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Health Savings Accounts (HSAs) under the Medicare Prescription Drug, Improvement and Modernization Act of 2003

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I. Background and General Discussion

Section 1201 of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 added Section 223 to the Internal Revenue Code to permit eligible individuals to establish Health Savings Accounts (HSAs) for taxable years beginning in 2004. HSAs were created to help individuals save for qualified medical and retiree health expenses on a tax-free basis. In particular, HSAs may receive tax-favored contributions by or on behalf of eligible individuals, and amounts in an HSA may be accumulated over the years on a tax-free basis or distributed on a tax-free basis to pay or reimburse qualified medical expenses. Drafters of the HSA provisions in the Medicare law intend that the availability of HSAs will make consumers more savvy and discriminating in their use of health care services, thereby reducing overuse. In that regard, the law requires that HSAs be linked with high-deductible health plans.

A. HSAs are trust or custodial accounts maintained with insurance companies, banks, other financial institutions or other approved custodians.

B. HSAs are portable. An HSA is owned by the individual, similar to an IRA.

C. No part of the assets of an HSA may be invested in life insurance contracts, and the assets of an HSA may not be commingled with other property except in a common trust fund or common investment fund.

II. Eligibility

In general, any individual under age 65 who has coverage under a qualified high-deductible health plan (HDHP) may have an HSA.

A. To be eligible, the individual cannot be covered under Medicare or under another health plan that is not an HDHP, except for (1) "permitted insurance," e.g., workers' compensation insurance, auto insurance, liability insurance, insurance for a specified disease or illness, or insurance that pays a fixed amount per day (or other period) of hospitalization and (2) coverage for accidents, disability, dental care, vision care or long-term care.

B. An eligible individual cannot be claimed as a tax dependent for federal income tax purposes by another person.

C. In general, at age 65, an individual cannot contribute to an HSA, but may receive distributions from an HSA established before age 65. In IRS notice 2004-50, however, the IRS has said that merely reaching the Medicare eligibility age of 65 does not necessarily mean that an individual becomes ineligible to contribute to an HSA. If a person is Medicare-eligible but not enrolled in Medicare Part A or Part B, he or she may contribute to an HSA until the month that the individual is enrolled in Medicare.

III. High-Deductible Health Plan defined and Health Plan Benefits that need not be subject to the high deductible

To be eligible to benefit under an HSA, an individual must be covered under an HDHP and the individual may not, while covered under an HDHP, be covered under any health plan which is not an HDHP and which provides coverage for any benefit which is covered under the HDHP.

A. Definition. For individual coverage, an HDHP is a plan which has an annual deductible of not less than $1,000 and an annual out-of-pocket expense limit of not more than $5,000. For family coverage, the minimum annual deductible is $2,000 and the maximum annual out-of-pocket expense limit is $10,000.

B. Exceptions to the Prohibition Against Health Plan Benefits Not Covered Under the HDHP. Permitted insurance and coverage (whether through insurance or otherwise) for accidents, disability, dental, vision care and long-term care do not violate the prohibition against other health plan benefits not covered under the HDHP.

1. **Permitted Insurance.** "Permitted insurance" means: (a) insurance if substantially all the coverage provided under it relates to liabilities incurred under (i) worker's compensation laws; (ii) tort liabilities; (iii) liabilities relating to ownership or use of property or (iv) other similar liabilities as the Secretary of the Treasury may specify by regulations; and (b) insurance for a specified disease or illness (e.g., cancer, diabetes, asthma, congestive heart failure) and (c) insurance paying a fixed amount per day (or other period) of hospitalization.

2. **Other Permitted Coverages.** Coverage (whether through insurance or otherwise) for accidents, disability, dental care, vision care or long-term

care also does not violate the prohibition. In IRS Notice 2004-50, the IRS also states that coverage under an employee assistance program (EAP), disease management program or wellness program does not make an individual ineligible to contribute to an HSA as long as the program "does not provide significant benefits in the nature of medical care or treatment."

