PAYCHEX®

POPs, FSAs, HSAs, and HRAs

Understanding Your Options When Helping Employees Pay for Health Care

This white paper outlines a number of employer-offered benefits to help employees cover health-care expenses.

Executive Summary

Besides wages, helping pay for health care is the most valued benefit that businesses can offer their employees. Even small businesses with modest benefit budgets can help their workers pay insurance premiums or medical bills with several options that offer tax benefits both to the employee and the company.

With section 125 plans – premium only plans (POP) and flexible spending accounts (FSA) – employees can save pretax dollars to use toward medical and dependent care expenses or to pay health insurance premiums. Both employees and employers can contribute to health savings accounts (HSAs), which are used in conjunction with a qualified high-deductible health plan (HDHP).

Health reimbursement arrangements (HRAs) are accounts that employers contribute to in order to help their workers pay medical expenses regardless of whether the employees have insurance.

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Health Care Costs Are a Growing Concern

Consumers are concerned with the rising costs of health care. During the last decade, employer-sponsored health insurance premiums increased at a rate more than three times that of worker wages and four times the rate of inflation,[1] and another nationwide survey revealed that more people are worried about rising health-care costs (69%) than about losing their jobs (37%).[2]

Employees appreciate, and in many skilled job categories, expect to get help from their employer to meet these expenses. A 2008 survey showed that U.S. employees value health benefits above all others except salary and wages.[3]

In addition, benefits have a significant influence on employee loyalty – apparently more than employers realize. While 83% of surveyed employees see salary as an important loyalty factor, only 69% of employers see it that way. When it comes to health benefits, 75% of employees say it influences their loyalty, but only 59% of employers agreed.[4]

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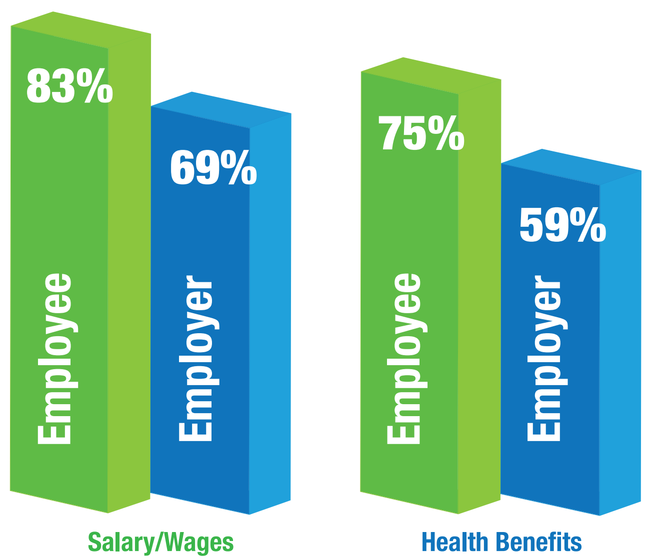
Employers Underestimate the Value of Health Benefits



Everyone agrees that providing health benefits has a positive influence on employee loyalty, but employers may underestimate its importance.

Many small businesses assume they can't compete with large companies that offer group health plans. In fact, group insurance is available to companies as small as one employee, with plan options that cost less than traditional indemnity policies and HMOs. Health Care Reform, with provisions signed into law in 2010, is focused on making health insurance more affordable for both individuals and employers. While business owners must become familiar with new regulations, providing health insurance for employees can make health-care coverage more affordable for participants and their families in a number of ways. In addition to offering health insurance, or in place of it, there are other benefits that business owners can offer to help employees pay their portion of medical bills. Some options are designed to help employees save some of their income for health-care expenditures, and others allow employers to help workers pay. All offer potential tax benefits for employers and employees.

Section 125 Plans

Named after a part of the Internal Revenue Code, section 125 plans enable employees to set aside pretax income for any qualified medical, dental, or dependent-care expenses. Another special type of account, under section 129 of the Internal Revenue Code, is the Dependent Care Assistance Plan, which can be offered to employees who would like to set aside pretax earnings solely for dependent care expenses.

For employers that are looking for a simple and effective way to start or expand their basket of employee benefits, a section 125 plan is a good beginning. It's especially valuable for organizations with a number of employees who regularly incur child-care expenses.

