THINGS YOUR MOTHER NEVER TOLD YOU ABOUT HEALTH SAVINGS ACCOUNTS (HSAs)

By

Larry Grudzien

Attorney at Law

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Health Savings Accounts (HSAs) are individual-owned accounts that were created by the Medicare Prescription Drug, Improvement and Modernization Act of 2003. Used in conjunction with a High Deductible Health Plan (HDHP) they are designed to help individuals save and pay for qualified health expenses on a tax-free basis.

THE ADVANTAGES OF HSAs

Every month, new studies indicate that more and more employers are adopting high deductible health plans (HDHP) with Health Savings Accounts (HSAs). This adoption brings many advantages to both the employer and employee. These advantages include:

- Lowering of health care premiums under the HDHP for coverage for employees;
- Lowering the employer's administrative costs;
- Providing employees an opportunity to contribute for future health care expenses under the HSA for him or herself and his or her dependents;
- Providing any employee who contributes to an HSA with a tax deduction and/or an income tax and payroll tax free contribution;
- No monies in employees' HSAs can ever be forfeited back to the employer, even if contributions are deemed in excess;
- Providing an employer with an opportunity to contribute to eligible employees at any time and at any amount up to statutory limits;
- Giving employees immediate access to their HSAs for any reason;
- Providing for tax free distributions at any time for health care expenses incurred after the HSA has be established if the expense was neither reimbursed from any other source or deducted by the employee;
- Providing for reimbursement of health care expenses for his or her spouse after the employee's death, provided the spouse is named as the beneficiary under the HSA;
- Providing either a trust or custodial account that accumulates earnings on a tax free basis;
- Getting the employer out of the business of substantiating health care claims;
- Avoiding the requirements of ERISA (and COBRA and HIPAA) if the employer does not make participation in the HSA mandatory; and

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- Giving the employees who participate in an HSA complete portability in transferring their accounts at any time.

THE DARK SIDE OF HSAs

However, along with the advantages that HSAs provide, they have a number of disadvantages that should be explained to both employers and employees. HSAs are very complex and, if not administered properly, could cause adverse tax consequences to employees. The purpose of this article is to discuss these complexities and disadvantages of HSAs so that both employers and employees will have a complete picture.

Administration of the HSA

When an employer participates in an HSA program, the responsibility for administering the account is transferred to the employee. It is the employee who decides:

- Whether he or she is eligible to make contributions to an HSA;
- The amount of the eligible contribution to the HSA for any calendar year;
- The withdrawal of any excess contributions;
- How funds in his or her HSA will be spent; and
- Whether the distributions are taxable or nontaxable.

Employees are prohibited from delegating any of the above responsibilities to either the employer or the HSA trustee or custodian. Since the employee is in control of the HSA, he or she is responsible for reporting all contributions and distributions to the Internal Revenue Service (IRS) on his or her Form 1040. If the employee makes any errors, he or she must pay any additional tax or penalties to the IRS.

Eligibility to Participate

For any month, an eligible individual is defined under Internal Revenue Code (Code) Section 223(c)(1)(A) as any individual who:

- is covered only by a high-deductible health plan (HDHP) 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);
- is not enrolled in benefits under Medicare; and
- may not be claimed as a dependent on another person's tax return.

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If an employee is covered under a spouse's health plan, that coverage can affect the employee's ability to contribute to an HSA. This coverage also includes reimbursements under a spouse's Health FSA. For any month that a spouse could submit an employee's expenses for reimbursement, the employee is ineligible to make a contribution to an HSA. Since a spouse's coverage could change at any time during a calendar year, it is the employee's responsibility to determine whether he or she is eligible to make a contribution to an HSA. Neither the employer or the HSA trustee or custodian can make that determination for the employee. If an employee makes a contribution to an HSA when he or she is not eligible, the entire contribution is considered to be an excess contribution and the employee will be penalized for this contribution, as discussed below.

Amount of Contribution

The maximum amount that an employee can contribute to his or her HSA for years prior to 2007 is either the deductible amount under the employee's HDHP or the statutory maximum for the specified year, whichever is less. For years beginning in 2007 and after the maximum amount is based on the statutory limit for the employee's type of HDHP coverage. Additionally, if an employee is age 55 or older, he or she can make additional "catch-up" contributions.

If the employee has self-only HDHP coverage, his or her maximum contribution is $2,850 for 2007, $2,900 2008 and $3,000 for 2009. For family coverage it is $5,650 for 2007, $5,800 for 2008 and $5,950 for 2009. The maximum catch-up contribution amount is $500 for 2004, $600 for 2005, $700 for 2006, $800 for 2007, $900 for 2008, and $1,000 for 2009 and thereafter.

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, as provided in Revenue Ruling 2005-25.

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.

EXAMPLE: H and W are married. H is 58 and W is 53. 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 total contribution of $6,700

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($5,800 + $900 catch-up contribution) can be made to their HSAs. For 2009, a total contribution of $7,950 ($5,950 + $1,000 + $1000 catch-up contribution) 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, $5,800 for 2008 and $5,950 for 2009 even if one or both of the spouses have separate HSAs with family coverage.

Excess Contributions

If an employee contributes over the stated limits for the taxable year, these contributions are not deductible under Code Section 223(a). Contributions made by an employer over the limits are included in the employee's income.

In addition, an excise tax applies to contributions in excess of the maximum contribution amount, as provided in Code Section 223(f)(3). 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, as provided under Code Section 4973(g).

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 as provided in Code Section 223(f)(3).

