

HEALTH INSURANCE COVERAGE PROJECT

John A. Pickens
Executive Director
Alabama Appleseed Center for Law & Justice, Inc.

Zayne B. Smith
Advocacy Staff Associate
Alabama Appleseed Center for Law & Justice, Inc.

Alabama Appleseed
P.O. Box 4864
Montgomery, Al 36103
(334)263-0086
(334)263-0270 (fax)
alabamaappleseed.org

REPORT ON ALABAMA'S UNINSURED AND MAJOR COVERAGE OPTIONS

Participating Pro Bono Attorneys

Margaret Ann Huckstep
Laurence J. McDuff
Stephen A. Rowe
Adams Reese
Birmingham

J. Andrew Lemons
Baker Donelson
Birmingham

James M. Pool
Lauren C. DeMoss
Maynard Cooper & Gale
Birmingham

James F. Henry
Bradley Arant Boult Cummings
Birmingham

John H. McEniry, IV
Maridi L. Thompson
Haskell Slaughter Young & Rediker
Birmingham

Gregory P. Rhodes
Sirote Permutt
Birmingham

S I R O T E
— & —

P E R M U T T

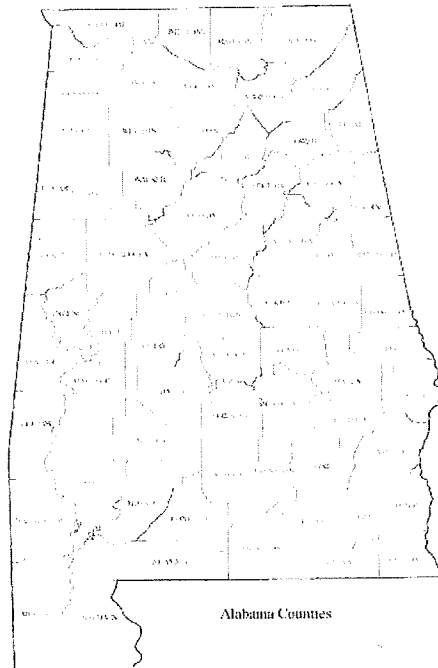
A PROFESSIONAL CORPORATION

2311 Highland Avenue South
Birmingham, Alabama 35205

Reply to:

Post Office Box 55727
Birmingham, Alabama 35255-5727
Telephone (205) 930-5100
Facsimile (205) 930-5101

Health Insurance Coverage in the State of Alabama: Alabama's Uninsured



Analysis of Health Savings Accounts, Health Reimbursement Accounts & Flexible Spending Arrangements

January 2009

Law Offices and Mediation Centers

2311 Highland Avenue South
Birmingham, Alabama 35205
Main: (205) 930-5100

305 Church Street/Suite 800
Huntsville, Alabama 35801
Main: (256) 536-1711
<http://www.sirote.com>

One St. Louis Centre/Suite 1000
Mobile, Alabama 36602
Main: (251) 432-1671

ALABAMA APPLESEED

HEALTH INSURANCE COVERAGE PROJECT

Mechanisms Under Consideration. The committee has analyzed several mechanisms to help expand healthcare coverage for the subject group. A brief description of each mechanism analyzed and their potential application by the State of Alabama is described below:

1. MEDICAL SAVINGS ACCOUNTS

Medical Savings Accounts ("MSAs") are no longer relevant for purposes of this analysis. For all practical purposes MSAs have been superseded by Health Savings Accounts ("HSAs"). Although contributions can still be made to MSAs, employers have not been able to establish new MSA programs since 2003.

2. HEALTH SAVINGS ACCOUNTS

Description. HSAs were created to replace MSAs. An HSA is a trust or custodial account exclusively created for the benefit of the account holder and his or her spouse and dependents, and is subject to rules similar to those applicable to individual retirement arrangements ("IRAs"). Contributions to an HSA are deductible, within limits, if made by an "eligible individual". An eligible individual generally means an individual covered by a high-deductible health plan ("HDHP"). An HDHP may include family coverage and may be sponsored by an employer. HSA contributions are tax deductible within certain limits described below. Earnings on the assets of an HSA are not taxable, nor are distributions from an HSA that are used to pay qualified medical expenses. An HSA, unlike an HRA is fully portable.

There are four federal requirements to be eligible for HSAs. First, an individual must be covered by a HDHP. An HDHP is an insurance policy having an annual coverage deductible of at least \$1,100 for an individual or \$2,200 for families for years 2007 and 2008. Second, the HSA enrollee cannot be covered by any other health insurance plan, such as a spouse's plan. Third, the HSA enrollee must be under the age of 65. Fourth, the HSA enrollee cannot be claimed as a dependent on a third party's federal income tax return.

