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# **AN EMPLOYER'S GUIDE TO HEALTH SAVINGS ACCOUNTS (HSAs)**

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**By**

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## **Introduction to the Guide**

The following provides you, as an employer, with information about Health Savings Accounts (“HSAs”) under Internal Revenue Code (Code) Section 223. You should read this explanation to evaluate whether HSAs may be used either as an alternative to, or in addition to, health flexible spending accounts (Health FSAs) under Code Section 125 or Health Reimbursement Arrangements (“HRAs”) under Code Section 105(h).

To fully understand the requirements of these new accounts, the following discusses their terms and compares their advantages and disadvantages over Health FSAs and HRAs in a question and answer format. In addition, a chart comparing both Health FSAs and HRAs with HSAs is included at the end of this explanation.

It is important to remember that this explanation is not intended to serve as a substitute for the advice of your lawyer, accountant, or other personal tax or financial advisor.

### **1. Why should we consider establishing HSAs for our employees?**

HSAs are similar to Archer Medical Savings Accounts (MSAs) in structure and benefits, but there are many important differences. HSAs represent a significant improvement over MSAs and offer an impressive list of attractive features:

- Funding flexibility - employer contributions, pre-tax employee salary reduction contributions and tax-deductible contributions are all permissible within specified limits.
- No “Use-It-or-Lose-It” rule - participants may accumulate funds and self-direct investments in a tax-exempt trust or custodial account.
- The ability to transfer amounts from your Health FSA, HRA or IRA to the HSA.
- The ability to use funds for non-medical purposes without any effect on the tax-free character of amounts remaining in the individual’s HSA.
- Account portability for participants - monies can be transferred to another HSA at anytime without limitation.
- Any employer may offer HSAs.
- Participant self-substantiation of expenses is required.
- The tandem high-deductible health plan (HDHP) that is required is almost a mainstream design.
- Family members, employers and any other third party may make contributions to an HSA on behalf of the eligible individual.

## 2. In general, what is required?

HSAs provide employees with a tax-free basis for paying current medical expenses, as well as the ability to save on a tax-favored basis for future medical expenses. In general, HSAs use tax-exempt trusts or custodial accounts to store contributions and earnings to pay for the qualified medical expenses of an employee and his or her spouse and dependents that are subject to rules similar to those applicable to individual retirement arrangements (IRAs).

Within limits, contributions to HSAs are deductible if made by or for an eligible individual and are excludable from such individual's income and wages for employment tax purposes if made by the employer of an eligible individual or made by the employee in the form of pre-tax salary reduction contributions (through a cafeteria plan). Distributions from HSAs for qualified medical expenses are not includible in the eligible individual's gross income. Distributions that are not for qualified medical expenses are includible in an eligible individual's gross income and are subject to an additional 10 percent tax. The additional 10 percent tax does not apply for distributions made after death, disability, or when the individual attains the age of Medicare eligibility (i.e., age 65).

## 3. Which employees are eligible to make or receive contributions to an HSA?

For any month, an eligible individual is defined as any individual who:

- is covered only by a high-deductible health plan (HDHP) (defined below in Q/A-7) as of the first day of such month;
- is not also covered by any other health plan that is not a HDHP (with certain exceptions for plans providing certain limited types of coverage as discussed in Q/A-5);
- is not enrolled in benefits under Medicare; and
- may not be claimed as a dependent on another person's tax return.

To be eligible to make or receive HSA contributions for any month, an employee must meet all of the requirements, including HDHP coverage as of the first day of the month.

**Note:** If each spouse of a married couple has separate family coverage, but covers dependents other than the other spouse, such coverage will not affect the other spouse's eligibility to make HSA contributions. In addition, those dependents covered under the HDHP can be covered by a health plan that is not a HDHP.

An employee will still be considered an eligible individual if he or she is:

- given a choice between a low-deductible health plan and a HDHP, and if the employee selects coverage under the HDHP. In this situation, the actual coverage selected by the employee is controlling. It does not matter what the employee could have chosen or did not choose.

- required to pay the costs of the health care (taking into account a discount) until the deductible is satisfied. For example, the employee may be given a pharmacy discount card that provides discounts off the usual and customary fees charged by providers, but the card will not cover the full cost of drugs until the deductible is satisfied under the HDHP.
- eligible for coverage under an Employee Assistance Program (EAP), disease management program, or wellness program, if the program does not provide significant benefits in the nature of medical care or treatment and therefore would not be considered to be a “health plan.” In making the determination, screenings and other preventive care services are disregarded.

#### **4. Which employees are not eligible to make or receive contributions to an HSA?**

An employee may not make or receive a contribution to an HSA if he or she is covered under:

- a spouse’s or dependent’s employer’s health plan that is not an HDHP; or
- a Health FSA or HRA unless coverage under such Health FSA or HRA is limited to “permitted coverage” or “permitted insurance” or other benefits specified in Q&A-5.

#### **5. Can an employee be eligible for other coverage from an employer and still be eligible to make or receive contributions to an HSA?**

Yes. An employee may be eligible for other “permitted coverage” or “permitted insurance” in addition to a HDHP and still be eligible to make or receive a contribution to an HSA.

“Permitted insurance” includes:

- Insurance if substantially all of the coverage provided under such insurance relates to:
  - Insurance incurred under worker’s compensation law,
  - Tort liability insurance, or
  - Property insurance (e.g., auto insurance),
- Insurance for a specified disease or illness (cancer insurance); and
- Insurance that provides a fixed amount per day (or other period) of hospitalization.

Benefits for “permitted insurance” must be provided through insurance contracts and not on a self-insured basis. However, where benefits (such as workers’ compensation



benefits are provided in satisfaction of statutory requirement and any resulting benefits) for medical care are secondary or incidental to other benefits, the benefits will qualify as "permitted insurance" even if self-insured.

"Permitted coverage" includes coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

## **6. Can an employee participate in either a Health FSA or an HRA in the same month and still be eligible to make or receive contribution to an HSA?**

No, unless the employee's situation is one of the following:

- The employee's expenses reimbursed under a Health FSA and/or an HRA are limited to dental, vision and/or preventive care benefits ("Limited Purpose Health FSA or HRA").
- The employee suspends participation in an HRA for the year ("Suspended HRA").
- The Health FSA or HRA pays expenses above the deductible of the HDHP ("Post-Deductible Health FSA or HRA").
- The HRA pays or reimburses the employee's expenses incurred after the employee retires ("Retirement HRA").

For tax years beginning before January 1, 2007, if an employer amended its cafeteria plan to provide a "grace period" (period of up to 2-12 months after the end of the plan year), all participants under the cafeteria plan are not eligible to contribute to an HSA during the grace period, even if a participant spent his or her entire Health FSA balance by the end of the plan year and did not take advantage of the grace period.

For tax years beginning after December 31, 2006, if an employer has amended its cafeteria plan to provide a "grace period," such provisions will be disregarded for determining a participant's eligibility to contribute to an HSA if: (i) the balance in the participant's Health FSA account at the end of the plan year is zero, or (ii) in accordance with rules prescribed by the IRS, the entire remaining balance in the participant's Health FSA account at the end of the plan year is contributed to an HSA as provided above. (This is explained in Q/A-25 below.)

## **7. What is a high-deductible health plan (HDHP)?**

A high deductible health plan (HDHP) is an insured or self-insured health plan that satisfies certain requirements with respect to deductibles and out-of-pocket expenses. In the case of individual coverage, the plan must have an annual deductible of not less than \$1,000 for 2004 and 2005, \$1,050 for 2006, \$1,100 for 2007 and 2008 and \$1,150 for 2009 and in the case of family coverage; the plan must have an annual deductible of not less than \$2,000 for 2004 and 2005, \$2,100 for 2006, \$2,200 for 2007 and 2008 and \$2,300 for 2009. In addition, the 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.

“Family coverage” under an HDHP is any coverage other than individual coverage. Therefore, family coverage would include a health plan covering one eligible employee and at least one other individual (whether or not the other individual is an eligible individual).

A health plan may contain the following features and still be considered an HDHP:

- A reasonable lifetime limit on benefits. Any lifetime limit on benefits designed to circumvent the maximum annual out-of-pocket amount is not reasonable.
- Limitation of payments to usual, customary and reasonable (UCR).
- Uses amounts toward the deductible from a prior health plan if newly adopted during the year.
- Different levels of payment of benefits depending on whether a participant goes in or out of network.

A plan with no express limit on out-of-pocket expenses will generally not be considered an HDHP unless such limit is not necessary to prevent exceeding the out-of-pocket maximum.