3. **Preventive Care.** Also excluded from the prohibition is preventive care services (within the meaning of Section 1871 of the Social Security Act). Specifically, the law provides that a plan will not fail to be an HDHP because it has no deductible for preventive care. At this writing, the IRS has not been willing to regard prescription drug services generally as preventive care services, which would enable them to be offered at lower deductibles, although the Service has provided transitional relief (in Revenue Procedure 2004-22) through January 1, 2006 to employers who provide such benefits as either a separate drug plan or a rider to the HDHP in view of the fact that some employers already had these types of plans in the belief that they could be linked with an HSA.
   a. To date, guidance from the IRS has been that some drugs or medications can fall within preventive care "when taken by a person who has developed risk factors for a disease that has not yet manifested itself or not yet become clinically apparent…or to prevent the reoccurrence of a disease from which a person has recovered." Some examples cited by the IRS are cholesterol-lowering drugs to prevent heart disease and angiotensin-converting enzyme (ACE) inhibitors when used to help recovered heart-attack or stroke victims prevent reoccurrence.
   b. The IRS has also stated that drugs or medications used as part of a weight-loss or tobacco cessation program also meet the preventive care standard.
   c. On the other hand, drugs or medications used to treat an existing illness, injury or condition do not meet the preventive care standard according to Revenue Ruling 2004-38 and IRS Notice 2004-50.

C. **Network Plans.** An HDHP that is a network plan may require high deductibles and/or higher out-of-pocket expense maximums for out-of-network expenses.

D. **Self-Insured Plans.** Self-insured plans may be HDHPs.

IV. Contributions

Both employees and employers may contribute to HSAs. Annual contributions to an HSA may be made in an amount of up to 100 percent of the HDHP deductible or the maximum annual contribution, if lower.

A. **Maximum Annual Contribution.** For individuals who have not and will not attain age 55 before the end of the taxable year, the maximum annual contribution for individual coverage in 2004 is $2,600 (indexed annually), and the maximum annual contribution for family coverage in 2004 is $5,150. (indexed annually). For individuals who have attained age 55 or will attain age 55 before the end of the taxable year, the maximum annual contribution is increased by a "catch-up" contribution amount of $500 in 2004, which amount increases by $100 each year until it reaches $1,000 in 2009.

B. **Coordination with Other Contributions.** The limitation on annual contributions to an HSA that would otherwise apply for a taxable year must be reduced (but not below zero) by the aggregate amount paid for that year to Archer Medical Savings Accounts (MSAs) and the aggregate amount of employer contributions to health savings accounts for that year.

C. **Time by which Contributions May Be Made; Annual Limit Must Be Prorated.** Contributions for a taxable year may be made up to April 15 of the following year, and maximum annual contributions are pro-rated for months of participation in the HDHP.

D. **Excise Tax on Excess Contributions.** The account holder is subject to a 6 percent excise tax on any employer or employee contributions that exceed the maximum allowed.

V. Income tax treatment of contributions, investment earnings and distributions

A. **Contributions.** Employer contributions are not taxable to the employee, are not treated as wages and are not subject to FICA tax or income tax withholding.
   1. Contributions made by individuals and family members are tax-deductible for the account holder, even if the individual does not itemize deductions.
   2. No deduction is available, however, for an individual who is claimed as a dependent by another for federal income tax purposes.
   3. Contributions to or distributions from an HSA are not taken into account for purposes of determining the amount of deduction allowed under Section 213 of the Internal Revenue Code, which allows individuals a deduction for medical expenses that exceed 7.5 percent of adjusted gross income.
   4. Contributions made through a Section 125 cafeteria plan are treated as employer contributions and are subject to the nondiscrimination rules under Section 125 of the Internal Revenue Code.

B. **Investment Earnings.** Investment earnings of an HSA accrue tax-free so long as the HSA meets with requirements of Section 223. Unrelated business taxable income of the HSA is taxable, however.