Like any proposed alternative to the current health care system, HSAs have their fair share of advocates as well as critics. Advocates view HSAs as a novel tool through which ordinary citizens can combat escalating health care costs. They argue that enrollees will save money over the long-term because of the lower monthly premiums and because of their increased awareness of associated medical costs. Advocates further contend that HSAs force citizens to become better educated and active with regard to their own well-being.

On the other hand, critics assail HSAs as a temporary fix to an already confusing and inadequate health care system. Advocates of HSAs argue that lower income individuals would be attracted by the allure of lower premiums, but critics worry that these individuals will lack the capital to adequately fund their accounts. According to critics, the wealthy are likely to benefit the most as they will use HSAs to "accumulate tax-advantaged savings rather than pay

for medical expenses.” *HSAs Health Savings Accounts and the States, 2008*, available at www.ncsl.org/programs/health/hsm.htm. Support exists for this contention as tax filers who reported HSA activity in 2005 had higher incomes on average than other tax filers. Among tax filers between the ages of 19 and 64, the average adjusted gross income for filers reporting HSA activity was about \$139,000 compared with about \$57,000 for all other filers. The income differences existed across all age groups. *HSAs Health Savings Accounts and the States, 2008*, available at www.ncsl.org/programs/health/hsm.htm.

Background. Consumer-driven health care has been a staple of the Bush Administration’s health care policy, beginning with the passage of the Medical Prescription Drug, Improvement, and Modernization Act on December 8, 2003. See The Medical Prescription Drug, Improvement, and Modernization Act, Pub. Law No. 108-173, 117 Stat. 2066 (2003) (hereinafter, “Medical Prescription Act”). The Medical Prescription Act created HSAs. With the passage of the Health Opportunity Patient Empowerment Act of 2006, the Bush Administration further enhanced the role of HSAs as a mechanism through which citizens could access the health care market. According to the Bush Administration, the Health Opportunity Patient Empowerment Act of 2006, which is part of the Tax Relief and Health Care Act of 2006, provides new, affordable opportunities for HSA participants to gain greater control over their own health budgets and build their funds. *President Bush Signs Bill to Make Health Care more Affordable, Accessible*, available at <http://www.treas.gov/press/releases/hp209.htm>.

The premise of HSAs is simple. Individual taxpayers own a tax-advantaged medical savings account through which they can pay “routine” health care expenses. These accounts are then matched with an HDHP, which protect them against catastrophic medical expenses. The goal is to provide citizens with greater control over their health care while simultaneously reducing their health care costs. The argument for HSAs is as follows: “When consumers pay the true charge for healthcare, they will consume less and price competition will reduce the societal burden from healthcare costs.” Edie Milligan Driskill, *The Pocket Idiot’s Guide to Health Savings Accounts* (2006), cited in Peter G. Weinstock and Stephanie E. Kalahurka, *Health Savings Accounts and the Convergence of Healthcare and Banking*, 125 *Banking L.J.* 3 (2008).

HSAs save individual taxpayers money in numerous ways. First, money contributed to an HSA is pretax. If an employer contributes to an employee’s HSA, the contribution will not be taxable to the employee. If an individual taxpayer contributes to his or her own HSA, then the contribution will be treated as an “above the line” deduction. Under the Tax Relief and Health Care Act of 2006, the amount that can be contributed to HSAs is capped by an indexed dollar amount specified by law. Prior to the passage of the Tax Relief and Health Care Act of 2006, contributions were capped at the lesser of the deductible amount of taxpayer’s individual HDHP or the indexed dollar amount specified by law. In 2008, the maximum annual contribution amount was \$2,900 for individuals and \$5,800 for families.

HSAs are also fully portable. Some studies have found that the fact that an HSA is fully portable, whereas HRAs and other accounts lack portability, make an HSA a more desirable alternative. The portability factor makes the insured more conscious of the value of the account, and is more likely to make the insured conscious of its healthcare expenditures. See *Employee Retirement System of Texas, Actuarial Evaluation of Long-Term Impact of Health*

Savings Accounts or Health Reimbursement Accounts and High Deductible Health Plans Within the Texas Employees Group Benefits Program, available at http://www.ers.state.tx.us/about/legislation/documents/cdhpreport_execsummary.pdf (analyzing several options for providing insurance to the employees of the State of Texas and determining that a high deductible health insurance plan coupled with an HSA, as opposed to an HRA, structure provides the best option).

