McGraw Wentworth

BENEFIT Advisor

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In This Issue

In this third issue of the McGraw Wentworth Benefit Advisor for 2007, we will overview Health Savings Accounts. Health Savings Accounts (HSAs) are individually-owned trust accounts that allow individuals to save money tax-free to be used for qualified medical expenses.

HSAs were introduced by the Medicare Prescription Drug Improvement and Modernization Act at the end of 2003. However, initial guidance was limited and the government has issued numerous clarifications over the last three years. This Advisor will pull together all the guidance issued over the last few years and provide you an overview of the issues relevant to offering HSA options in your organization.

We welcome your comments and suggestions regarding this issue of our technical bulletin. For more information on this Benefit Advisor, please contact your Account Manager or visit the McGraw Wentworth web site at www.mcgrawwentworth.com.

"Health Savings Accounts - Today"

Health Saving Accounts or HSAs have changed dramatically since they were introduced in the Medicare Prescription Drug Improvement and Modernization Act at the end of 2003. These changes certainly make sense; the initial guidance on HSAs was pretty sparse. Over the last three years, the government has issued regular guidance to respond to employers' concerns and questions about HSAs.

The latest guidance allowed many individuals to increase the amount of tax-favored dollars they could contribute to an HSA. This change will likely increase employer interest in offering a consumer driven health plan option with an HSA. We have addressed every change in HSA guidance over the last several years in our *Advisors* and *Special Alerts*. However, with the volume of changes, it makes sense to overview the current state of affairs with HSAs. This *Benefit Advisor* will provide:

- An Overview of HSAs
- The Requirements for a Qualifying High Deductible Health Plan
- The Eligibility Provisions for HSAs
- The Contribution Rules and Requirements
- A Discussion of the Coordination Process with HSAs, medical FSAs and HRAs
- A Summary of the Distribution Rules of HSAs

If your organization already offers a health plan with an HSA option, this *Advisor* will serve as a refresher on the rules and requirements. If your organization is considering a high deductible health plan option, this *Advisor* will help you understand key HSA rules and complexities.

Overview of HSAs

Health Savings Accounts are individually-owned trusts or custodial accounts typically managed by a bank or a financial institution. The government needs to approve any vendor offering these accounts.

HSAs can be established to provide tax-favored funds for qualifying medical expenses. The funds can be used for any purpose; if they are used for qualified medical expenses, they are tax-free. Individuals can also save funds to use for future medical expenses. The interest an HSA fund earns is also tax-free. After the account reaches a certain threshold of savings, most vendors will offer the account holder a variety of investment options.

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Section 223 of the Internal Revenue Code governs HSAs. Often these accounts are referred to informally as medical IRAs because they share many of the same IRA tax requirements.

High Deductible Health Plan Requirements

In order to contribute funds to an HSA, an employee must be covered by a qualifying high deductible health plan or HDHP. An HDHP can be fully insured or self-funded, and it can be a group health plan or an individual insurance policy.

In any case, the plan must meet the following IRS requirements in order to qualify:

- The plan must apply the deductible to all services. The only exception is preventive care services. For 2007, the minimum deductible is $1,100 for a single person and $2,200 for a family. Under IRS guidelines preventive care can include routine health exams, pre-natal exams, immunizations, smoking cessation programs, cancer screenings, weight-loss programs, and so on. Even some prescription medications, such as statins, may be considered preventive. If a medication is considered preventive, your health plan vendor or PBM must be able to administer preventive medications such that it is not subject to the deductible.

- The out-of-pocket maximum can be no more than $5,500 for a single person or $11,000 for a family.
- The plan cannot have separate office visit copays, emergency room copays or pharmacy copays unless the copays are assessed after the deductible is met.

The IRS will look at the in-network deductibles and out-of-pocket maximums to determine whether the plan qualifies as an HDHP. In addition, the deductible and out-of-pocket maximums are indexed annually.

One of the problems organizations have had with HDHPs is that the IRS announces the annual limits very late in the year, typically in November. By November, most employers have made their health plan decisions for the next year. By 2008, the law will require the IRS to announce the next year's plan requirements by June 1. Receiving this information earlier should be a great help for employers sponsoring HDHPs.

HDHPs have a few other miscellaneous requirements. An "embedded deductible" must be at least as much as the minimum family deductible or the plan will not qualify. For example, if a plan has a $5,000 family deductible, but the plan will begin paying benefits if one family member meets at least $2,500 of the deductible; this is an embedded deductible situation. In this case, the plan would be a qualifying HDHP because the $2,500 embedded deductible is greater than the minimum required family deductible of $2,200.

