Notional accounts are limited to employer contributions and may be administratively simpler: they exist only in employers’ accounting books and real assets are not set aside.</li> </ul>
<p><b>2. Tax Treatment</b> Ideally, employee contributions are pre-tax, employer contributions are deductible, earnings, when applicable, accumulate and grow tax free, and distributions for qualified expenses are not taxed.</p>	<ul style="list-style-type: none"> <li>• These provisions would help ensure that the maximum amounts are available for health care expenses. Such tax benefits are achievable: they are available today for active employees under a Health Savings Account (HSA).</li> <li>• Accounts that provide tax benefits over many years, such as the HSA, may benefit additionally from the power of compounding.</li> <li>• Tax treatment is critical in determining the maximum financial benefit that may be derived by the employee.</li> </ul>
<p><b>3. Lifetime Duration</b> Ideally, accounts are structured to remain accessible throughout participants’ entire lives (i.e., they are “portable”), rather than depending on active employment with a single employer. Alternatively, they would allow for account consolidation, possibly through a rollover feature.</p>	<ul style="list-style-type: none"> <li>• This approach lets employees take their accounts with them when they switch jobs. (This freedom is not currently available on all account types.) In certain instances, employers can allow terminated employees to access their accounts for qualified health care expenses.</li> <li>• Additional contributions are typically not allowed after termination.</li> </ul>
<p><b>4. Contribution Amounts</b> Ideally, the amounts are sufficient to cover current year expenses and allow for savings in future years. Catch-up provisions at older ages are attractive for accounts that allow employee contributions.</p>	<ul style="list-style-type: none"> <li>• Currently, employee and employer contributions may be defined by regulatory limits and budget constraints.</li> <li>• Many contribution limits in place today do not allow the average individual to cover all their expected health care expenses over a given time period.</li> </ul>

Plan Elements and Ideal Design Features	Employer and Employee Considerations
<p><b>5. Investment Direction</b> Ideally, accounts give employees a broad spectrum of investment options. Low-volatility investments are important to help fund short term needs. Ideally, long-term investments may be used for less immediate medical expenses.</p>	<ul style="list-style-type: none"> <li>Given the sizable health care expenses individuals face—and the continuing high rate of medical inflation—the need for growth potential is evident and significant over a longer-term horizon.</li> <li>Offering investment choices calls for adequate education about making appropriate investment decisions.</li> </ul>
<p><b>6. Covered Expenses</b> Ideally, individuals may use account funds to pay for both health insurance premiums and qualified out-of-pocket expenses.</p>	<ul style="list-style-type: none"> <li>The employer, federal law, or both typically define the benefits and eligible expenses under health care accounts. Section 213(d) of the Internal Revenue Code defines allowed expenses.</li> <li>Broader limits make accounts more useful; however, they may add administrative complexity.</li> <li>Disbursement rules could prevent high incidences of small-dollar withdrawals, which could add unnecessary administrative expense.</li> </ul>
<p><b>7. Access to Health Plan</b> Ideally, individuals have the ability to secure health coverage on favorable financial terms and without medical underwriting.</p>	<ul style="list-style-type: none"> <li>Account-based solutions can be structured in a variety of ways with respect to access.</li> <li>At one extreme, there may be no access provided, with only an account to use for payment of premiums and/or out-of-pocket expenses.</li> <li>Access to a plan could be a requirement, such as contributing to an HSA for which enrollment in a qualified high-deductible health plan is required.</li> </ul>
<p><b>8. Targeted Employee Populations</b> Ideally, eligibility requirements will allow employers to meet their objectives for attracting and retaining employees.</p>	<ul style="list-style-type: none"> <li>With nonqualified benefit plans, employers have flexibility in determining eligibility under the plans.</li> <li>For qualified plans with tax-favored status, strict nondiscrimination rules (and attendant testing requirements) generally apply.</li> </ul>
<p><b>9. Flexibility</b> Ideally, employers would have the ability to customize the account to meet the specific employer and employee objectives desired.</p>	<ul style="list-style-type: none"> <li>Current law and regulations enabling a particular account define the design parameters.</li> <li>For some accounts, basing eligibility on service and age is allowed.</li> </ul>
<p><b>10. Survivor Benefits</b> Ideally, account provisions would include rights of survivorship consistent with a lifetime approach.</p>	<ul style="list-style-type: none"> <li>Many questions arise regarding the treatment of account funds upon the death of an account holder.</li> <li>Variability regarding survivor benefits is permitted. However, a surviving spouse and/or dependent may be able to retain benefits from an account (e.g., only a spouse may receive a tax-free transfer of an HSA upon the account holder's death), depending upon applicable tax and plan rules.</li> <li>Some accounts may not have rights of survivorship.</li> </ul>