In case of individual coverage, the maximum out-of-pocket expense limit on covered expenses cannot exceed \$5,000 for 2004, \$5,100 for 2005, \$5,250 for 2006, \$5,500 for 2007, \$5,600 for 2008 and \$5,800 for 2009. In case of family coverage, the maximum out-of-pocket expense limit on covered expenses cannot exceed \$10,000 for 2004, \$10,200 for 2005, \$10,500 for 2006, \$11,000 for 2007, \$11,200 for 2008 and \$11,600 for 2009 in the case of family coverage. Out-of-pocket expenses include deductibles, co-payments, and other amounts (other than premiums) that the individual must pay for covered benefits under the plan.

Note: In applying the above limitations, an employer could provide an HDHP with a deductible as high as \$5,500 for 2007, \$5,600 for 2008 and \$5,800 for 2009 for individual coverage and \$11,000 for 2007, \$11,200 for 2008 and \$11,600 for 2009 for family coverage, but after the employee meets the deductible, the plan would have to pay 100% of any medical expense and could not impose any co-payments or other amounts on the employee or any dependents once the deductible was met.

The following items are not included in determining the maximum amount of out-of-pocket expenses under an HDHP:

- Amount paid in excess of usual, customary and reasonable (UCR) charges (if the plan makes such limitation),

- Amounts above the life-time limits,
- Penalties imposed by the plan for failing to obtain a pre-certification,
- Increased coinsurance amounts for failure to obtain a pre-certification for a specific provider, or
- Amounts incurred for premiums or uncovered benefits.

The following items are included in determining the maximum amount of out-of-pocket expenses under an HDHP:

- Cumulative embedded deductibles under family coverage and
- Co-payments not taken into account if the plan's deductible is satisfied.

Like the annual deductible maximum, the minimum and out-of-pocket expense amount limits are indexed for inflation.

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). However, except for preventive care, a plan may not provide benefits for any year until the deductible for that year has been met.

For any period before January 1, 2006, there was a special transition relief for health plans that would otherwise qualify as an HDHP, but for the requirement under state law that certain benefits be provided without a deductible or below the minimum annual deductible indicated above. Such health plans were still be considered HDHPs if the disqualifying benefits which was required by state law in effect on January 1, 2004.

## **8. What services are included in preventive care?**

Preventive care includes, but is not limited to, the following:

- Periodic health evaluations, including tests and diagnostic procedures ordered in connection with routine examinations, such as annual physicals,
- Routine prenatal and well-child care,
- Child and adult immunizations,
- Tobacco cessation programs,
- Obesity weight-loss programs, and
- Certain screening services or devices (extensive list of permissive screening devices and tests are contained in an appendix to IRS Notice 2004-23).

Preventive care does not generally include any service or benefit intended to treat an existing illness, injury, or condition. Treatment of a related condition made during a

preventive care or screening is considered to be preventive care when it would be unreasonable or impracticable to perform another procedure to treat the condition, such treatment would be considered to be incidental or ancillary to a preventive care service or screening. For example, the removal of polyps during a diagnostic colonoscopy would be considered preventive.

Drugs or medications are part of preventive care when taken by an individual who has developed risk factors of 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.

Examples include treatment of high cholesterol with cholesterol-lowering medications to prevent heart disease or the treatment of recovered heart attack or stroke victims with Angiotensin-converting Enzyme (ACE) inhibitors to prevent reoccurrence.

Some state laws require certain services to be covered regardless of whether the deductible has been met. Whether such services are treated as "preventive" for purposes of the exception for preventive care will be based on standards specified in guidance issued by the IRS, rather than how the care is characterized by state law. There was transition relief until January 1, 2006 for any state mandates in effect as of January 1, 2004.

### **9. Will employees covered under both a prescription drug benefit and an HDHP be eligible to contribute to an HSA?**

No. Individuals covered by both an HDHP that does not cover prescription drug benefits and a separate prescription drug plan (or rider) that provides benefits before individuals have satisfied the minimum annual deductible requirement on a first dollar basis, will not be eligible to make contributions to an HSA. Since a prescription drug program is not considered "permitted insurance", such a program must meet the requirements for an HDHP and comply with the required minimum annual deductible requirement.

For any period beginning before January 1, 2006, the IRS had provided a transition relief for an individual who would otherwise be eligible to make contributions to an HSA, but was covered by both an HDHP that did not provide benefits for prescription drugs and by a separate health plan or rider that provides prescription drug benefits before the minimum annual deductible of the HDHP was satisfied. Such an individual would continue to be eligible to make contributions to an HSA based on the annual deductible of the HDHP. For any period before January 1, 2006, coverage under the prescription drug program would be ignored.

### **10. How is an HSA established?**

Beginning January 1, 2004, any eligible individual (as described in Q/A-3) can establish an HSA with a qualified HSA trustee or custodian, in much the same way that individuals establish IRAs or MSAs with qualified IRA or MSA trustees or custodians. No

permission or authorization from the IRS is necessary to establish an HSA. An eligible individual who is an employee may establish an HSA with or without involvement of the employer.

In addition, if an employer wants to permit pre-tax employee-made HSA contributions, it must amend its cafeteria plan to provide for such contributions. The making of these pre-tax HSA contributions must be voluntary on behalf of eligible employees, but the employer may provide for these HSA contributions through a “negative” election.

#### **11. Will the IRS offer model HSA Trust and Custodial Agreements?**

Yes. The IRS offers Form 5305-B (Trust) and Form 5305-C (Custodial) for use in establishing HSAs.

#### **12. Who can be a qualified HSA trustee or custodian?**

Only insurance companies defined in Code Section 816 or any bank (including a similar financial institution as defined in Code Section 408(n)) can be an HSA trustee or custodian. In addition, any other person already approved by the IRS to be a trustee or custodian of IRAs or MSAs is automatically approved to be an HSA trustee or custodian. Other persons may request approval to be a trustee or custodian in accordance with the procedures set forth in Treas. Reg. § 1.408-2(e) (relating to IRA nonbank trustees). For additional information concerning nonbank trustees and custodians, see IRS Announcement 2003-54.

#### **13. Does an HSA have to be established at the same institution that provides the HDHP?**

No. The HSA can be established through a qualified trustee or custodian who is different from the HDHP provider. Where a trustee or custodian does not sponsor the HDHP, the trustee or custodian may require proof or certification that the individual is an eligible individual, including that the individual is covered by a health plan that meets all of the requirements of an HDHP.

#### **14. Once an HSA is established by or for an employee, may the employee revoke the account?**

Yes. An employee may revoke his or her HSA by mailing or delivering a written notice of revocation to the trustee or custodian (whichever is applicable) within 7 days after the establishment of the HSA. Mailed notice is treated as given to the trustee or custodian (whichever is applicable) on the date of the postmark (or on the date of post office certification or registration if notice is sent by certified or registered mail). Upon timely revocation, an employee will receive a payment equal to the initial contribution, without adjustment for administrative expenses, commissions or sales charges, fluctuations in market value or other charges.

**15. Are there any restrictions on the types of investments available under an HSA?**

An employee may invest in any vehicle approved for IRAs (e.g., bank accounts, annuities, certificate of deposit, stocks, mutual funds, or bonds). HSAs may not invest in life insurance contracts or in collectibles. HSAs may, however, invest in certain types of bullion or coins. The trust or custodial agreement may restrict investments to certain types of permissible investments. HSA trust assets may only be commingled in a common trust fund or common investment fund. No other arrangement is permitted.

An employee is prohibited from making certain investments that are considered “prohibited transactions” under Code Section 4975(c). These transactions involve certain sales, exchanges or leasing of property between an individual and his or her HSA (or any other interference with the independent status of the account). If an employee engages in a prohibited transaction, then the account would lose its tax-exempt status by reason of Code Sections 223(e)(2) and 408(e)(2)(A), and the entire account balance would be treated as having been distributed to the employee in the year during which the prohibited transactions occurred. The value of the entire account would be included in the employee’s income and taxed as ordinary income. In addition, if the employee is under age 65, the “distribution” would also be subject to the additional 10% penalty tax imposed on premature distributions.

In addition, employers who do not promptly transfer employees’ HSA contributions to HSA trustees and custodians may violate the prohibited transactions provisions and be penalized. Employers are required to transfer employees’ HSA contributions to the HSA trustee or custodian as of the earliest date on which such amounts can reasonably be segregated from the employer’s general assets.

**16. What contributions are permitted under an HSA and how are they treated for tax purposes?**

Contributions to an HSA must be made in cash and may be made by an eligible individual, the employer, family member or any other third person. Contributions made by a family member or any other third person are deductible (within limits) in determining adjusted gross income (i.e., “above-the-line”) of the eligible individual.

