

IF YOU HAVE QUESTIONS REGARDING THIS MATTER, PLEASE CONTACT:



[Luke Bailey](#)
Partner, Dallas
901 Main St., Suite 4400
Dallas, Texas 75202-3794
214.651.4572
Luke.Bailey@Strasburger.com

EDITORS

Kathy Darling & David Bain

HEALTHCARE GROUP

David Andrew Bain
Virginia A. Barry
Debra W. Biehle
Thomas W. Burton
Renee Chafitz
Merritt M. Clements
Joseph F. Coniglio
Kathryn Midboe Darling
William Duane Darling
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Craig H. Myers
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David L. Ovard
Donald Patrick Owens
Paul W. Sheldon
Layne Thompson
Joseph A. Turano
Melissa Webb
Carol D. Williamson
Ivan Wood
Kevin M. Wood

"Consumer-Driven" Health Plans — What's the Buzz About?

Over the past several years, as health care cost increases have consistently outpaced general inflation, a new type of employer health plan, often referred to as "consumer-driven," has begun to gain a foothold in the marketplace. What are these plans, and how do they work?

Consumer-driven health plans can vary widely in their detailed provisions. However, the basic idea is to change the employer's traditional health coverage, at least partially, to a catastrophic coverage plan by increasing deductibles and copays, while using part or all of the resulting premium savings to fund an individual uninsured medical expense reimbursement account for each covered employee. The employee then pays his or her own routine medical expenses from the account. The goals of such plan design changes are:

- Since year-to-year premium increases for catastrophic coverage tend to be smaller than for conventional coverage, the employer's total cost is reduced over time.
- Since the employee has greater control over routine health care expenses (thus the term "consumer-driven") his or her satisfaction with the plan may be increased.
- Since savings from reduced utilization accumulate in the employee's account, the employee has an incentive to be more disciplined about his or her consumption of health care services.
- The employer can obtain an immediate cost savings if it chooses not to rebate all of its premium savings to employees in the form of account contributions.

There are two basic "flavors" of consumer-driven health plans: Health Reimbursement Accounts ("HRA's") and Health Savings Accounts ("HSA's").

HRA's make use of new twists on long-standing federal income tax principles. They enable employers to fund accounts for their employees upon which the employees can draw to pay for routine medical expenses. These accounts are typically only "notional." That is, like the accounts in a Section 125 cafeteria plan, they are bookkeeping entries consisting of periodic credits equal to the amount of the employer's commitment. Employee medical expenses submitted for reimbursement are debited against the account. Credit balances are not invested and typically do not bear interest. Employees can typically carry over credit balances from year to year, and may, depending on the plan design, be permitted to continue to access credit balances after termination of employment, e.g., after retirement with a minimum combination of age and service. Because employees can only use amounts credited to their accounts for medical expenses, the accounts and their operation are typically tax-free to the employee, and the employer is able to deduct all amounts credited to the employees' account when paid. The tax rules for HRA's were set forth in Rev. Rul. 2002-41 and IRS Notice 2002-45. HRA's do not interfere with the normal operations of an IRC § 125 cafeteria plan.

HSA's take advantage of new Section 223 of the Internal Revenue Code, enacted in 2001 and first effective in 2005. HSA's are actual investment accounts, like IRA's. Either the employee or the employer, or both, can make contributions to the account. Any employer contributions are subject to a rule requiring equal contributions for all employees. Account balances can be invested in anything an IRA can invest in, and are the property of the employee at all times. Contributions

are deductible by the person making them (employee and/or employer). The account's earnings are not taxed (just like an IRA), and distributions also are not taxed if spent on medical care. The HSA recordkeeping burdens fall almost entirely on the employee, and are quite reasonable.

The maximum amount that can be contributed to an HSA is the lesser of (a) the deductible under the employer's required "high deductible health plan" ("HDHP") or (b) a limit set by the Code (for 2006, \$5,450 for family coverage, \$2,700 for individual coverage).

Although the special tax treatment provided to HSA's might seem to make them superior to HRA's, HSA's are subject to rigid rules prohibiting first-dollar coverage of most health care expenses other than preventive care. They also restrict employees' ability to use the employer's Section 125 cafeteria plan. For these reasons, they have met with some initial resistance in the large employer marketplace. However, with careful attention to design issues they can work for large employers, or at least for certain populations carved out from a larger employer's workforce. HSA's are ideal for professional partnerships and other businesses dominated by self-employed owners, since self-employed persons cannot utilize Section 125 cafeteria plans.

Strasburger can help you design and implement a "consumer-driven" health plan for your business. Please contact luke.bailey@strasburger.com for more information. ■