The pretax savings feature of section 125 plans helps employees stretch their dollars. They can reduce their taxable income by setting aside as much as their employer allows in their plan for health-related costs. Beginning January 1, 2013, medical FSA contributions will be limited to $2500 per year or the employer-defined maximum, whichever is less. The $2500 maximum will be adjusted annually for inflation beginning in 2014. By paying less in taxes, employees in effect get a bonus that makes their health- or dependent-care dollars go further. The employer also saves on a variety of taxes, including FICA, federal, and unemployment. This savings also includes state unemployment taxes in most states, and employers should contact their accounting professional for specific state details.

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Employers can choose to set up one of two types of section 125 plans. A premium-only plan (POP) enables employees to pay their share of health-care insurance premiums using pretax dollars. A flexible spending account (FSA) is used to pay out-of-pocket expenses for dependent and health care. To contribute to an FSA account, employees establish an annual contribution amount, a portion of which is deducted from each paycheck. This enables employees to budget for anticipated expenses such as dependent care and elective medical treatment.

One potential drawback for employees is that some FSA plans contain a "use-it-or-lose-it" provision. Any money not spent during the year it was set aside, or during a grace period of about ten weeks into the following year, must be forfeited back to the plan. A potential drawback for employers is that the employee's total health-care election for the year, unlike dependent care, must be available for qualified expenses as soon as they are incurred. That raises the possibility that an employee could leave the company during the year, before the dollar amount withheld from their paychecks matches what the plan has paid out in FSA claims.

Small-business employers typically outsource the management of section 125 plans, which requires the plan administrator to ensure that the plans are not discriminatory, based on IRS guidelines, to review reimbursement claims, make payments, and issue statements. Many firms that specialize in FSA administration offer debit cards that are linked to participant accounts employees can use to pay qualified expenses and, in some circumstances, eliminate the need to file claims paperwork. In some cases, FSA debit card users must submit receipts after a purchase to validate the expense. FSA administration firms usually charge a monthly fee based on the number of enrolled employees. In many instances, the employer's tax savings covers the cost of administering the plan.

Health Savings Accounts

A health savings account (HSA) is a tax-advantaged bank account for individuals who have a high-deductible health plan (HDHP). Participants can help reduce health insurance costs by using an HSA in conjunction with an HDHP, which typically has lower cost premiums in exchange for a higher deductible on health-care expenses. People who open HSAs can pay for qualified out-of-pocket health-care expenses with tax-free dollars from this account, which can grow through investment earnings. In this way, they are like an individual retirement arrangement (IRA) for retirement or 529 plans for educational expenses.

HSAs are similar to health FSAs in that they allow employees to set aside pretax dollars that can be used for qualified medical expenses – but that's where the similarities end. All qualified contributions, earnings, and distributions are exempt from federal income taxes, social security taxes, and state income taxes based on state tax regulations. Once a contribution is made to an HSA, there is no mandatory withdrawal schedule, so balances can stay in place with no penalty for the life of the owner, and the accounts are completely portable. Owners can use them at any time and can contribute while employed at any job where they are enrolled in a qualifying HDHP. Owners can use them at any time and can contribute while employed at any job where HDHPs are offered.

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In order to qualify for an HSA, an employee must be enrolled in a qualified high-deductible health plan (HDHP), an account which provides coverage only when a deductible has been met. In addition, the employee must not be enrolled in Medicare or be a dependent on another person's tax return. The 2010 minimum annual deductible levels for HDHPs are $1,200 for individuals and $2,400 for families. In addition, out-of-pocket maximum amounts (including deductibles, co-pays, and co-insurance) are $5,950 for individuals and $11,900 for families. Services such as well-child examinations, adult routine physical exams, and mammography all are covered in full by the HDHP.

HDHPs typically carry much lower premiums than other types of plans, and employees can use the savings to fund their accompanying HSAs.

Health Reimbursement Arrangements

Another savings option that can accompany any type of health plan is the health reimbursement arrangement (HRA), an account that is fully funded by the employer, who also sets the ground rules for its use. A common practice with HRAs is that they are allowed to be used by employees to pay qualified medical expenses such as co-pays and deductibles. They behave like an employer-funded FSA, but a major benefit is that HRAs are not subject to the use-it-or-lose-it rules that apply to FSAs.

The HRA benefit is not counted in the employee's income, so it's tax free, and employers need to make payments only when employees incur qualified medical expenses. Employers also can choose to allow employees to roll over their HRA balances from year to year.

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Typical HSA/HRA Contributions

Employers can administer either of these types of accounts – HSAs or HRAs – using a third-party administrator or plan provider that keeps records on the plan and provides any paperwork for required IRS reporting. Employers also could choose to self-administer an HRA, but HSAs must be set up by a qualified trustee such as a bank or insurance company that is approved by the IRS. Of course, employees should always retain copies of receipts for which they seek reimbursement.

