IRS PROVIDES GUIDANCE ON HEALTH SAVINGS ACCOUNTS

IRS has issued guidance on Health Savings Accounts (HSAs), a new type of tax-favored vehicle created by the Medicare Act of 2003, which was signed into law on December 8, 2003. Using a question and answer format, the guidance explains what HSAs are, who can establish them and the basic rules for HSA contributions and withdrawals.

■ HSA Eligibility

< An HSA may be established by an "eligible individual" - an individual, who, for any month: (1) is covered under a high-deductible health plan (HDHP) on the first day of the month; (2) is not also covered by any other non-HDHP health plan (with certain exceptions); (3) is not entitled to benefits under Medicare (generally, has not yet reached age 65); and (4) may not be claimed as a dependent on another person's tax return.

< For self-only coverage, an HDHP must have an annual deductible of at least $1,000 and annual out-of-pocket expenses required to be paid not exceeding $5,000; for family coverage, the minimum annual deductible is at least $2,000 and annual out-of-pocket expenses required to be paid can't exceed $10,000. For family coverage, a plan is an HDHP only if, under its terms and without regard to which family member or members incur expenses, no amounts are payable from it until the family has incurred annual covered medical expenses in excess of the minimum annual deductible. A plan does not fail to qualify as an HDHP merely because it does not have a deductible (or has a small deductible) for preventive care (e.g., first dollar coverage for preventive care).

< A network plan (i.e., a plan that provides more favorable benefits for services provided by its network of providers than for services provided outside of the network) doesn't fail to be an HDHP solely because the out-of-pocket expense limits for services provided outside of the network exceeds the maximum annual out-of-pocket expense limits allowed for an HDHP. In addition, a network plan's annual deductible for out-of-network services is not taken into account in determining the annual contribution limit. Rather, the annual contribution limit is determined by reference to the deductible for services within the network.

< Generally, an individual is ineligible for an HSA if, while covered under an HDHP, he is also covered under a health plan (whether as an individual, spouse, or dependent) that is not an HDHP.

< An individual doesn't fail to be eligible for an HSA merely because, in addition to an HDHP, he has coverage for (1) any benefit provided by "permitted insurance" (substantially all coverage relates to liabilities incurred under workers' compensation laws, tort liabilities, liabilities relating to ownership or use of property, insurance for a specified disease or illness, and insurance that pays a fixed amount per day of hospitalization), or (2) accidents, disability, dental care, vision care, or long-term care.

< A self-insured medical reimbursement plan sponsored by an employer may be an HDHP.

■ Establishing an HSA

< Beginning January 1, 2004, an eligible individual can establish an HSA with a qualified HSA trustee or custodian, such as an insurance company or bank. No permission or authorization from IRS is necessary.

< An eligible individual who is an employee may establish an HSA with or without his employer's involvement.

< An HSA can be established through a qualified trustee or custodian who is different from the HDHP provider.

■ Contributions to HSAs

< The maximum annual contribution to an HSA is the sum of the limits determined separately for each month, based on status, eligibility and health plan coverage as of the first day of the month. For 2004, the maximum monthly contribution for eligible individuals with self-only coverage under an HDHP is 1/12 of the lesser of 100% of the annual deductible under the HDHP (minimum of $1,000) but not more than $2,600. For eligible individuals with family coverage under an HDHP, the maximum monthly contribution is 1/12 of the lesser of 100% of the annual deductible under the HDHP (minimum of $2,000) but not more than $5,150.

<u>Illustration</u>: Smith begins self-only coverage under an HDHP on June 1, 2004 and continues to be covered under the HDHP for the rest of the year. The annual deductible is $5,000 for the HDHP. Thus, the lesser of the annual deductible and $2,600 is $2,600 so that the monthly contribution limit is $216.67 ($2,600 divided by 12). The annual contribution limit is $1,516.69 (7 times $216.67).

< All HSA contributions made by or on behalf of an eligible individual to an HSA are aggregated for purposes of applying the limit. The annual limit is decreased by the aggregate contributions to an Archer MSA. Contributions may be made by or on behalf of an eligible individual even if he has no compensation or if the contributions exceed his compensation.

<u>Observation</u>: Thus, deductible contributions can be used to shelter all forms of income from tax including interest, pensions, dividends, stock gains and other items.

< For individuals (and their spouses covered under the HDHP) between ages 55 and 65, the HSA contribution limit is increased by $500 in calendar year 2004. This catch-up amount will increase in $100 increments annually, until it reaches $1,000 in calendar year 2009. The catch-up contribution is also computed on a monthly basis. After an individual has attained age 65 (the Medicare eligibility age), contributions, including catch-up contributions, cannot be made to an individual's HSA.

