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**CLIENT ALERT****HEALTH CARE ACCOUNT COMPARISON****PRACTICE AREAS**

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CLARKE "MAC" GILLESPIE, III  
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**HEALTH CARE FLEXIBLE SPENDING ACCOUNTS (HCFSA's)**

A Health Care Flexible Spending Account (HCFSA) is a tax-favored program that allows employees to pay for eligible out-of-pocket health care expenses. By using pre-tax dollars to pay for eligible health care expenses, an HCFSA gives an employee an immediate discount on these expenses. The discount equals the taxes the employee would otherwise pay on that money. The HCFSA can be used to pay for qualified medical costs and health care expenses that are not paid by the health care plan of the employee or other insurance, but cannot be used to pay for any type of insurance premiums, including long-term care insurance premiums.

A limited HCFSA could be used by employees who are enrolled under a High Deductible Health Plan with a Health Savings Account (HSA). Expenses are limited to dental and vision care services/products that meet the Internal Revenue Service (IRS) definition of medical care. By using an HCFSA, funds of an employee in an HSA could be used or saved for other purposes.

**HCFSA DETAILS**

An HCFSA is used to pay for medical expenses not paid for by insurance. This usually means deductibles, copayments, and coinsurance for the employee's health plan, but may also include expenses not covered by the health plan, such as dental and vision expenses and over-the-counter drugs. An HCFSA cannot pay for health insurance premiums, cosmetic items, cosmetic surgery, or items that improve "general health". All items must be intended to treat or prevent a specific medical condition. The medical condition can be as significant as cancer or a heart condition, or as trivial as a headache. Generally,

allowable items are the same as those for which a medical tax deduction may be taken. Permissible medical expenses are outlined in IRS publication 502 (<http://www.irs.gov/publications/p502/index.html>).

The annual maximum contribution amount for an HCFSA varies by employer. There is no IRS cap on an HCFSA, but employers generally limit the annual amount each employee may contribute in order to reduce the risk of discrimination in favor of the highly-compensated. Should the employee leave or be terminated and thus no longer pay into the plan, the employer can not recapture from the employee the cost of medical expenses paid from the HCFSA which exceeds the HCFSA payroll deductions from the employee as of the date of termination of employment. This is another reason why employers place a limit on the amount employees can contribute to an HCFSA.

An HCFSA's coverage period stops either at the time the "plan year" ends for the plan or at the time when coverage of the employee under that plan ends. An example of the latter is that coverage will be lost upon separation from employment with the employer. This means that if you are employed by an employer from January through June and covered by the HCFSA during that time, but do not elect and pay for continued coverage under that plan (i.e. COBRA), your coverage period is defined only as January through June, not January through December.

Typically, covered expenses must be incurred (or be dated) during the coverage period. However, in 2005 the Internal Revenue Service authorized an optional two and a half month grace period that employers can use in their plans. This allows employees to use the funds for two and a half months after the end of the plan year.

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# HEALTH CARE ACCOUNT COMPARISON

One very important advantage of HCFASAs is that they are funded in advance. If an employee sets aside an amount per year in an HCFSA, the entire amount is available for use of the employee immediately—either at the start of the plan year (commonly January 1) or after the first contribution to the HCFSA is received by the HCFSA administrator, depending on the plan. This is the case even though the employee only contributes to the HCFSA in small increments throughout the year (for example, 1/24 of the annual amount if the employee is paid bimonthly).

The employee does not continue to contribute to the plan upon termination of employment. Thus, the employee could use the entire amount on day one of the plan year, terminate employment on day two of the plan year, and contributions would have been none or negligible (e.g., perhaps 1/24 in the case of bimonthly contributions). The "free" money is not taxable. The reason for this is that the IRS views these plans for tax purposes as insurance policies.

A substantial drawback to HCFASAs is that the money must be spent within the coverage period as defined by the plan coverage definition. This coverage period is usually defined as the period that the employee is covered under the plan during the "plan year". As stated above effective in 2005 employers can add a two and a half month grace period at the end of the "plan year". The "plan year" is often 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. A second requirement (which less timely employees may consider a drawback) is that all applications for refunds must be made by a date defined by the plan.

## HEALTH SAVINGS ACCOUNTS (HSAs)

A Health Savings Account (HAS) is an account that an employee can put money into to save for future medical expenses. There are certain advantages to putting money into these accounts, including favorable tax treatment.

An adult can contribute to an HSA if the adult:

- Has coverage under an HSA-qualified "high deductible health plan" (HDHP).
- Has no other first-dollar medical coverage (other types of insurance like specific injury insurance or accident, disability, dental care, vision care, or long-term care insurance are permitted).
- Is not enrolled in Medicare.
- Cannot be claimed as a dependent on someone else's tax return.