A key decision when setting up a health savings option is the employer contribution, so it's helpful to know what others are doing. In 2009, the average annual firm contribution (for all size organizations) toward HRAs was $1,052 for single members and $2,073 for families. For HSAs, the average firm contributions in 2009 were $688 for single members and $1,126 for families.[5]

Choosing the Right Option for Your Business

In an era of continually rising health-care costs, the focus for many small-business owners is how to help employees and employers reduce the cost of health-care insurance. Section 125 plans, HSAs, and HRAs were designed to help both employers and employees make the best use of health-care expenditures. Employers also find that offering the best benefits package possible helps to attract and maintain the talent they need for their businesses.

Account Type	Features	Positives	Negatives
Section 125	• Payroll-deduction savings plan enables employees to save for out-of-pocket medical, dental, and dependent-care expenses. Two types: • Premium Only Plan. Limited to health-care insurance premiums. • Flexible Spending Account. For out-of-pocket health costs and dependent care.	• Tax savings for employees and employers: contributions are exempt from federal withholding, FICA, and state withholding taxes based on state tax regulations (for further details, contact your CPA). • Easy budgeting tool for planned expenses.	• Funds must be used before certain deadlines each year, or they are forfeited to the plan.
Health Savings Account	• Tax-advantaged savings account similar to an IRA. • Enables employees to save for current, future and retiree health expenses. • To participate, individuals must be covered by a qualified high-deductible health plan and not covered by any other impermissible non-HDHP coverage.	• Typically significantly lower health insurance premiums for HDHP. • Account funds can grow tax free. • The account is portable from job to job (because it belongs to the employee). • No use-or-lose provisions. • Both employer and employee may contribute.	• Can be used only with a qualified high-deductible health plan. • To continue contributing to an HSA from a previous employer, an employee must be enrolled in a qualified HDHP with their current/future employer.
Health Reimbursement Arrangement	• The employer contributes a set amount to this account each year. • Employers set the rules for using the funds and carryovers. • Fund usage includes eligible health-care expenses.	• Can be used with any type of health-care insurance plan, or without any insurance. • Can be rolled over at year end.	• Only the employer may contribute.

Additional Options for Special Circumstances

For employees who have experienced an involuntary termination of employment, the Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA) is a federal law that requires group health plans to offer temporary continuation of coverage under the plan to covered employees as well as their covered spouse and dependent children. Generally, participants who elect COBRA coverage are responsible for paying the entire cost of coverage under the group health plan.

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For employees with unexpected major medical bills, another option is an emergency IRA withdrawal. Health-care expenses are one of the few circumstances under which the law allows hardship distributions from IRA plans. In most cases, however, workers who find it necessary to take an IRA distribution before age 59½ are penalized in three ways: the IRS takes a 10% penalty on the withdrawn amount, the individual must pay income taxes on it, and he or she loses any interest or dividends that result from keeping the money in the IRA.

Where to Go for Help

Helping employees pay for health care is a complex subject. For more information and guidance, small-business owners can turn to an accountant or other trusted adviser to help guide the process, or to an organization that administers these types of accounts.

About Paychex

Founded in 1971, Paychex, Inc. is a leading provider of payroll, human resource, and benefits outsourcing solutions for small- to medium-sized businesses. The company has more than 100 offices and serves over a half million payroll clients nationwide.

The company offers comprehensive payroll services, including payroll processing, payroll tax administration, and employee pay services like direct deposit and check signing. Human resource services include 401(k) plan recordkeeping, employee handbooks, job descriptions, workers' compensation administration, section 125 plans, time and attendance applications, administrative services organization solutions, and other administrative services for business.

Professional employer organization options are available from Paychex Business Solutions, Inc. (PBS).

About Paychex Insurance Agency, Inc.

Paychex Insurance Agency is a full-service insurance agency that has taken a leadership role in transforming how businesses adapt to, and benefit from, the rapidly changing insurance industry. Whether you're looking for a business owner's policy, workers' compensation insurance, group health, or life insurance, we offer flexible, scalable insurance solutions for you, your business, and your employees. We work with 150 carriers across the nation. So, just like our nearly 100,000 insurance clients, you can feel confident in your coverage now and as your business needs change.

Contact Information

To view the Paychex Insurance Agency Web site, go to www.paychexinsurance.com. Licensed Paychex Insurance Agency representatives are available at 877-393-8688 to answer questions.

Sources

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