# Appendix B

## Comparison of Health Care Accounts

Feature	Employer Funding Vehicles				
	Defined Contribution Plan – 401(k) – Retiree	Employee-Pay-All VEBA – Retiree	Employer-Paid VEBA – Retiree	Health Reimbursement Account (HRA) – Active/Retiree	Health Savings Accounts (HSA) – Active/Retiree
<b>Availability</b>	All employers	All employers; tax-exempt employers can commingle employer/employee funds	Available on a tax-advantaged basis for tax-exempt employers, collectively bargained plans, and certain plans involving 10 or more employers	All employers	Available to eligible individuals covered by a high-deductible health plan (HDHP) and meeting all other eligibility requirements; account is owned by employee. Medicare Part A or B enrollment will make individual ineligible to contribute to an HSA
<b>Funding of Accounts</b>	Employee, before tax; and employer contribution, before tax. Some allow for employee after-tax; annual contribution subject to limits	Employee after tax	Employer	Notional (employer credited) and not funded; funded accounts may be possible through a VEBA, but is generally not available to for-profit employers with non-collectively bargained plans	Employer and/or employees into an account
<b>Tax Treatment</b>	Before- and after-tax contributions permitted; tax-deferred accumulation; withdrawals are taxed (excluding withdrawal of any after-tax employee contributions)	After-tax employee contributions; tax-free accumulation; tax-free withdrawals	Generally, whether contributions are tax deductible and permit tax-free accumulation of investment earnings may vary depending on applicable tax rules; funds must be used to pay for qualified medical expenses	HRA contributions to a funded Employer-Paid VEBA may or may not be tax deductible and subject to unrelated business income tax (UBIT) for the employer. Tax-free reimbursement of qualified medical expenses permitted	Employer tax-free contributions; employee pre-tax contributions; federal tax-free accumulation; federal tax-free distributions (at the federal level) of funds used for qualified medical expenses
<b>Annual Carryover of Accumulation</b>	Allowed; no limits	Allowed; no limits	Allowed; no limits	Allowed; limits may be imposed by employer	Allowed; no limits
<b>Lifetime Approach</b>	Portable; can roll over account balance into new employer's qualified retirement plan or an IRA	Not portable; post-termination access available	Not portable; post-termination access available	Generally not portable (but theoretically could transfer to another employer's HRA); post-termination access available	Portable

## Comparison of Health Care Accounts (continued...)

Feature	Employer Funding Vehicles				
	Defined Contribution Plan – 401(k) – Retiree	Employee-Pay-All VEBA – Retiree	Employer-Paid VEBA – Retiree	Health Reimbursement Account (HRA) – Active/Retiree	Health Savings Accounts (HSA) – Active/Retiree
<b>Investment Direction</b>	Employee	Trustees or participant-directed	Trustees	N/A	Employee
<b>Covered Expenses</b>	Not applicable; plan withdrawals are taxed (other than employee after-tax contributions) and may be used at retiree's discretion to fund health care expenses	All qualified medical expenses; at employer's discretion	All qualified medical expenses associated with health plan; at employer's discretion	All qualified medical expenses; at employer's discretion	Qualified medical expenses not reimbursed by the HDHP; premiums for specified insurance coverages
<b>Access to Health Plan</b>	N/A	Generally, provided; may be reimbursement only	Usually provided	Generally, provided; stand-alone accounts allowed	Employers offering an HSA typically offer the HDHP
<b>Survivor Benefits at Employee's Death</b>	Yes	Available	Permitted	Available	Yes, if the spouse is the beneficiary

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