Special rules also apply if your plan has a fourth quarter deductible carryover provision. The minimum deductible and the contribution limits are affected if the deductible accumulation period exceeds 12 months. To avoid confusion, most health plan vendors typically do not include the fourth quarter deductible carryover provision in an HDHP.

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Acronyms Aplenty

- **HSAs** - Health Saving Accounts (individually-owned trust accounts designed for tax-favored savings for health expenses)
- **FSAs** - Flexible Spending Accounts (permitted by Section 125 and permits pre-tax savings for eligible medical care expenses)
- **HRAs** - Health Reimbursement Arrangements (treated like self-funded medical plans, allows for tax-favored payments on eligible medical expenses. Only employer funding permitted.)
- **HDHP** - High Deductible Health Plan (In order to be eligible to contribute to an HSA, an individual needs to be covered by a qualifying HDHP. Parameters are set by the IRS and indexed annually.)
- **CDHP** - Consumer Driven Health Plans (strategy employers are using to increase employee involvement in the health care purchasing decision - it involves shifting significantly more cost to the employee)

Eligibility Provisions

Eligibility for an HSA is different from eligibility for the employer's HDHP. An employee may be eligible for an HDHP and not be eligible to contribute to the HSA.

To contribute to an HSA, an employee must meet the following conditions:

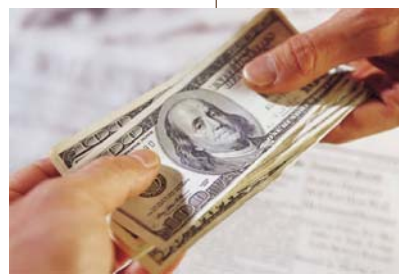
- The employee must be covered by a qualifying HDHP as of the first of the month to be eligible to contribute for that month.
- An employee covered by any other comprehensive health plan cannot contribute to an HSA; however, the rules allow exceptions for "exempted coverage" and "permitted insurance."

Exempted coverage includes any coverage for accidents, disability, dental services, vision care, long-term care and so on. Permitted insurance includes workers' compensation, critical illness or dread disease policies, fixed dollar hospital coverage and so on.

An employee enrolled in any part of Medicare (Part A, B, C or D) cannot contribute to an HSA. In addition, an individual who is claimed as a tax dependent of another is not eligible to contribute to an HSA. This would include any dependent children or any principally supported dependent.

Contribution status is determined solely by the coverage status of an account holder. The account holder must be an individual. For example, an account holder can have family coverage under a qualifying HDHP and be eligible to contribute up to the family maximum contribution. The account holder's spouse and children may be covered by other comprehensive health coverage and it will not impact the account holder's ability to contribute to an HSA.

Some employees do not understand how this would work with a medical FSA. Since coverage under a medical FSA extends to any eligible tax dependent, if the spouse of the account holder sets aside funds in a full-scope medical FSA, this would be viewed as "other comprehensive health coverage" and disqualify the account holder from contributing to the HSA. This is because coverage under that medical FSA is considered comprehensive health coverage and that coverage would extend to the account holder.



HSA trustees are not required to verify an account holder is covered by a qualifying HDHP. It will be the account holder's responsibility to prove he or she has qualifying HDHP coverage, if the individual is audited.

Contribution Rules and Requirements

Many rules apply to HSA contributions. Anyone can make a contribution to an HSA on behalf of an account holder, including employers. The contribution must be made in cash or with a check. Eligible contributions are tax-favored.

If an employer makes a contribution on behalf of employees, that contribution is excluded from Federal tax and employment tax. In many states, HSA contributions are also tax-favored, but it does depend on the state. If you have employees in different states and plan on offering HSAs, you should investigate the tax law in the states your employees are located.

Employees can contribute to HSAs in two ways. First, they can contribute pre-tax dollars under a Section 125 plan. The employer would have to amend the plan document to allow this option. Second, employees can contribute directly to the HSA. These HSA contributions can be "deducted off the top" at tax-time. In other words, account holders can deduct those contributions from their W-2 gross income thus decreasing their taxable income.

Account holders must use the 1040 tax form to take advantage of the tax-favored status of HSAs; the EZ form is not designed to be used with HSAs.

The IRS sets annual limits for contributions to HSAs. For 2007, the limit for single coverage is $2,850 and the limit for family coverage is $5,650. Individuals 55 years or older are permitted to make "catch up" contributions in addition to the normal contributions. For 2007, the catch up contribution amount is $800. The catch up amount rises annually until it reaches $1,000 in 2009. Only the account holder can make the catch up contribution, even if a husband and wife are both covered under a qualifying HDHP. In this situation, to take full advantage of the permitted catch-up contribution, the husband and wife would need to have separate HSAs to set aside the full amount of their individual catch-up contributions.

