



Q & A ON HSA RESTRICTIONS

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On April 9, 2008, the House Ways and Means Committee passed legislation (H.R. 5719) with provisions placing additional restrictions on Health Savings Accounts (HSAs). In anticipation of floor consideration of the measure, the RSC has prepared the following document providing context and background information on the proposal.

What change to Health Savings Accounts are Democrats proposing?

Section 17 of H.R. 5719 requires “substantiation” of all HSA transactions from an independent third party, to ensure that money withdrawn from an HSA pays for qualified medical expenses. Specifically, the section would make the income tax deduction associated with HSA contributions contingent on substantiation of all withdrawals, beginning in 2011. This oversight of every single account transaction would make HSAs similar to Flexible Spending Arrangements (FSAs), an earlier consumer-driven health care model.

How are FSAs and HSAs different?

One of the prime differences between the two account-based models lies in the control source for the funds in the account. The Internal Revenue Code makes clear that FSA accounts are held by *employers*, while HSA funds remain exclusively the property of the *employee*. This distinction explains why unused FSA funds in an employee’s account at the time of departure revert back to the employer, while HSA funds always remain with the employee, and remain portable from job to job and into retirement. Some conservatives may be concerned about the potential implications of transferring a “substantiation” system designed for employer-owned FSAs to individually-owned HSAs—both in terms of the legal liabilities placed on employers and administrators to verify transactions, and the restrictions placed on individuals to control their HSA account dollars.

How are HSA and FSA withdrawals administered?

Right now, most HSA transactions take place using point-of-sale debit cards that make electronic fund transfers directly from the account. Conversely, most FSA transactions remain paper-based, requiring out-of-pocket spending by the individual and subsequent reimbursement from the FSA after approval by an administrator. While Treasury has released new regulations to make FSA reimbursement simpler, some conservatives may remain concerned that the Democrats’ proposed change may make the HSA model less attractive to consumers.

What penalties are currently in place to ensure HSA funds are spent on qualified medical expenses?

Under the Internal Revenue Code, non-qualified withdrawals from an HSA are subject to individual income taxes, as well as a 10% penalty. HSA account activity is subject to audits from the Internal Revenue Service, and account holders are advised to retain their receipts documenting qualified medical expenses in the event of an audit.

What measures do HSA administrators currently have in place to ensure that withdrawals from the account are made for qualified medical expenses?

Right now, some banks that administer HSAs have electronic debit cards that can “read” the merchant code where the transaction is taking place (e.g. a doctor’s office). If a request for transaction is occurring at a location not normally associated with qualified medical expenses, the debit card can decline the transaction. Some administrators have developed more advanced technology to differentiate product codes within a merchant’s offerings—for instance, accepting grocery store transactions for cough syrup (a permissible over-the-counter drug) while rejecting attempts to purchase items within the same store for items without a clear medical use, such as beer or wine. This advanced technology is in the process of being rolled out; however, many banks and account administrators have expressed their view that enactment of this legislative provision could prompt their withdrawal from the HSA marketplace.

Does the fact that some HSA withdrawals are made at places like grocery stores mean that these withdrawals are not for qualified medical expenses?

Not necessarily. The list of [qualified medical expenses](#) is quite broad, and generally includes most items reimbursable from a Flexible Spending Arrangement or deductible on an individual tax return if total medical expenses exceed 7.5% of an individual’s adjusted gross income. Under certain circumstances, legal expenses (to authorize mental health care), lodging and travel expenses (related to medical treatment) and even the cost of a telephone (for the hearing impaired) can be considered medical expenses. Some conservatives may be concerned that the proposal under consideration would essentially shift the burden of proof from the government (to prove that an expenditure was improper in the context of a tax audit) to the consumer to prove compliance at the time of withdrawal, causing additional inconvenience to the HSA holder.

Are withdrawals made for causes other than qualified medical expenses unlawful?

Only if the account holder does not pay income taxes and a 10% penalty. Under current law, it is the account holder’s obligation to declare such non-qualified withdrawals—a policy comparable to withdrawals from an Individual Retirement Account (IRA). Account holders who do not pay appropriate taxes and penalties on withdrawals not for qualified medical expenses are subject to an Internal Revenue Service audit.