Contributions made by an eligible individual’s family members or any other person are deductible by the eligible individual to the extent the contributions would be deductible if made by that individual. However, the individual making the contribution cannot also deduct the contributions as medical expense deductions under Code Section 213. In addition, employer contributions to an HSA (including pre-tax salary reduction or employer matching contributions made through a cafeteria plan) are excludable from gross income and wages for employment tax purposes to the extent the contribution would be deductible if made by the employee. The employee cannot deduct employer contributions on his or her federal income tax return as HSA contributions or as medical expense deductions under Code Section 213.

In making contributions to an employee's HSA, an employer's only responsibility is to determine whether its eligible employees are covered under an HDHP (and the deductible) or low deductible health plan or plans (including Health FSAs and HRAs sponsored by the employer and to determine its employees' ages for catch-up contributions.

### **17. Can pre-tax salary reduction contributions be made to an HSA?**

Yes. As indicated above, an employee may make pre-tax salary reduction contributions under an HSA, but these contributions must be made to a cafeteria plan. They are treated as employer contributions and are not subject to income and employment taxes. Code Section 125 has been amended to allow HSAs to be offered under cafeteria plans.

The following requirements do not apply to HSA contributions if made to cafeteria plans:

- "Use-it-or-Lose-it" Rule,
- Uniform Coverage Rule,
- Mandatory 12 month period of coverage, and
- Change in status requirements for changing elections – An eligible employee may start or stop his or her election or increase or decrease his or her election at any time as long as the change is effective prospectively. An employer is not required to allow all changes and can restrict the employee's ability to make or change elections, but allow an employee to change his or her election monthly.

Even though these contributions are made under a cafeteria plan, these HSA contributions must be contributed to an HSA trust or custodial account and the claim substantiation requirements of cafeteria plans do not apply. Employers can provide negative elections for HSA contributions if provided through a cafeteria plan.

If an employer amends its cafeteria plan to permit employees to elect an HSA mid-year, such election for the HSA must be on a made on a prospective basis. This election does not permit a change or revocation of any other coverage under the cafeteria plan, unless the change is allowed under the cafeteria rules.

In addition, if HSA contributions are made though a cafeteria plan, an employer may contribute matching contributions to an employee's HSA up to the maximum amount elected by the employee. This contribution by the employer must be made equally available to all participating employees throughout the plan year on the same terms.

All contributions made though a cafeteria plan (including employer contributions to employees' HSAs) are subject to Code Section 125 nondiscrimination rules (eligibility rules, contributions and benefit tests, and key employee concentration tests). These employer contributions made though a cafeteria plan are not subject to the comparability rules discussed in Q/A-26 below.

## 18. What are the limits for contributions to an HSA?

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. Any individual who begins HDHP coverage in mid-month would not be eligible to make an HSA contribution until the beginning of the following month.

**Example:** An individual enrolls in individual coverage under an HDHP in March 1, 2009 and remains covered until he or she terminates in late August 2009. He takes a job with an employer that does not sponsor an HDHP. How much can he or she contribute for 2009? He or she can contribute \$1,500 for 2009 (1/2 of the limit for 2009 because he or she had HDHP coverage for 6 months during 2009).

For tax years beginning after 2006, an individual, who becomes covered under an HDHP in a month other than January and who is covered by a HDHP in December of that year, may make a full deductible HSA contribution for the year if he or she has HDHP coverage for the entire “testing period”. The testing period is the period beginning with the last month of the taxable year and ending on the last day of the 12<sup>th</sup> month following such month. If an individual does not remain an eligible individual during the testing period, the amount of the contributions attributable to months preceding the month in which the individual was not an eligible individual (which could have not have been made but for the provision) will be includible in the individual’s gross income.. The amount is includible for the taxable year of the first day during the testing period that the individual was not an eligible individual. A 10-percent additional tax also applies to the amount includible. An exception applies if the individual ceases to be an eligible individual by reason of death or disability.

**Example:** An individual enrolls in an HDHP effective on December 1, 2008 and is otherwise an eligible individual in that month. The individual is not an eligible individual in any other month in 2008. The individual can make an HSA contribution for 2008 as if he or she had been enrolled in the HDHP for all of 2008. If the individual ceases to be an eligible individual (e.g., if he or she ceases to be covered under an HDHP) in June 2009, an amount equal to the HSA deduction attributable to treating the individual as an eligible individual for January through November 2009 is included in the individual’s income in 2009. In addition, a 10-percent additional tax applies to the amount includible.

Note: If the individual makes a contribution of 1/12 of the annual limit for 2008 to his HSA and leaves in June 2009, nothing would be included in his or her income.

For tax years beginning before 2007, the maximum monthly contribution for eligible individuals with individual coverage under an HDHP was 1/12 of the lesser of 100% of the annual deductible under the HDHP (minimum of \$1,000 for 2004 and 2005 and \$1,050 for 2006) but not more than \$2,600 for 2004, \$2,650 for 2005, \$2,700 for 2006. For eligible individuals with family coverage under an HDHP, the maximum monthly contribution for tax years beginning before 2007 was 1/12 of the lesser of 100% of the



annual deductible under the HDHP (minimum of \$2,000 or 2005 and 2005 and \$2,100 for 2006)) but not more than \$5,150 for 2004, \$5,250 for 2005, \$5,450 for 2006. In addition to the maximum contribution amount, catch-up contributions, as described below, may be made by or on behalf of individuals age 55 or older and not enrolled in Medicare.

For tax years beginning after 2006, the requirement limiting HSA contributions to the lesser of specified dollar amount or the annual deductible under the HDHP has been repealed. With these changes, the maximum aggregate annual contribution that an individual can make to an HSA is \$2,850 for 2007, \$2,900 for 2008 and \$3,000 for 2009 in the case of individual coverage and \$5,650 for 2007, \$5,800 for 2008 and \$5,950 for 2009 in the case of family coverage. The individual's deductible is not considered in determining the amount of his or her contribution.

Administration and account maintenance fees paid by the account holder or the employer directly to the trustee or custodian are not counted toward the annual maximum contribution limit to the HSA.

**EXAMPLE:** An employee has family coverage with an annual deductible of \$3,000 for the HDHP. The employee may contribute the lesser of the annual deductible or \$5,450 for 2006. In this case, the employee may contribute \$3,000 for 2006. For 2007, the annual deductible for the HDHP remains at \$3,000, but the employee may now contribute \$5,650. For 2008, the annual deductible for the HDHP remains at \$3,000, but the employee may now contribute \$5,800. If the annual deductible remains at \$3,000 for 2009, the Employee may now contribute \$5,950.

If an employee has reached age 55 by the end of the taxable year, the HSA annual contribution limit is increased by \$500 for 2004, \$600 for 2005, \$700 for 2006, \$800 for 2007, \$900 for 2008, and \$1,000 for 2009 and thereafter. As with the annual contribution limit, the catch-up contribution is also computed on a monthly basis for tax years beginning before 2007. For tax years beginning after 2006, the catch-up contribution is no longer computed on a monthly basis if certain conditions are met. Like the annual contribution limit discussed above, the monthly limit requirement is waived for catch-up contributions if an individual continues to have HDHP coverage during the testing period.

**EXAMPLE:** If an employee attains age 65 and enrolls in Medicare in July 2009 and had been participating in single coverage under an HDHP with an annual deductible of \$1,150, such individual is no longer eligible to make HSA contributions (including catch-up contributions) after June 2009. The monthly contribution limit is \$333.33 ( $\$3,000 + \$1,000/12$ ) for both the regular HSA contribution and the catch-up contribution. The individual may make HSA contributions for January through June totaling \$1,999.98 ( $6 \times \$333.33$ ), but may not make any contributions for July through December, 2009 or thereafter.

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 a MSA. The same annual contribution limit applies whether the contributions are made by an employee, an employer, a self-employed person, or a family member. Unlike MSAs, contributions may be made by or on behalf of eligible individuals even if the individuals have no compensation or if the contributions exceed their compensation. If an individual has more than one HSA, the aggregate annual contributions to all the HSAs are subject to the limit. Joint HSAs for husband and wife are not allowed.

Note: Contributions, including catch-up contributions, cannot be made once an individual is enrolled in Medicare.

In the case of married couples, if either spouse has family coverage, both are treated as having family coverage, unless they do not cover each other and cover other dependents.

For tax years beginning before 2007, if each spouse has family coverage under a separate health plan, both spouses are treated as covered under the plan with the lowest deductible, if they cover each other. The contribution limit for the spouses is the lowest amount, divided equally between the spouses unless they agree on a different division. The family coverage limit is reduced further by any contribution to a MSA. However, both spouses may make the catch-up contributions for individuals age 55 or over without exceeding the family coverage limit.