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Employees covered by a qualifying HDHP for a full 12 months can contribute the maximum amount. Employees covered for only part of the year can contribute, but the amount is pro-rated depending on the number of months they were covered. Catch-up contributions are also prorated. However, newly eligible employees may be able to contribute the full annual maximum, even though they are covered for only part of the plan year if they meet all of the following conditions:

- They become newly eligible for an HSA midway through the calendar year, which is coincidentally the plan year.
- They remain covered as of the first of the month in December of that year.
- For contributions greater than the permitted amount to remain tax-favored, the employee must remain eligible to contribute to the HSA during the "testing period." The testing period is the 12-month period following the close of the plan year.

This rule is complicated; the following example may clarify the issue. Employees eligible to begin contributing to an HSA in April and remain eligible to contribute through the end of the year are eligible to contribute 9/12ths of the maximum (the HDHP is in effect for 9 months of the year). In 2007, the single maximum contribution is $2,850 and 9/12th is $2,137.50. However, since they were newly eligible, they can set aside the full $2,850, providing they remain covered through the testing period. If they do not remain covered through the testing period, the "extra" amount contributed becomes taxable income and subject to a 10% excise tax penalty. In this example, the "extra" amount is $712.50 ($2,850-$2,137.50).

Some rollover contributions are also allowed. Rollover contributions are permitted from other HSAs, Archer MSAs, IRAs, and in limited circumstances, HRAs and medical FSAs.

Archer MSAs are Medical Savings Accounts the that IRS established about eleven years ago. They had limited scope and therefore are not common. Rollover funds from either an Archer MSA or another HSA must be deposited into the HSA within 60 days after they are withdrawn.

IRA rollovers are permitted only once in a person's lifetime and the amount cannot exceed the contribution limit for the year in which they were made. In fact, any IRA rollover amount offsets any other allowed contributions for the year. For the IRA rollover to remain tax-favored, an individual must remain eligible to contribute to the HSA for the testing period. In the case of an IRA rollover, the testing period is the 12 months directly following the transfer of funds. If an account holder fails to remain eligible to contribute to an HSA during the testing period, the IRA rollover amount becomes taxable income and subject to a 10% excise penalty.

Because HRA and medical FSA rollovers are fairly complicated, the IRS recently released a notice explaining the applicability of these rollovers and the administrative steps to allow the rollover. The details on these rollovers can be found in our *Special Alert* at http://www.mcgrawwentworth.com/Special_Alert.html, 2007, Issue 3.

Employers are not required to contribute to their employees' HSAs. However, if employers do contribute to one employee's HSA, they must also contribute a "comparable" amount to all other employees' HSAs. Comparable contributions may sound simple, but they are quite complex. Employers are allowed some flexibility with their contributions in some circumstances. The *Special Alert* at http://www.mcgrawwentworth.com/Special_Alert.html, 2006, Issue 6 explains the rules in detail.

This *Special Alert* also explains the time frame for contributing to an HSA. Direct contributions must be made by the time the tax return is filed. Employees can make 2007 contributions any time until they file their 2007 tax return (tax filing deadline is usually April 15).

Whether the employer contributes on a "look back" basis or a prospective basis, employers contributing to their employees' HSAs must set up a schedule for making those contributions. Contributions employees make through Section 125 must be sent to the HSA vendor as soon as reasonably possible.

Employers need to be careful if they make contributions for employees' HSAs. If an employer makes excess contributions as a matter of plan design or if the employer makes non-comparable contributions to their employees' HSAs, a 35% tax penalty applies to all contributions the employer makes to any employee's HSA. Employers cannot

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recover any contribution once it is made to an employee's HSA.

The IRS penalizes the employee for contributions that exceed the maximum amount permitted. Remember, the contribution amount is pro-rated in most cases for the number of months in the year the employee is eligible to contribute to the HSA. Individuals can withdraw any excess contribution before filing their income tax to avoid the 6% excise penalty. If an individual makes an excess contribution in one year, the contribution maximum for the next following year should be decreased by the amount of the excess contribution. The 6% excise penalty will apply annually if an individual does not offset the excess contribution with permitted contributions during the next year.