C. **Distributions.** Distributions may be made from an HSA at any time and for any purpose. Account balances are never forfeited.
   1. Distributions from an HSA are tax free if used to pay for qualified medical expenses. Distributions made for any other purpose, however, are subject to income tax and a 10 percent penalty. The 10 percent penalty does not apply in the case of death or disability of the account holder or distributions after the account holder attains age 65.
   2. If an excess contribution to an HSA is returned to an individual on or before the last day for filing his or her income tax return (including extensions) for the taxable year in which such contribution was made, and the excess contribution is accompanied by the amount of net income attributable to the excess contribution, the amount of the distributed excess contribution is not taxable.
   3. IRS guidance also states that no tax penalties will be imposed for mistaken

distributions from an HSA that are repaid to the HSA.

4. Amounts distributed from an HSA to the account holder that are in turn rolled over to another HSA for the benefit of the account holder within 60 days of receipt are not taxable, but an account holder is limited to one tax-free rollover during any one-year period.
5. Upon the HSA owner's death, ownership of the HSA transfers to the named beneficiary. If the spouse is the beneficiary, the transfer is tax free, and the assets may be used for the spouse's qualified medical expenses. On the other hand, if the beneficiary is not the spouse, the value of the HSA is included in the beneficiary's taxable income.
   a. If the beneficiary is not the spouse and is not the estate of the decedent, the amount includable in gross income is reduced by the amount of qualified medical expenses which were incurred by the decedent before the date of his or her death and paid by the beneficiary within one year after that date.
   b. If the beneficiary is the estate of the decedent, an appropriate deduction shall be allowed under Section 691(c) of the Internal Revenue Code for estate taxes attributable to amounts included in gross income.
6. Employers and HSA custodians are not required to verify whether distributions are used for qualified medical expenses. The individual must maintain records to document that distributions were used for qualified medical expenses. (On the other hand, employers are responsible for determining: (a) whether the employee is covered by an HDHP; (b) whether the employee is covered by any employer-sponsored low-deductible health plans; and (c) the employee's age for purposes of making catch-up contributions to HSAs.)
7. Transfer of an individual's interest in an HSA to the individual's spouse or former spouse under a divorce or separation instrument shall not be a taxable transfer, and such interest in the HSA shall, after such transfer, be treated as owned by the spouse to whom it is transferred.
8. IRS guidance states that account fees paid from an HSA is a nontaxable distribution, while account fees paid outside an HSA directly to the trustee or custodian is not treated as a contribution.

VI. Qualified Medical Expenses Defined

Qualified medical expenses mean expenses paid for medical care as defined in Section 213 of the Internal Revenue Code, which are amounts paid for the diagnosis, cure, treatment or prevention of disease.

A. Qualified medical expenses include:
   1. Non-prescription drugs
   2. Some but not all prescription drugs, i.e., when they fall within the preventive care safe harbor (see III.B.3 above)
   3. Qualified long-term care services and premiums for long-term care insurance
   4. Premiums for continuation coverage under COBRA
   5. Premiums for health insurance while an individual is receiving unemployment compensation
   6. Premiums for Medicare Part A and Part B and for employer-sponsored retiree health insurance

B. Except as stated above, premiums for health insurance coverage are not qualified medical expenses.

C. Premiums for Medicare supplemental coverage are not qualified medical expenses.

VII. Non-Discrimination Rules

If an employer makes HSA contributions, it must make comparable contributions on behalf of all eligible employees with comparable coverage during the same period.

A. Employees Who Do Not Elect Coverage under the HDHP. On the other hand, an employer is not required to make contributions for employees who do not elect coverage under the HDHP.

B. Contributions to HSAs Through Section 125 Plans. Contributions through a Section 125 cafeteria plan, including employer matching contributions, are not subject to the comparability requirement, but as noted above, such contributions are subject to the nondiscrimination rules under Section 125. ■

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