For tax years beginning after 2006, the deductible limit is no longer considered for determining the amount of contributions.

**EXAMPLE:** H and W are married. H is 58 and W is 53 in 2007. H and W both have family coverage under separate HDHPs and they cover each other. H has a \$3,000 deductible under his HDHP and W has a \$2,500 deductible under her HDHP. For 2007, a total contribution of \$6,450 (\$5,650 + \$800 catch-up contribution) can be made to their HSAs. They can split the contribution any way, but the catch-up contribution must be made to H's HSA. For 2008, a contribution of \$6,700 (\$5,800 + \$900 catch-up contribution) can be made to their HSAs. For 2009, a contribution of \$7,950 (\$5,950 + \$1,000 + \$1000 catch-up contributions) can be made to their HSAs. W turned age 55 during 2009 and she can make her own catch-up contribution to her HSA.

**EXAMPLE:** Same facts as in the previous example except that H and W do not cover each other, but cover their dependent children. A contribution of \$6,450 can be made for 2007, \$6,700 for 2008 and \$7,950 for 2009.

**EXAMPLE:** H and W are married. H is 35 and W is 33. H and W each have individual coverage under an HDHP. H has a \$1,100 deductible under his HDHP and W has a \$1,500 deductible under her HDHP for 2006. For 2006, H can contribute \$1,100 to an HSA and W can contribute \$1,500 to an HSA. But for 2007, H and W can contribute a

total of \$5,650, not \$5,700 (\$2,850 x 2). At no time can a family contribute more than the family coverage contribution limit of \$5,650 for 2007, even if one or both of the spouses have single coverage. For 2008, the family can contribute \$5,800. For 2009, the family can contribute \$5,950, if the plan is updated to be an HDHP.

Remember, if either spouse has family coverage, but does not cover each other, such coverage does not affect the eligible spouse's ability to make an HSA contribution.

In addition, where a spouse has single coverage under an HDHP and the other spouse has family coverage under a non-HDHP plan covering dependents other than the spouse, the spouse covered under the HDHP would be eligible to make HSA contributions under the single coverage rate.

For any taxable year, HSA contributions for the benefit of a married couple cannot exceed the dollar limit for family coverage (\$5,650 for 2007, \$5,800 for 2008 and \$5,950 for 2009). This limit will apply even if one or both spouses have individual coverage.

For tax years beginning before 2007, the maximum contribution for an individual who has family coverage under an HDHP with embedded individual deductibles and an umbrella deductible is the least of the following amounts:

- (1) the maximum annual contribution limit for family coverage;
- (2) the umbrella deductible; or
- (3) the embedded individual deductible multiplied by the number of family members covered under the plan.

For tax years beginning after 2006, the above limit does not apply; an individual can make a full contribution no matter the amount the embedded individual deductibles or umbrella deductibles under the HDHP.

**EXAMPLE:** In 2006, a married couple has an HDHP for themselves and their two dependent children. The HDHP pays for any family member whose covered expenses exceed \$2,200 (the embedded individual deductible) and will pay benefits for all family members after their covered expenses exceeds \$5,000 (the umbrella deductible). The maximum annual contribution limit is \$5,450. The embedded deductible multiplied by the number of family members is \$8,800. The maximum annual contribution which the married couple may make to their HSAs is \$5,000. The \$5,000 is divided between the couple.

If only one spouse is eligible to make a contribution to an HSA, only that spouse may establish and contribute to an HSA on his or her behalf.

The couple can make a contribution of \$5,650 for 2007, \$5,800 for 2008 and \$5,950 for 2009.

**EXAMPLE:** The same facts as in previous example above, but only one of the spouses is eligible. The entire \$5,000 contribution would be made to the HSA of the eligible spouse for 2006. The eligible spouse can make a contribution of \$5,650 for 2007, \$5,800 for 2008 and \$5,950 for 2009.

#### **19. When must contributions be made for a taxable year?**

Contributions for the taxable year can be made in one or more payments, at the convenience of the individual or the employer, at any time prior to the time prescribed by law (without extensions) for filing the eligible individual's federal income tax return for that year, but not before the beginning of that year. For calendar year taxpayers, the deadline for contributions to an HSA is generally April 15 following the year for which the contributions are made. Although the annual contribution is determined monthly, the maximum contribution may be made on the first day of the year or any other time during the year.

In addition, an individual may also establish an HSA for any taxable year at any time prior to the time prescribed by law (without extensions) for filing the eligible individual's federal income tax return for that year, (April 15 for calendar year taxpayers).

#### **20. What is the tax treatment of contributions made by a partnership to a partner's HSA or by an S Corporation to a 2-percent shareholder's HSA?**

If HSA contributions made by a partnership to a partner are treated as distributions, they are deductible HSA contributions by the partner, not the partnership, and the contributions then have no effect on the partner's self-employment income. The contributions are reported as distributions of money on the partner's Schedule K-1.

If HSA contributions made by a partnership to a partner are treated as guaranteed payments, they are deductible by the partnership, includible in the partner's income, deductible by the partner as an HSA contribution, and subject to self-employment tax by the partner. The contributions are reported as guaranteed payments on the partner's Schedule K-1.

If HSA contributions are made by an S Corporation to a 2% S corporation shareholder, they are treated as taxable wages to the shareholder, but not normally taxable for FICA tax purposes, and deductible on the shareholder's Form 1040 as an HSA contribution.

#### **21. What are the consequences if either the employer or the employee overcontributes to an HSA for any year?**

If an individual contributes over the stated limits for the taxable year, these contributions are not deductible. Contributions made by an employer over the limits are included in the employee's income, but not returned to the employer.

In addition, an excise tax applies to contributions in excess of the maximum contribution amount. The excise tax is generally equal to six percent of the cumulative amount of excess contributions that are not distributed from the HSA to the contributor.

However, if the excess contributions for a taxable year and the net income attributable to such excess contributions are paid to the individual before the last day prescribed by law (including extensions) for filing the individual's federal income tax return for the taxable year, then the net income attributable to the excess contributions is included in the individual's gross income for the taxable year in which the distribution is received, but the excise tax is not imposed on the excess contribution and the distribution of the excess contribution is not taxed. If the eligible individual is under age 65 and is not dead or disabled, he or she will be subject to the 10% penalty tax on the earnings.

The rules for computing attributable net income for excess IRA contributions apply to HSAs. Under IRS Regulations Section 1.408-11, the net income attributable to a contribution made to an IRA is determined by allocating to the contribution a pro rata portion of the earnings on the assets in the IRA during the period the IRA held the contribution. The attributable net income is calculated with the following formula:

$$\text{Net Income} = \frac{\text{Contribution} \times (\text{Adjusted Closing Balance} - \text{Adjusted Opening Balance})}{\text{Adjusted Opening Balance}}$$

**EXAMPLE:** On May 1, 2008, when Fred's HSA is worth \$4,800, he makes a \$1,600 contribution to his HSA. Fred then requests that \$400 of the contribution be returned to him as an excess contribution. On February 1, 2009, when the HSA is worth \$7,600, the HSA trustee distributes to Fred the \$400, plus attributable net income. During this time, no other contributions have been made to the HSA and no distributions have been made.

The adjusted opening balance is \$6,400 [\$4,800 +\$1,600] and the adjusted closing balance is \$7,600. Therefore, the net income attributable to the \$400 May 1, 2007, contribution is \$75 [\$400 x (\$7,600- \$6,400) ÷ \$6,400]. This results in a total of \$475 to be distributed on February 1, 2009. The \$400 is not subject to the 10% penalty tax, but the \$75 of net income is taxable on Fred's 2008 tax return and will be subject to the 10% penalty tax if Fred is under age 65 or is not dead or disabled.

## **22. What type of trust or custodial account must be established to accept HSA contributions?**

The trust or custodial account must meet the following requirements:

- The trustee or custodian must be a bank, an insurance company or another person who demonstrates to the satisfaction of the IRS that the manner in which such person will administer the trust or custodial account will be consistent with the HRA requirements.
- No part of the trust or custodial account is invested in life insurance contracts.

- The assets of the trust or custodial account are not commingled with property except in a common trust fund, and
- The interest of an individual in the balance in his or her account is nonforfeitable.

### **23. Can amounts be rolled over to another HSA?**

Yes. Amounts can be rolled over into an HSA from a MSA or another HSA on a tax-free basis. Rollovers need not be made in cash. Amounts can be rolled over into an HSA from another HSA. Amounts transferred from another HSA or a MSA are not taken into account under the annual contribution limits.