Any funds deposited to an HSA belong to the account holder and any interest accrued cannot be forfeited. At the point an HSA is established, the account holder will be asked to name a beneficiary. If the beneficiary is the legal spouse, ownership of the HSA is transferred to the spouse when the account holder dies and the spouse can continue to request tax-favored distributions for qualified medical expenses. If the beneficiary is not the legal spouse, the beneficiary receives the amount remaining in the HSA and must pay tax on that amount.

Coordination of HSAs with Medical FSAs and HRAs

Coordinating HSAs with medical FSAs and HRAs has been a concern since the launch of HSAs. The IRS has issued several notices to discuss how these three vehicles can work together.

HSAs cannot coordinate with full-scope medical FSAs or general purpose HRAs. Both of those accounts are viewed as "comprehensive" health plans and an HSA offered along with those accounts would result in dual coverage. Therefore, anyone covered under a full-scope medical FSA or HRA would not be eligible to contribute to an HSA.

On the other hand, an employer could limit expenses the plan will cover under an FSA or an HRA to allow these accounts to co-exist with an HSA. For example, the plan could limit coverage to vision expenses, dental services, preventive care and expenses after the deductible is met. Also the employer could allow employees to use the HRA for post-retirement health expenses only. In this case, current employees would be allowed to contribute to an HSA since they would not be eligible to withdraw funds from the HRA until they retire.

Distribution Rules

An employee can request HSA funds at any time. The HSA trustee may limit the frequency or even minimum dollar amounts of distributions.

An employee can request HSA funds for any reason. The reason for the request determines whether or not the funds are tax-free. For example, amounts withdrawn for qualified medical expenses (as defined in Section 213(d) of the Internal Revenue Code) are tax-free. They are typically the same expenses a medical flexible spending account would cover. In addition to these medical expenses, the following premium payments are also considered tax-favored when HSA funds are used:

- Qualified long-term care premiums
- COBRA premiums
- Health coverage premiums while collecting unemployment
- If you are over age 65 and did not qualify for Medicare because of a disability:
  - ➢ Medicare premiums (Part A, B, or D)
  - ➢ Medicare Advantage plan premiums
  - ➢ Contributions for an employer-sponsored retiree medical plan

Interestingly, the premiums for individually purchased Medicare supplement plans are *not* tax-favored if premiums are paid with HSA funds.

Funds withdrawn from an HSA to pay medical expenses for an accountholder, legal spouse and any eligible dependent children are tax-favored even when the spouse and children are not covered by the HDHP. The definition of legal spouse and children is determined at the federal level. The requirements set forth in the Working Families Tax Relief Act (WFTRA) apply to HSAs. For more information on WFTRA, please see our *Advisor* at http://www.mcgrawwentworth.com/resources_benefitsadvisor.html, 2004, Issue 14.

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Accountholders can withdraw funds from their HSAs for any purpose, but if the withdrawal is not for a qualified medical expense, there will be tax consequences. First, any non-qualified distribution is treated as taxable income. In addition, a 10% excise tax penalty may also apply. The 10% penalty will not be applied if:

- The account holder is over age 65 at time of distribution.
- The account holder dies and a distribution is made to close the account.
- The account holder is disabled as defined by federal law.

HSA trustees simply make and report distributions; they do not substantiate claims. Account holders must indicate whether the distribution was for a qualified medical expense when they file their tax returns. For that reason, account holders need to maintain the proof the expense was for a qualified medical expense with their tax records. Account holders will need to provide that proof if the IRS ever audits their tax returns.

For a medical expense to be qualified for tax-favored treatment, the expense must be incurred after the effective date of the HSA.

Conclusion

Although the Medicare Prescription Drug, Improvement and Modernization Act of 2003 introduced Health Savings Accounts, it provided few details. For that reason, over the last few years, the government has issued a steady stream of guidance to answer questions and explain the administrative process.

The additional guidance has made these accounts more complex every step of the way. As you can see, even briefly outlining where HSAs are today is a complicated proposition. However, with the new contribution limits and more employers launching consumer driven health plans, HSAs are poised to become a mainstream vehicle for funding health care expenses and saving for post-retirement health care expenses.

Although employers may offer HSAs, they generally have much less control over these accounts than other employee benefits. In a way, this is a good thing since HSAs typically will not be viewed as employer-sponsored ERISA health plans. Employees will have much more control and tax responsibility under HSAs. Employees are not used to this much responsibility, so it will be important to inform them of their obligations if your organization launches a CDHP with an HSA.

It will be interesting to see how widespread HDHPs with HSA options become over the next several years. If you have any questions regarding this *Advisor*, please contact your McGraw Wentworth Account Director. MW

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