Contributions to an HSA can be made by the employee, the employer, or both. However, the total contributions are limited annually. The contributions can be made on a pre-tax basis.

Contributions to the account must stop once the employee is enrolled in Medicare. However, the employee can keep the money in the account and use it to pay for medical expenses tax-free.

## HSA DETAILS

Eligible individuals may contribute up to \$3,000 (self-only) or \$5,950 (family) for 2009, regardless of the annual deductible under the individual's HDHP. These amounts will be increased for inflation in future years.

Individuals age 55 and older can also make additional "catch-up" contributions. The maximum annual catch-up contribution is \$1,000 for 2009 and all years going

forward (\$2,000 if both spouses are age 55 or older).

For 2009, the maximum annual out-of-pocket amount for HDHP self-coverage is \$5,800. For 2009 the maximum annual out-of-pocket amount for HDHP family coverage is \$11,600. In addition, for 2009, the minimum deductible for HDHPs is \$1,150 for self-only coverage and \$2,300 for family coverage.

In addition, a fiscal year plan that satisfies the requirement for an HDHP on the first day of the first month of its fiscal year may apply that deductible for the entire fiscal year.

An employee can use the money in the HSA account to pay for any "qualified medical expense" permitted under federal tax law. This includes most medical care and services, and dental and vision care, and also includes over-the-counter drugs such as aspirin.

An employee can generally not use the money to pay for medical insurance premiums, except under specific circumstances, including:

- Any health plan coverage while receiving federal or state unemployment benefits.
- COBRA continuation coverage after leaving employment with a company that offers health insurance coverage.
- Qualified long-term care insurance.
- Medicare premiums and out-of-pocket expenses, including deductibles, co-pays, and coinsurance for:

1. hospital and inpatient services;
2. physician and outpatient services;
3. Medicare HMO and PPO plans; &
4. prescription drugs

An employee can use the money in the account to pay for medical expenses of the employee, his or her spouse, or dependent children. An employee can pay

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# HEALTH CARE ACCOUNT COMPARISON

for expenses of his or her spouse and dependent children even if they are not covered by the employee's HDHP.

Any amounts used for purposes other than to pay for "qualified medical expenses" are taxable as income and subject to an additional 10% tax penalty. Examples include:

- Medical expenses that are not considered "qualified medical expenses" under federal tax law (e.g., cosmetic surgery).
- Other types of health insurance unless specifically described above.
- Medicare supplement insurance premiums.
- Expenses that are not medical or health-related.

After the employee turns age 65, the 10% additional tax penalty no longer applies. If the employee becomes disabled and/or enrolls in Medicare, the account can be used for other purposes without paying the additional 10% penalty.

## CONCLUSION

There are many similarities between HCFASAs and HSAs but there are also many differences. The principal difference is that an HCFSA is an ancillary plan to the employer health plan. On the other hand, an HSA can be the only healthcare plan offered by the employer or it can be one of the options offered by the employer along with a health maintenance organization (HMO) plan, a preferred provider organization (PPO) plan and/or a fully insured plan. If employees are given a choice by their employer of various types of health care plans, employees must look at their individual situation and choose the plan that they believe will work the best for them. An incorrect decision could prove very costly to the employee.

For younger employees who are unlikely to have many medical expenses and for older employees who do not have retiree medical coverage the ability to use an HSA to save money for medical expenses that will arise after they have children or after they retire, respectively, might be appealing. For married employees with young to teenage children dealing with a very large deductible under an HSA where almost all medical expenses except routine medical examinations must be paid out-of-pocket could be a major financial burden. On the other hand, married employees with younger children may be very appreciative of having the ability to pay on a pre-tax basis through an HCFSA for medical costs that normally are not covered at all or only partially covered through their employer's healthcare plan.

From an employer point of view the cost of offering an HSA is substantially less than the cost of any other healthcare plan an employer might offer its employees. However, for some employees an HSA is not going to work well. Thus, employers that are financially able to do so generally will have a happier workforce through offering employees alternatives other than an HSA. Should the only plan that an employer provides for its employees be an HSA then it probably does not make sense to offer a limited HCFSA as well. Conversely if the employer offers its employees an HMO, a PPO and/or a fully insured plan, establishing and maintaining an HCFSA as well gives employees an added vehicle to reduce their healthcare costs and, perhaps, increase employee morale.

Please contact KUBASIAK, FYLSTRA, THORPE & ROTUNNO, P.C. if you have any questions regarding this newsletter, other employee benefits issues, or our other practice areas.

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