An individual may make only one rollover contribution to an HSA during a one-year period. To qualify as a rollover, any amount paid or distributed from an HSA to an eligible individual must be paid over to an HSA within 60 days after the date of receipt of the payment or distribution.

### **24. Are transfers of HSA amounts from one HSA trustee directly to another HSA trustee subject to the rollover restrictions?**

No. There is no limit on the number of trustee-to-trustee transfers allowed during any year.

### **25. Can amounts distributed from a Health FSA, HRA or IRA be directly transferred to an HSA?**

Yes, amounts can be distributed from a Health FSA, HRA or IRA and then transferred to an HRA if made after January 1, 2007.

### **Health FSA and HRAs**

For distributions and contributions made on or after January 1, 2007 and before January 1, 2012, certain amounts in a Health FSA or HRA can be distributed and contributed directly by the employer to an employee's HSA without violating the otherwise applicable requirements for such arrangements. An employee with a balance in a general purpose Health FSA with a grace period or in a general purpose HRA at the end of the plan year can transfer certain amounts to an HSA and participate in an HSA as of the first day of the month following the end of that plan year, if all of the following requirements are met and the employee continues to have HDHP coverage for the testing period:

- The employer amends the Health FSA or HRA effective by the last day of the plan year to allow a Qualified HSA distribution.
- A Qualified HSA Distribution has not previously been made for that employee with respect to that Health FSA or HRA.

- The employee has HDHP coverage as of the first day of the month during which the distribution occurs, and is otherwise an eligible individual.
- The employee elects by the last day of the plan year to have the employer make a Qualified HSA Distribution.
- The Health FSA or HRA makes no reimbursements to the employee after the last day of its plan year.
- The employer makes the distribution directly to the HSA trustee or custodian by the fifteenth day of the third calendar month following the end of the plan year, but after the employee becomes HSA eligible.
- The Qualified HSA Distribution does not exceed the lesser of the balance of the Health FSA or HRA on September 21, 2006 or the balance on the date of the distribution.
- After the distribution, there is either a zero balance in the Health FSA or HRA and the employee is no longer a participant in any non-HSA compatible health plan, or before the first day of the eligible distribution, the general purpose Health FSA or HRA is converted to an HSA-compatible plan for all participants.

The balance in the Health FSA or HRA as of any date is determined on a cash basis (i.e., expenses incurred that have not been reimbursed as of the date the determination is made are not taken into account).

Any amounts contributed to the HSA are excluded from the employee's income for income tax and employment tax purposes and are not taken into account in applying the maximum deduction limitation for HSA contributions. This provision is limited to one distribution with respect to each Health FSA or HRA of the individual.

If the individual does not remain in HDHP coverage during the testing period, the amount of the Qualified HSA Distribution is includible in the individual's gross income. The testing period is the period beginning with the month of the contribution and ending on the last day of the 12th month following such month. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual. A 10-percent additional tax also applies to the amount includible in the individual's gross income. An exception applies if the individual ceases to be an eligible individual by reason of death or disability.

**Example:** An individual has a balance in his Health FSA as of September 21, 2006 of \$2,000 and the balance in his or her account as of January 1, 2008 is \$3,000. The individual may distribute an amount not to exceed \$2,000 from his or her Health FSA to his or her HSA. If the individual ceases to be an eligible individual as of June 1, 2008, the \$2,000 contribution amount is included in his or her gross income and subject to a 10-percent additional tax. If instead, the distribution and contribution are made as of June 30, 2008 when the balance in the Health FSA is \$1,500, the amount of the distribution and contribution is limited to \$1,500.

## **IRAs**

For tax years beginning after 2006, an individual is allowed to make a one-time contribution to an HSA of an amount distributed from his or her IRA. The contribution must be made in a direct trustee-to-trustee transfer. Amounts distributed from the IRA are not includible in the individual's income to the extent that the distribution would otherwise be includible in income. Such distributions are not subject to the 10-percent additional tax on early distributions.

In determining the extent to which amounts distributed from the IRA would otherwise be includible in an individual's income, the aggregate amount distributed from the IRA is treated as includible in an individual's income to the extent of the aggregate amount which would have been includible in the individual's income if all amounts were distributed from all of the individual's IRAs of the same type (i.e., in the case of a traditional IRA, there is no pro-rata distribution of basis).

The amount that can be distributed from the IRA and contributed to an HSA is limited to the otherwise maximum deductible contribution to the HSA computed on the basis of the type of coverage under the HDHP at the time of the contribution. The amount that can otherwise be contributed to the HSA from the IRA in a given year is reduced by the amount contributed from the IRA. No deduction is allowed from the amount contributed from an IRA to an HSA.

An individual is allowed only one distribution and contribution during his or her lifetime, except when a distribution and contribution are made during a month in which an individual has individual coverage as of the first day of the month. In such a case, an additional distribution and contribution may be made during a subsequent month within the taxable year in which the individual has family coverage. The limit applies to the combination of both contributions.

If the individual does not remain an eligible individual during the testing period, the amount of the distribution and contribution is includible in the individual's gross income. The testing period is the period beginning with the month of the contribution and ending on the last day of the 12th month following such month. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual. A 10-percent additional tax also applies to the amount includible. An exception applies if the individual ceases to be an eligible individual by reason of death or disability.

These changes do not apply to amounts in simplified employee pensions ("SEPs") or SIMPLE retirement plans.

### **26. Does an employer have to meet any nondiscrimination rules if it makes contributions to its employees' HSAs?**

Yes, the employer must satisfy the following "comparability rules" or be subject to



subject to an excise tax (Q/A-27). If an employer makes contributions to employees' HSAs, the employer must make available comparable contributions (e.g. the same amount or the same percentage of deductible) on behalf of all employees with comparable coverage during the same period (e.g. single/family) with certain exceptions, as explained below.

For tax years beginning in 2007, an employer is now allowed to make larger HSA contributions for nonhighly compensated employees than for highly compensated employees. Highly compensated employees are defined under Code Section 414(q). (5% or greater owners and employees earning in excess of \$100,000 for 2007 and \$105,000 for 2008) The comparable contribution rules will continue to apply to the contributions made to nonhighly compensated employees so that the employer must make available comparable contributions on behalf of all nonhighly compensated employees with comparable coverage during the same period. This means that an employer can make a contribution to just the nonhighly compensated employees, but all the nonhighly compensated employees must receive the same contribution based on coverage.

For contributions made after 2006, family coverage has now been subdivided into additional categories of family HDHP coverage: self-plus-one, self-plus-two, and self-plus-three or more. An employer may contribute different amounts for each of these new categories of family coverage, but its contribution for the self-plus-three or more categories must be greater or equal to the contribution for employees in the self-plus-two-or-more category, and its contribution with respect to the self-plus-two category must be greater than or equal to the contribution in the self-plus-one category.

**Example:** An employer maintains and contributes to the HSAs of eligible employees who elect coverage under the HDHP. The HDHP has the following coverage options: self-only, self-plus-one, self-plus-two, and self-plus-three or more.

The employer contributes \$500 to the HSA of each eligible employee with self-only HDHP coverage, \$750 to the HSA of each eligible employee with self-plus-one HDHP coverage, \$900 to the HSA of each eligible employee with self-plus-two HDHP coverage and \$1,000 to the HSA of each eligible employee with self-plus-three or more HDHP coverage. The employer's contributions satisfy the comparability rules.

If an employee has not established an HSA at the time the employer funds its employees' HSA, the employer complies with the comparability rules for any contributions made on or after January 1, 2007 by contributing comparable amounts plus reasonable interest to an employee's HSA when the employee establishes the HSA, taking into account each month that the employee was a comparable participating employee. The determination of whether a rate of interest used by an employer is reasonable is based on all of the facts and circumstances. If an employer calculates interest using the Federal short-term rate as determined by the IRS, it will be deemed by the IRS to be a reasonable interest rate.

If an employee has not established an HSA by December 31 of any year or has not informed the employer of timely establishment, an employer will comply with the comparability requirements if it complies with a notice and contribution requirement.

To comply with the notice requirement for any calendar year, an employer must give all employees who have established an HSA or not informed the employer of such establishment a written notice stating that if each HSA-eligible employee, by the last day of February of the following year, both establishes an HSA and notifies the employer that he or she has done so the employee will receive a comparable contribution to his or her HSA for the calendar year. The employer must provide the notice no later than January 15 of the following calendar year.