Potential application of HSAs by the State of Alabama. Because HSAs, like the other accounts we reviewed, are generally used in connection with an employment arrangement, there is a lack of analysis as to how HSAs can be used outside an employment scenario. Nonetheless, the analysis done by states seeking to provide benefits to their state employees provides some good insight into the advantages and disadvantages of HSAs. Specifically, several states have considered adopting an HSA structure with regard to their state employee benefits structure, and have advised the adoption of such accounts as a superior alternative to other options. See *Employee Retirement System of Texas, Actuarial Evaluation of Long-Term Impact of Health Savings Accounts or Health Reimbursement Accounts and High Deductible Health Plans Within the Texas Employees Group Benefits Program*; Tim D. Lee November 9, 2006 (recommending the HSA structure for the Texas state employee benefits system); and *States Should Adopt Health Savings Accounts*; Michael D. LaFaive, View Point of Public Issues, April 7, 2008.

Additionally, there has been a steady flow of states which have amended their state tax codes to provide state tax benefits which mirror the benefits provided under federal law for HSA contributions. In fact, only four states do not allow a state income tax deduction for HSA contributions. These states include Alabama, California, New Jersey, and Wisconsin.

3. HEALTH REIMBURSEMENT ARRANGEMENT

Description. An HRA is an arrangement that: (1) is paid for solely by the employer and not provided pursuant to salary reduction election or otherwise under a Section 125 Cafeteria Plan; (2) reimburses the employee for medical care expenses (as defined by Section 213(d) of the Internal Revenue Code) incurred by the employee and the employee's spouse and dependents (as defined in Section 152); and (3) provides reimbursements up to a maximum dollar amount for a coverage period and any unused portion of the maximum dollar amount at the end of a coverage period is carried forward to increase the maximum reimbursement amount in subsequent coverage periods. To the extent that an HRA is an employer-provided accident or health plan, coverage and reimbursements of medical care expenses of an employee and the employee's spouse and dependents are generally excludable from the employee's gross income under Sections 106 and 105 of the Internal Revenue Code.

HRAs cover medical expenses of retirees and/or beneficiaries qualified under the Consolidated Omnibus Budget Reconciliation Act ("COBRA") in addition to active employees and their dependents, but not self-employed individuals. However, under Section 106(c), long-term care expenses cannot be reimbursed under an HRA.

As stated above, an HRA is not available to a self-employed individual. Moreover, an HRA is not portable.

Because an HRA is paid for solely by the employer and cannot be provided pursuant to salary reduction election or otherwise under a Section 125 Cafeteria Plan, an accident or health plan funded pursuant to a salary reduction is not an HRA and is subject to the rules under Section 125 of the Internal Revenue Code.

HRAs are normally used in connection with an HDHP. By using an HRA, the employer is able to purchase a cheaper insurance plan (due to the high deductible) without adversely affecting the employee. Generally, the employee is not adversely affected because the HRA will (or is intended to) cover the costs associated with the higher deductible.

Application of HRAs by the State of Alabama. Because an HRA is required to be paid for by an employer, the potential coverage benefits of such a plan are limited. Nonetheless, there are lessons to be learned about the usefulness of an HRA-type structure by looking to the benefits they have provided in the private sector.

The benefits which stem from HRAs are similar to those produced by an HSA structure. Specifically, the HRA structure, like the HSA structure, generally results in higher degree of active participation by an insured in terms of determining when care is necessary and which care should be foregone. The presence of an account which the insured can monitor is generally found to result in this active participation. HRAs, unlike HSAs, however, are not portable.

4. FLEXIBLE SPENDING ACCOUNTS

Description: A Flexible Spending Account ("FSA") is one of a number of tax-advantaged financial accounts that can be set up through a cafeteria plan of a U.S. employer. It is a benefit program that provides employees with coverage which reimburses specified, incurred expenses, but only if they are incurred during a specific period of coverage. There are several types of FSAs, but the most common of these are Health FSAs (also known as medical FSAs). A Health FSA is similar to an HSA or a HRA. The primary difference between the plans is that, while HSAs and HRAs are almost exclusively used as components of a consumer driven health care plan (i.e. a program involving a high deductible plan), Health FSAs are commonly offered in conjunction with a traditional health care plan. A medical FSA is permitted to limit payment or reimbursement to only certain medical expenses (except health insurance, long-term care services or insurance). For example, an FSA could permissibly exclude over-the-counter drugs.

A Medical FSA is used to pay for medical expenses not paid for by insurance, such as deductibles, copayments, and coinsurance for the employee's health plan, but it may also include expenses not covered by the health plan, such as dental and vision expenses. Importantly, a Health FSA cannot pay for health insurance premiums as well as other items such as cosmetic surgery, controlled substances (in violation of federal law), or items that improve "general health."