<u>Illustration</u>: Jones attains age 65 and becomes eligible for Medicare benefits in July, 2004 and had been participating in self-only coverage under an HDHP with an annual deductible of $1,000. He can't make HSA contributions (including catch-up

contributions) after June, 2004. The monthly contribution limit is $125 ([$1,000 divided by 12] plus [$500 divided by 12 for the catch-up contribution]). Jones may make contributions for January through June totaling $750 (6 x $125), but can't make any contributions for July through December, 2004.

< Both spouses are treated as having family coverage if either one has it. If each spouse has family coverage under a separate health plan, both are treated as covered under the plan with the lowest deductible. The contribution limit for the spouses is the lowest deductible amount, divided equally between them unless they agree on a different division. The family coverage limit is reduced further by any contribution to an Archer MSA. However, both spouses may make the catch-up contributions for individuals age 55 or over without exceeding the family coverage limit.

< Contributions made by a family member on behalf of an eligible individual to an HSA are deductible by the eligible individual in computing adjusted gross income.

< Employer contributions are treated as employer-provided coverage for medical expenses under an accident or health plan and are excludable from the employee's gross income. They aren't subject to income tax withholding, FICA or FUTA. Contributions through a cafeteria plan are treated as employer contributions. An employee cannot deduct employer contributions as either HSA contributions or medical expense deductions.

< An HSA is generally exempt from tax (like an IRA or Archer MSA), unless it has ceased to be an HSA. Earnings on amounts in an HSA are not includable in gross income while held in the HSA.

< Contributions for the tax year can be made in one or more payments, at the convenience of the individual or the employer, at any time before the due date (without extensions) for filing the eligible individual's income tax return for that year, but not before the beginning of that year.

< Contributions by individuals to an HSA, or if made on behalf of an individual to an HSA, are not deductible to the extent they exceed the limits discussed above. Employer contributions are included in the gross income of the employee to the extent that they exceed the limits or if they are made on behalf of an employee who is not an eligible individual. In addition, an excise tax of 6% for each tax year is imposed on the account beneficiary for excess individual and employer contributions. But the latter can be avoided if the excess contributions and net income attributable to them are distributed to the account beneficiary before the return due date (including extensions). In such case, the net income would be taxed in the year of distributions.

< Rollover contributions from Archer MSAs and other HSAs into an HSA are permitted. Unlike regular contributions, rollover contributions need not be in cash.

■ **Distributions from HSAs**

< An individual may receive distributions from an HSA at any time.

< Distributions used exclusively to pay for qualified medical expenses of the account beneficiary, his or her spouse, or dependents are excludable from gross income. However, any amount of the distribution not used exclusively to pay for qualified medical expenses of the account beneficiary, spouse or dependents is includable in gross income of the account beneficiary and is subject to an additional 10% tax on the amount includable, except in the case of distributions made after the account beneficiary's death, disability, or attaining age 65.

< Qualified medical expenses are expenses paid by the account beneficiary, his or her spouse or dependents for medical care as defined in Code Sec. 213(d) (including nonprescription drugs described in Rev Rul 2003-102), but only to the extent the expenses are not covered by insurance or otherwise. The qualified medical expenses must be incurred only after the HSA has been established. For purposes of determining the itemized deduction for medical expenses, medical expenses paid or reimbursed by distributions from an HSA are not treated as expenses paid for medical care under Code Sec. 213 .

Observation: Thus, distributions can be received tax-free to pay for purchased over-the-counter medicine or drugs, like antacid, allergy medicine, pain reliever or cold medicine even though amounts paid for such items are not deductible medical expenses.

< Generally, health insurance premiums are not qualified medical expenses except for the following: qualified long-term care insurance, COBRA health care continuation coverage and health care coverage while an individual is receiving unemployment compensation. In addition, for individuals over age 65, premiums for Medicare Part A or B, Medicare HMO and the employee share of premiums for employer-sponsored health insurance, including premiums for employer-sponsored retiree health insurance can be paid from an HSA. Premiums for Medigap policies are not qualified medical expenses.

< Distributions used exclusively to pay for qualified medical expenses are excludable from the account beneficiary's gross income even if the account beneficiary is no longer an eligible individual (e.g., the individual is over age 65 and entitled to Medicare benefits, or no longer has an HDHP).

< HSA trustees or custodians, as well as employers, need not determine whether HSA distributions are used for qualified medical expenses. Individuals should maintain records to show that distributions were made exclusively for qualified medical expenses.

< Upon death, any balance remaining in the account beneficiary's HSA becomes the property of the individual named in the HSA instrument as the beneficiary of the account. An account passing to a spousal beneficiary becomes her HSA and she is taxed only to the extent distributions from the HSA are not used for qualified medical expenses. An account passing to a non spousal beneficiary ceases to be an HSA as of the date of HSA owner's death. The nonspace beneficiary must include in gross income the fair market value of the HSA assets as of the date of death. For such a person (except the decedent's estate), the includable amount is reduced by any payments from the HSA made for the decedent's qualified medical expenses, if paid within one year

after death.

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