To comply with the contribution requirement for a calendar year, an employer must make comparable contribution (plus reasonable interest) by April 15 of the following calendar year to the HSA to each eligible employee who establishes an HSA by December 31 and so notifies the employer that he or she has established an HSA, or if the employer has already contributed to that employee's HSA, the employer must not require the employee to provide additional notices to the employer in order to receive contributions.

Contributions to independent contractors, sole proprietors and partners in a partnership are not taken into account under the comparability rules.

Note: An employer's matching contributions to a cafeteria plan are not subject to the comparability rule. These contributions are subject to the cafeteria nondiscrimination rules.

If an employer makes contributions to an employee's HSA on condition of an employee's participation in health assessments, disease management programs, wellness programs or any other conditions and makes the same contributions to all employees who participate in the programs, its contributions will not satisfy the comparability rule unless all eligible employees receive that payment in currently taxable cash rather than having a nontaxable contribution to the HSA.

The comparability rule may apply separately to part-time employees (i.e., employees who are customarily employed for fewer than 30 hours per week) and former employees. This comparability rule does not apply separately to groups of collectively bargaining employees for contributions made before January 1, 2007, but does apply separately to groups of collectively bargaining employees for contributions made on or after January 1, 2007, if health benefits are the subject of good faith bargaining between such employee representatives and such employer or employers.

**Example:** An employer offers its employees an HDHP with a \$1,500 deductible for self-only coverage. It has collectively bargained and non-collectively bargained employees. The collectively bargained employees are covered by a collectively bargained agreement under which health benefits were bargained in good faith. For 2007, the employer contributes \$500 to the HSAs of all eligible non-collectively bargained

employees with self-only coverage under its HDHP. The employer does not contribute to the HSAs of the collectively bargained employees. The employer's contribution to the HSAs of non-collectively bargained employees would satisfy the comparability rules because they apply separately to its collectively bargained employees.

The comparability rule does not apply to amounts transferred from an employee's HSA or MSA or from a Health FSA, HRA or IRA or to contributions made through a cafeteria plan.

If an employer has some employees who work full-time during the entire calendar year and other employees who work full-time for less than the entire calendar year, it meets the comparability rules if the contribution amount is comparable when determined on a month-to-month basis.

**EXAMPLE:** If the employer contributes \$240 to employees to the HSAs for each full-time employee who works the entire calendar year, the employer must contribute \$60 to the HSA of a full-time employee who works three months of the year.

The employer is not required to make contributions to any current or former employees who are participating in an HDHP not sponsored by the employer. If an employer does make contributions for all eligible current or former employees whether or not covered under the employer's HDHP, it then must make comparable contributions to all eligible current or former employees participating in any HDHP, whether or not sponsored by the employer.

If an employer is making contributions to former employees after, 2006, it must take reasonable actions to locate any missing comparable former employees. These reasonable efforts include the use of certified mail, the Internal Revenue Service Letter Forwarding Program, or the Social Security Administration Letter Forwarding Service.

An employer must establish a consistent policy for making its comparable HSA contributions to employees' HSAs during the calendar year. If it makes HSA contributions for one employee at the beginning of the calendar year, it must make contributions at the same time for all other eligible employees.

## **27. What happens if the employer does not comply with the above comparability rules?**

If employer contributions do not satisfy the comparability rules during a period, then the employer is subject to an excise tax equal to 35% of the aggregate amount contributed by the employer to HSAs of the employer for that period. The excise tax is designed as a proxy for the denial of the deduction for employer contributions. In the case of a failure to comply with the comparability rule due to reasonable cause and not to willful neglect, the IRS may waive part or all of the tax imposed to the extent that the payment of the tax would be excessive relative to the failure involved. For purposes of the comparability rule, employers under common control are aggregated.

## **28. When can distributions be made from an HSA and what is the tax treatment of such distributions?**

Distributions from an HSA for “qualified medical expenses” of the individual and his or her spouse or dependents generally are excludable from gross income and can be made at anytime. In general, amounts in an HSA can be used for “qualified medical expenses” even if the individual is not currently eligible for contributions to an HSA.

In addition, administrative and account maintenance fees withdrawn from HSAs are treated as non-taxable distributions.

## **29. What are “qualified medical expenses”?**

Qualified medical expenses generally are defined as under Code Section 213(d) (including nonprescription drugs) and include expenses for diagnosis, cure, mitigation, treatment, or prevention of disease, including prescription drugs, transportation primarily for and essential to such care, and qualified long term care expenses but only to the extent that the expenses are not covered by insurance or otherwise.

Qualified medical expenses do not include expenses for insurance coverage except for:

- long-term care insurance,
- premiums for COBRA coverage and
- premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law.

For purposes of determining the itemized deduction for medical expenses, distributions from an HSA for qualified medical expenses are not treated as expenses paid for medical care under Code Section 213.

In addition, qualified medical expenses include health insurance premiums for individuals eligible for Medicare, other than premiums for Medigap policies. Qualified health insurance premiums include, for example, Medicare Part A, Part B or Part D premiums, Medicare HMO premiums, and the employee’s share of premiums for employer-sponsored retiree health insurance for individuals age 65 or older.

Generally, an HSA may only reimburse expenses incurred after the HSA has been established.

## **30. How are distributions from an HSA taxed after an employee is no longer an eligible individual?**

If an individual is no longer an eligible individual (e.g., the individual is over age 65 and enrolled in Medicare benefits, or no longer covered by an HDHP), distributions used exclusively to pay for qualified medical expenses continue to be excludable from the

individual's gross income.

**31. What are the consequences if an HSA account holder receives a distribution as the result of a mistake of fact due to a reasonable cause and repays the distribution to the HSA?**

If there is clear and convincing evidence that amounts were distributed from the HSA because of a mistake of fact due to reasonable cause, the account holder may repay the mistaken distribution no later than the April 15<sup>th</sup> following the first year that he or she knew or should have known the distribution was a mistake.

In this situation, the distribution is not subject to income tax or the 10% additional tax, and the repayment is not subject to excise tax on excess contributions.

The HSA trustee or custodian is not required to allow such repayment (for details, see Q/A-33).

**32. Can one spouse use his or her HSA to reimburse the medical expenses of the other spouse even if the other spouse has an HSA?**

Yes. However, both HSAs cannot reimburse the same expense.

**33. If distributions are made from the HSA for reasons other than the reimbursement of qualified medical expenses, what are the consequences?**

Distributions from an HSA that are not for qualified medical expenses are includible in the employee's gross income. Distributions includible in gross income are also subject to an additional 10-percent tax unless made after death, disability, or after the individual attains the age of Medicare eligibility (i.e., age 65).

Note: It is the employee that determines whether a distribution is taxable or nontaxable by reporting the treatment of the amount on Form 8889, an attachment to the employee's Form 1040 for the taxable year
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**34. Must HSA trustees or custodians who maintain HSAs or employers who make contributions determine whether HSA distributions are used exclusively for qualified medical expenses?**

No. HSA trustees, custodians or employers cannot determine whether HSA distributions are used for qualified medical expenses. Individuals who establish HSAs must make this determination and should maintain records of their medical expenses sufficient to show that the distributions have been made exclusively for qualified medical expenses and are therefore excludable from gross income.

### **35. What responsibilities does an HSA trustee or custodian have in maintaining an HSA?**

Except in the case of rollover contributions or trustee-to-trustee transfers, the trustee or custodian may not accept annual contributions to any HSA that exceed the sum of: (1) the maximum dollar limit for the year, plus (2) the catch-up contributions. All contributions must be in cash, other than rollover contributions or trustee to trustee transfers.

The trustee or custodian is responsible for determining whether contributions to an HSA exceed the maximum annual contribution for a particular account beneficiary. The account holder is responsible for notifying the trustee or custodian of any excess contributions and requesting a withdrawal of the excess contributions and any net income attributable to such contribution. The trustee or custodian is responsible for accepting cash contributions within the limits and filing required information returns (Form 5498-SA and Form 1099-SA).

The trustee or custodian is not required to permit the HSA account holders to return mistaken distributions to the HSA. It is optional. If it does allow such returns, the trustee or custodian may rely on the account holder's representations that the distribution was, in fact, a mistake.

The trustee or custodian must verify the HSA account holder's age and may rely on the account holder's representations as to his or her date of birth.

Lastly, the HSA trustee or custodian must follow the terms of the trust or custodial agreement and exercise those powers and responsibilities provided in that agreement.

### **36. What happens to an employee's HSA upon his or her death?**

Upon death, any balance remaining in the decedent's HSA is includible in his or her gross estate.