The benefit of an FSA is the tax savings that it can create. An FSA allows an employee to set aside a portion of his or her earnings to pay for qualified expenses as established in the cafeteria plan, most commonly for medical expenses but often for dependent care or other expenses. Money deducted from an employee's pay into an FSA is not subject to payroll taxes.

One major drawback (or potential benefit as seen from the side of the employer) is that the money must be spent within the coverage period as defined by the benefits cafeteria plan coverage definition. The coverage period is usually defined as the period during which the taxpayer is covered under the cafeteria plan during the "plan year". The "plan year" is commonly defined as the calendar year. Any money that is left unspent at the end of the coverage period is forfeited back to the employer. This is commonly known as the "use it or lose it" rule.

Another drawback of the FSA is that the maximum amount of reimbursement from a health FSA must be available at all times during the period of coverage. Thus, the maximum amount of reimbursement will not be conditioned upon the amount of money an employee has actually contributed to the FSA as of the time of the reimbursement, leaving the employee the ability to withdraw expenses, and then terminate their employment immediately after, without fully funding the FSA. Of course, what is undesirable from the employer's side might be a beneficial characteristic from the view of the employee (or state).

An individual covered by a general purpose health FSA or HRA is not eligible to contribute to an HSA.

CONCLUSION

Limits of Application. While each of the tax-advantaged plans analyzed have their benefits, all of them have a limited amount of applicability in the context of expanding health insurance among Alabama's currently uninsured population. Tax advantaged plans are of limited benefit to individuals in lower income tax brackets – the benefit of a deduction or excluding an item from income is worth less to a low income taxpayer. This is particularly problematic because the target population that these programs are seeking to affect will consist primarily of low-income taxpayers. Moreover, tax advantaged plans require informed decision making and a level of awareness that is unlikely to be possessed by low-income taxpayers. In order to benefit from a tax advantaged plan, a taxpayer would need to think long-term by creating realistic budgets and weighing the benefits and costs of various medical expenses.

The tax-advantaged accounts that have been reviewed also have limited applicability to the objective of expanding health care coverage in Alabama because the primary benefit of each plan rests in the federal tax savings that they can generate. Accordingly, there is little the state of Alabama can do to enhance or promote these plans. The Alabama income tax savings available through use of any of the tax advantaged plans will be very limited in comparison to the federal tax benefits available under the plans. This aspect obviously limits the ability of Alabama to use these plans as a tool to promote expanded health coverage.

Additionally, FSAs and HRAs, which require an employment relationship, provide no benefit to the unemployed. This is particularly problematic because the target group of individuals the program seeks to assist will consist in large part of unemployed individuals. This problem is compounded by the non-portability of the plans, and further hindered by the "use it or lose it" aspect of an FSA.

Useful Lessons. While there are some obvious limitations to expanding healthcare coverage in Alabama through use of tax-advantaged accounts, there are some lessons to be learned from the accounts. First, based on the literature that has been reviewed, there appears to be a general consensus that high-deductible plans provide the most efficient method of providing healthcare coverage. This high-deductible component of the plan cuts the cost of providing a plan to a segment of the population and makes an insured more cost conscious when determining whether to seek medical treatment.

Additionally, based on the literature reviewed, it appears that portable accounts, which supplement HDHPs, produce several benefits. Separate accounts that can be monitored by the insured heighten the insured's involvement in healthcare decisions. Specifically, it appears that when the insured can actually monitor their account, they will be more likely to monitor their healthcare spending. The portable aspect of an account further promotes this beneficial aspect.

Our Recommendation: HSAs. While HRAs and FSAs have some potentially beneficial characteristics, HSAs provide the best opportunity for expanded health care coverage in the State of Alabama. Although there are numerous problems with HSAs, among the various health insurance plans analyzed, HSAs present the best opportunity to expand health care coverage among the currently uninsured for the lowest cost. HSAs will not solve the state of Alabama's healthcare problems, but they do provide a small avenue to expand healthcare coverage.

HSAs are preferred because they do not require the existence of an employment relationship. Accordingly, HSAs can be used by employees, self-employed individuals or unemployed individuals. This aspect makes HSAs unique from, and potentially superior to, the other plans reviewed.

Additionally, HSAs are portable. This increases the incentive of an individual to contribute to a plan. Moreover, as discussed previously, this portability characteristic will increase the degree of scrutiny applied by the insured when determining whether to incur healthcare expenses.

Finally, HSAs are not currently tax-favored in Alabama. Alabama is one of only four states identified that does not offer a state tax incentive for contributions to an HSA. Thus, there is a clear opportunity to expand healthcare coverage in Alabama by implementing legislation that offer tax advantages for these accounts.