How many HSA withdrawals are unlawful?

The percentage is unclear for two reasons. First, estimates of the amount of withdrawals made that do not involve qualified medical expenses vary. While one HSA administrator claimed that 12% of withdrawals were made at vendors not normally associated with qualified medical expenses, HSA administrators affiliated with the American Bankers Association claim that only 2.7% of their withdrawals took place at such vendors—and, for the reasons explained above, the fact that a vendor is not a qualified health provider does not mean that a transaction itself is not a qualified medical expense. A 2006 Government Accountability Office (GAO) study on HSA usage found that 10% of all withdrawals were made for purposes other than qualified medical expenses; however, GAO had only a single year (2004) of HSA withdrawal data available at the time it compiled its report.

What remains largely unknown is the percentage of transactions not associated with qualified medical expenses for which the account holder does not pay appropriate taxes and penalties. At the Ways and Means markup, Treasury Department officials presented preliminary data indicating a relatively high rate of compliance with respect to self-attestation of non-qualified withdrawals, which if proven accurate would obviate the need for the legislative change. Even as the Ways and Means Committee passed the substantiation language, both Democrats and Republicans decried the lack of available evidence to judge the need for this particular provision.

How does this provision save money for the federal government?

The Joint Committee on Taxation notes that Section 17 of H.R. 5719 would save \$151 million over five years and \$308 million over ten years. However, the cause for this savings is unclear. During the Ways and Means markup, Joint Tax staff admitted their inability to determine how much of the savings would result from newly captured penalties and taxes and how much of the savings would come from lower HSA take-up rates and/or lower contribution levels to HSAs. Some conservatives may be concerned that it remains unclear whether this provision would achieve its stated purpose by increasing oversight of questionable HSA withdrawals—or will instead achieve budgetary savings by making HSAs less attractive to consumers.

Employers contribute money to their employees' HSAs. Shouldn't they have a right to know that their contributions are being spent for medical purposes?

Unlike FSAs, which are considered as being held by the employer, an HSA is considered the employee's property, and any cash contributions immediately accrue to the worker. Thus an employer has no more or less right to know the employer's contributions are spent on qualified medical expenses than a business has a right to determine that the employer's share of 401(k) contributions is ultimately spent on retirement expenses. In both cases, the penalties for a non-qualified distribution are the same—income taxes owed, plus a 10% penalty.

In an [advisory opinion](#) on the status of HSAs, the Department of Labor (DOL) held that an employer’s transfer of cash contributions into an employee’s HSA does not constitute group coverage under the Employee Retirement Income Security Act of 1974 (ERISA) because of the employer’s inability to control the funds in the employee’s account. Many small businesses—who have heretofore not been able to finance health insurance coverage for their workers—have used the flexibility provided by the DOL opinion to place cash contributions into their employees’ HSAs without triggering the regulatory burdens imposed on ERISA group health insurance plans, benefiting both the business and the worker.

What may be the practical implications of this proposed change to HSAs?

In addition to increased inconvenience for end users, introducing a new step of independent “substantiation” may well increase costs for banks and account administrators, who are likely to pass these costs on to employers and/or consumers. While Democrats have complained in recent months about the charges which banks and other commercial lending institutions pass on to their customers, this provision carries a strong likelihood of increasing those costs further. In addition, some conservatives may also be concerned that should this proposal pass, an HSA mechanism created to reduce the growth of health care costs—and which has achieved some noteworthy successes in the time since its introduction—would lead to increased costs for businesses and individuals.

What organizations oppose this proposed change to HSAs?

Although some members of the business community support other provisions included in H.R. 5719, many organizations have expressed concern about the substantiation requirements—including the company (Evolution Benefits) that first brought the issue to the Committee’s attention. A partial list of organizations opposing the HSA substantiation provision includes:

- America’s Health Insurance Plans
- Business Roundtable
- Credit Union National Association
- Financial Services Roundtable
- HSA Council (part of American Bankers Association)
- International Franchise Association
- National Association of Health Underwriters
- National Association of Manufacturers
- National Federation of Independent Business
- National Restaurant Association
- National Retail Federation
- National Taxpayers Union
- U.S. Chamber of Commerce

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