If the HSA account holder's surviving spouse is the named beneficiary of the HSA, then, after the death of the HSA account holder, the HSA becomes the HSA of the surviving spouse and the amount of the HSA balance may be deducted when computing the decedent's taxable estate, pursuant to the estate tax marital deduction. The surviving spouse is not required to include any amount in gross income as a result of the death; the general rules applicable to the HSA apply to the surviving spouse's HSA (e.g., the surviving spouse is subject to income tax only on distributions from the HSA for nonqualified expenses). The surviving spouse can exclude from gross income amounts withdrawn from the HSA for expenses incurred by the decedent prior to death, to the extent they otherwise are qualified medical expenses.

If, upon death, the HSA passes to a named beneficiary other than the decedent's surviving spouse, the HSA ceases to be an HSA as of the date of the decedent's death,

and the beneficiary is required to include the fair market value of HSA assets as of the date of death in gross income for the taxable year that includes the date of death. The amount includible in income is reduced by the amount in the HSA used, within one year after death, to pay qualified medical expenses incurred by the decedent prior to the death. As is the case with other HSA distributions, whether the expenses are qualified medical expenses is determined as of the time the expenses were incurred. In computing taxable income, the beneficiary may claim a deduction for that portion of the Federal estate tax on the decedent's estate that was attributable to the amount of the HSA balance.

If there is no named beneficiary of the decedent's HSA, the HSA ceases to be an HSA as of the date of death, and the fair market value of the assets in the HSA as of such date is includible in the decedent's gross income for the year of the death.

This rule applies in all cases in which there is no named beneficiary, even if the surviving spouse ultimately obtains the right to the HSA assets (e.g., if the surviving spouse is the sole beneficiary of the decedent's estate).

**37. Can the employer or an HSA trustee or custodian place any restrictions on the withdrawals from an employee's HSA?**

No. Since employees own their HSA, an employer or an HSA trustee or custodian cannot place any restrictions on withdrawals.

An HSA trustee or custodian can place reasonable restrictions on both frequency and the minimum amount withdrawn from an HSA. A trustee or custodian can prohibit distributions for amounts of less than \$50 or only allow a certain number of distributions per month.

An HSA trust or custodial agreement cannot restrict the account holder's ability to rollover or transfer an amount from that HSA.

HSA trustees or custodians or employers are not permitted to determine whether HSA distributions are used for qualified medical expenses. Individuals who establish HSAs must make that determination and should maintain records of their medical expenses sufficient to show that the distributions have been made exclusively for qualified medical expenses and are therefore excludable from gross income.

**38. Can an employee pledge or otherwise use any portion of the HSA as collateral for a loan?**

No. If an employee uses any portion of his or her account as collateral, the portion used will be deemed to have been distributed to the employee by reason of Code Sections 223(e)(2) and 408(e)(4). The value of the portion "distributed" would be included in an employee's income and taxed as ordinary income. In addition, if an employee is under

age 65, the portion "distributed" would also be subject to an additional 10% penalty tax imposed on premature distribution.

**39. Can an employee's HSA be transferred to another individual before death?**

Yes. An employee's interest in an HSA can be transferred under a divorce or separation agreement.

**40. Are there any limitations (e.g. size or type) on which employers can contribute to an HSA for its employees?**

No. Any employer may contribute to HSAs for its eligible employees as discussed above.

**41. Can self-employed individuals make or receive contributions to an HSA?**

Yes. There are no limitations. Any contributions made by a self-employed employee on his or her behalf are considered a deduction to determine adjusted gross income and reportable on the individual's Form 1040. It is not a deduction attributable to the self-employed individual's trade or business so it is not taken as a deduction on Schedule C, nor is it taken into account in determining net earnings from self-employment on Schedule SE.

**42. When does an HSA become an employee welfare benefit plan under ERISA?**

HSAs generally will not constitute employee welfare benefit plans established or maintained by an employer where employer involvement with the HSA is limited, whether or not the employee's HDHP is sponsored by an employer or obtained as individual coverage.

HSAs that meet the safe harbor for certain voluntary group or group-type insurance programs will not be considered ERISA welfare plans under DOL Regulations Section 2510.3-1(j). Under that section, a group-type insurance plan is not an ERISA welfare plan if: (1) it is a "group-type" insurance program offered by an insurer to employees or members of an employee organization; (2) no contributions are made by an employer or employee organization; (3) participation in the program is completely voluntary; (4) the sole functions of the employer or employee organization are, without endorsing the program, to permit the insurer to publicize the program to employees or members, to collect premiums through payroll deductions or dues checkoffs, and to remit them to the insurer; and (5) the employer or employee organization receives no consideration in the form of cash or otherwise in connection with the program, other than reasonable compensation, excluding any profit, for administrative services actually rendered in connection with the payroll deductions or dues checkoffs.



HSAs will be treated differently from other group plans if the employer makes employer or salary reduction contributions to the HSA. Making such contributions will not necessarily be significant in determining the status of HSAs under ERISA.

Because of the personal nature of HSAs (employees and beneficiaries have total control over the accounts), the Department of Labor has indicated that the making of employer contributions is not a relevant factor in determining whether an HSA is an ERISA welfare plan.

In addition, an HSA will not be an ERISA welfare plan if the establishment of the HSA on the part of employees is voluntary and the employer does not:

- limit the ability of eligible individuals to move their funds to another HSA, beyond restrictions imposed by the Code;
- impose conditions on the utilization of HSA funds beyond those permitted under the Code;
- make or influence the investment decisions with respect to funds contributed to an HSA;
- represent that the HSA is an employee welfare benefit plan established or maintained by the employer; or
- receive any payment or compensation in connection with the HSA.

An employer may limit the forwarding of contributions through its payroll system to a single HSA provider (or permits only a limited number of HSA providers to advertise or market HSA products) and such an arrangement would not be subject to ERISA, unless there were restrictions in the movement to another HSA.

An employer may also pay fees associated with an HSA that the employee would otherwise be required to pay and it would not make the employee's HSA an ERISA-covered plan

### **43. What reporting is required for HSAs?**

Eligible individuals must report contributions to their HSAs, contributions to their spouse's HSAs, any employer contributions, and distributions on Form 8889. Form 8889 is an attachment to an eligible individual's Form 1040.

Employer contributions are required to be reported in Box 12 of the Form W-2 of an employee, using code W.

In addition, HSA trustees and custodians must report contributions to an HSA for a year on Form 5498-SA and distributions for the year on Form 1099-SA.

**44. Are HSAs subject to COBRA coverage?**

No. Like MSAs, HSAs are not subject to COBRA coverage.

**45. Do the welfare fund reserve limits under Code Section 419 affect contributions by an employer to an HSA?**

No. Contributions by an employer to an HSA are not subject to the rules under Code Section 419. An HSA is a trust that is exempt from tax under Code Section 223. Thus, an HSA is not a "fund" under Code Section 419(e)(3) and, therefore, is not a "welfare benefit fund" under Code Section 419(e)(1).

**46. Can eligible individuals use debit, credit or stored-value cards to receive distributions from an HSA for qualified medical expenses?**

Yes.

**47. If an employer wants to cease making contributions to employees' HSAs, what procedures must it follow?**

It is suggested that the employer give advance notice to the employees and then stop making the contributions.

**48. What advantages and disadvantages do HSAs have over Health FSAs?**

**Advantages:**

- The "Use-It-or-Lose It" Rule does not apply.
- The "Uniform Coverage" Rule does not apply.
- Family members, employers and any other persons can make contributions on behalf of eligible individuals.
- Individuals own their accounts and the monies in the account can never be forfeited by the employer.
- Individuals can use accounts to pay medical expenses after they have left employment or retire.
- If an employer does not place restrictions on an employee's HSA, there are no ERISA reporting or disclosure requirements.
- There are no nondiscrimination rules for HSAs containing only employee contributions.
- Self-substantiation applies when paying claims.
- Amounts in an HSA can be held and distributed until after the individual's death.

- Spouses can use accounts to pay medical expenses after the eligible individual's death.
- Amounts in an HSA can be rolled over to another HSA.
- Amounts from a MSA can be rolled over or transferred to an HSA.
- Amounts in a Health FSA can be directly transferred to an HSA.
- Amounts in an HSA can be used by an employee for purposes other than reimbursing health care expenses.
- Self-employed individuals can contribute or have contributions made to an HSA.
- COBRA does not apply.
- HSA contributions can be made to a cafeteria plan and are not subject to the "use-it-or-lose it" rule, "uniform coverage" rule, or 12-month coverage rule,

**Disadvantages:**

- Yearly limits apply for contributions made to HSAs. There are no IRS-imposed limits for Health FSAs.
- A trust or custodial accounts are needed to hold deposits. No trust or custodial accounts are required for Health FSAs.
- An employer cannot control how amounts can be withdrawn from HSAs for reasons other than reimbursement of health care expenses.
- No outside substantiation is required for paying employee or dependent claims.
- If an employer makes contributions to HSAs on behalf of employees, it must make them for employees covered by an HDHP or it will be penalized.
- Amounts in HSAs can be transferred pursuant to a divorce or separation agreement.
- No monies in employees' HSAs can never be forfeited back to the employer, even if contributions are deemed in excess.

**49. What advantages and disadvantages do HSAs have over HRAs?**

**Advantages:**

- An employee can make contributions to his or her HSA.
- Family members, employers and any other third persons can make contributions on behalf of eligible individuals.

- Employees own their HSAs and the monies in the account can never be forfeited by the employer.
- If an employer does not place restrictions on an employee's HSA, there are no ERISA reporting or disclosure requirements.
- Self-substantiation applies when paying claims.
- Amounts in an HSA can be held and distributed after the employee's death.
- A spouse may use the deceased eligible individual's HSA to pay medical expenses after the eligible individual's death.
- Individuals can use accounts to pay medical expenses after they have left employment or retire.
- Amounts in an HSA can be rolled over to another HSA.
- Amounts in an HRA can be directly transferred to an HSA
- Amounts in an HSA can be used by an employee for purposes other than reimbursing health care expenses.
- Amounts from an MSA can be rolled over to an HSA.
- Self-employed individuals, partners and S corporation shareholders can contribute or have contributions made to an HSA.
- HSA distributions are not subject to nondiscrimination testing under Code Section 105(h).

**Disadvantages:**

- Amounts in an HSA cannot be forfeited by an employer.
- An employer cannot control distributions from HSAs.
- Yearly limits apply for contributions made to HSAs. There are no yearly IRS imposed contribution limits for HRAs.
- An employer cannot limit the carry-over of contributions to future years for HSAs.
- No substantiation is required in paying employee or dependent claims under HSAs.
- If an employer makes contributions to HSAs on behalf of employees, it must make them for employees covered by an HDHP or it will be penalized.
- HSA amounts can be transferred pursuant to a divorce or separation agreement.
- COBRA does not apply to HSAs.

## Chart Comparing Health FSAs and HRAs to HSAs

The chart below provides a summary of tax and related compliance issues applicable to HSAs as compared to Health FSAs and HRAs.

Plan Design / Compliance Issue	Health FSAs	HRAs	HSAs
<b>Internal Revenue Code</b>	§105, §106 & §125	§105, §106	§223
<b>Salary Reduction Funding</b>	Permitted	Not permitted, but can be offered with Health FSA	Permitted, and also can fund with deductible employee and employer contributions
<b>Carryover Of Unused Amounts</b>	Not permitted, unless HSA contributions made	Permitted	Permitted
<b>Medical Expenses Eligible For Reimbursement</b>	<p>Otherwise unreimbursed Code §§213(d) &amp; 105 medical expenses incurred during coverage period</p> <p>Cannot reimburse insurance premiums</p> <p>Cannot reimburse qualified long-term care services</p>	<p>Otherwise unreimbursed Code §§213(d) &amp; 105 medical expenses incurred while coverage in effect, including premiums for eligible health insurance and long-term care insurance</p> <p>Cannot reimburse qualified long-term care services as long as the HRA is a Health FSA</p>	<p>Otherwise unreimbursed Code § 213(d) medical expenses incurred while coverage in effect, but not expenses for insurance other than:</p> <ul style="list-style-type: none"> <li>• premiums for COBRA,</li> <li>• qualified long-term care contract, or</li> <li>• health plan while individual is receiving unemployment compensation.</li> </ul> <p>In addition, premiums for Medicare and retiree medical can be reimbursed</p>
<b>Cash-Outs Of Unused Amounts (If No Medical Expenses)</b>	Not permitted	Not permitted	Permitted, but such amounts are taxable and subject to 10% excise tax
<b>12-Month Period Of Coverage &amp; Prohibition Of Mid-Year Changes</b>	Applies, unless HSA contributions made	Not Applicable	Not Applicable
<b>Health FSA Uniform Coverage Requirement</b>	Applies — i.e., maximum amount of coverage must be available throughout coverage period (usually 12 months), unless HSA contributions are made	Not Applicable — i.e., coverage level may be prorated by plan design	Not Applicable
<b>Ability to Spend Down Unused Amounts after Termination of Active Participation</b>	Cannot use unused amounts to pay for claims incurred after termination; but COBRA rights may apply	HRA can permit unused amounts to be used until depleted to pay for claims incurred after termination; COBRA rights will also apply	Subject to certain restrictions, can permit unused amounts to be used up even after termination or retirement
<b>Claims Required to be Incurred During Current Period Of Coverage</b>	Applies, unless HSA contributions are made	To a certain extent, does not apply — i.e., claims incurred but not reimbursed in an earlier period while the individual was a participant can be reimbursed in subsequent year if individual still a participant	Does not apply, but claims must be incurred after HSA is established
<b>Expense Substantiation</b>	Required	Required	Not required by trustee, custodian or employer. – Individual must justify to IRS
<b>Claims Adjudication</b>	Required	Required	Not required
<b>Ordering Rules</b>	Required—Generally, Health FSAs must be payors of last resort vis-a-vis an HRA, however can draft HRA and Health FSA plan documents so HRA pays only after Health FSA amounts are exhausted	Generally, Health FSAs must be payors of last resort vis-a-vis an HRA, however can draft HRA and Health FSA plan documents so HRA pays only after Health FSA amounts are exhausted	In general, an individual is not eligible to have a HSA if, while covered under a HDHP, he or she is covered under any other health plan (including an HRA or Health FSA) which provides coverage for any benefit which is covered under the HDHP

Plan Design / Compliance Issue	Health FSAs	HRAs	HSAs
<b>Code §105(H) Nondiscrimination Requirement</b>	Applies, except for HSA contributions	Applies	Not Applicable –but if employer makes contributions, comparable contributions must be made for comparable participating employees
<b>Trust Account Requirement</b>	Not required by the Code but possibly by ERISA (no trust if Health FSA complies with ERISA Tech. Rel. 92-01 including that reimbursements are made directly out of the general assets of the employer)	Not required by the Code, but possibly by ERISA (no trust if HRA reimbursements are made directly out of the general assets of the employer)	Required
<b>Taxable Account Earnings</b>	Not if reimbursements are made directly out of the general assets of the employer and account funds are not set aside in a separate account – if funded with a VEBA, earnings are generally not taxable	Not if reimbursements are made directly out of the general assets of the employer and account funds are not set aside in a separate account – if funded with a VEBA, earnings are generally not taxable	Not if there is a qualified HSA trust or custodial account
<b>Funding Requirement</b>	Not required—no requirement to set funds aside in a separate account; but if an employer does so, ERISA's trust requirement may apply	Not required—employers can decide to fund (i.e. set aside funds) as potential liability increases, but any such funding can invoke ERISA's trust requirement if amounts are segregated from general assets	Employer and employee HSA contributions required to be made to in trust or custodial account
<b>ERISA Plan Asset Issues</b>	Even though a plan may be treated as "unfunded" under ERISA Tech. Rel. 92-01. , salary reduction amounts are plan assets for purposes of ERISA's exclusive benefit and fiduciary duty rules	Generally no plan assets unless funded (i.e., generally no plan assets if all reimbursements paid directly out of general assets of employer)	For plans with employer contributions, generally employer and employee contributions would be plan assets once placed in a HSA trust or custodial account
<b>ERISA Form 5500</b>	Applies – exception for small (fewer than 100 participants) unfunded plan	Applies – exception for small (fewer than 100 participants) unfunded plan	Applies, if employer places restrictions on the HSA trust or custodial account
<b>ERISA SPD and Other Disclosures, and Adherence To ERISA's Benefit Claims Procedures</b>	Required	Required	ERISA requirements may apply if employer imposes controls, but claims are self-reported and self-adjudicated, so claims procedures should not apply
<b>HIPAA</b>			
<b>Portability, Certificates Of Creditable Coverage, And Health Status Nondiscrimination</b>	Applies—exception for most Health FSAs funded with salary reductions	Applies—Health FSA exception generally not available	Applies to HDHP component
<b>Privacy</b>	Applies	Applies	Does not apply to employer-funded self-administered HSA or to HSAs receiving no employer contributions—would apply to HDHP component and HSAs that are not self-administered
<b>COBRA</b>	Applies—there is a special rule for qualifying Health FSAs	Applies—special rule for qualifying Health FSAs generally not available	Does not apply to HSA component, may apply to HDHP component