Remember, it is the employee who must either report and pay the penalty or withdraw the excess to avoid the penalty. Neither the employer or the HSA trustee or custodian can be involved in the determination of the excess or withdraw of the excess. It is the employee who must initiate the process.

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Distributions

Since HSA contributions are nonforfeitable, it is the employee who controls when withdrawals can be made and for what purpose from the HSA. In Notice 2004-2, Q/A-24, the IRS indicates that an employee is permitted to receive distributions from an HSA at any time. In IRS 2004-50, Q/A-79, the IRS further states that trust or custodial agreements are prohibited from containing provisions restricting distributions only for an employee's qualified medical expenses and confirming that the employee is entitled to distributions for any purpose. Further, an employee may determine how the HSA distributions will be used.

Those withdrawals made by an employee from the HSA are nontaxable if they reimburse eligible medical expenses incurred by the employee and/or his or her dependents, after the HSA has been established, and are not otherwise reimbursed from any other source or deducted by the employee, as provided in Code Section 223(f)(2) and IRS Notice 2004-2, Q/As 25-26. This means that an employee could reimburse him or herself for eligible medical expense that occurred many years in the past. Since the employee has to report the treatment of withdrawals on his or her Form 1040, it is he or she who must justify the treatment to the IRS if he or she is audited by the IRS. Employees should be advised to keep evidence of any medical expenses incurred in the past.

Lack of Control

As indicated above, the employees is in complete control of his or her HSA. The employer has no control as to how the funds in the HSA are spent. Most HSA trustees or custodians give employees full access to their HSAs by issuing employees and their dependents checking accounts and/or debit cards. No one can stop an employee from using his or her HSA to buy chips and beer when picking up his or her prescription at the local drug store.

Under IRS Notice 2004-50, Q/A-79, an HSA trustee or custodian may place reasonable restrictions on both the frequency and the minimum amount withdrawn from an HSA. An HSA trustee or custodian may prohibit distributions for amounts of less than $50 or only allow a certain number of distributions per month.

Employee's inability to contribute

For some employers, they need to understand that there will be a segment of their employee population that can never afford to contribute to an HSA on their own. Unless the employer makes contributions to employees' HSAs, some employees will have no balances in their HSA. If an employer can not contribute to employees' HSAs as they adopt a high deductible health plan, there may come a day in the future when an employee indicates to the employer that he or she cannot pay his or her portion of medical expenses incurred under the

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employer's health plan, that he or she has not contributed to an HSA, and may lose a house or car because of these of unpaid bills.

Portability

Under IRS Notice 2004-50, Q/A-79, an HSA trust or custodial agreement cannot restrict the employee's ability to rollover or transfer an amount from that HSA. If an employer requires an employee to establish an HSA at a particular financial institution to either receive an employer contribution and/or contribute through payroll deduction, the employee has the ability to transfer funds to another HSA sponsored by another financial institution at any time. The first institution may make it difficult for an employee to make a transfer by imposing fees, but may not prohibit transfers or rollovers.

Use of Health Reimbursement Arrangements (HRA) or Health Flexible Spending Accounts (Health FSA) with HSAs

In Revenue Ruling 2004-45, the IRS provides that an employee can not participate in both a Health FSA, HRA and HSA at the same time, 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").

In adopting an HSA program, an employer must limit or eliminate the use of devises (Health FSAs) that their employees may have used for many years. There could be situations where some employees could be contributing less under an HSA than they did under a Health FSA, depending on the limits that the employer imposed under the Health FSA.

Transfer Because of Divorce

Under Code Section 223(f)(7), an employee's interest in an HSA can be transferred to an HSA established for the spouse (or ex-spouse) under a decree of divorce or separate maintenance, or a written instrument incident to such decree. In the event of such transfer, the distribution is not taxable to either the employee or spouse or subject to the 10% excise tax, and the spouse (or ex-

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spouse) becomes the account holder of the newly created HSA. An employee's interest in an HRA or Health FSA is not subject to this transfer requirement.

Uniform Coverage Rule does not Apply

For participants in Health FSAs, employers are required to reimburse them for the entire amount that they elected to defer for the plan year at any time during the plan year. This requirement is called the "uniform coverage rule" and is provided in Proposed Treasury Regulations Section 1.125-2, Q/A-7. This rule does not apply to HSAs. Participants may only receive reimbursement for expenses up to the balance contained in their HSA.

Under IRS Notice 2004-50, Q/A-60, an employer may accelerate HSA funding up to the maximum amount elected by employees to cover incurred claims, so long as (a) the employee has elected to make HSA contributions through a cafeteria plan; (b) the accelerated contribution is equally available to all participating employees throughout the year and is provided on the same terms and (c) the employee is required to repay the amount advanced by the end of the plan year.

Use of HDHP

To be eligible to contribute to an HSA for any month, an employee must participate in a HDHP. As discussed above, an HDHP is defined as a health plan under Code Section 223(c)(2)(A) 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 $1,100 for 2008 and $1,150 for 2009, and in the case of family coverage, the plan must have an annual deductible of not less than $2,200 for 2008 and $2,300 for 2009. Below the deductible limits, the employee is responsible for paying expenses, except for dental, vision and preventive care expenses. There can be no drug or office co-pays under HDHP below the plan's deductible.

Employees with chronic conditions may find that switching to an HDHP so that they are eligible to contribute to an HSA can be very costly. In many cases, employers who adopt HDHP are offering it as option to a traditional comprehensive health plan. However the employer, who is sponsoring this arrangement, has to be careful to avoid adverse selection in the traditional comprehensive health plan because younger, healthier employees may be attracted to the HDHP.

THINGS TO CONSIDER

Both employees and employees need to understand that the switch to providing health coverage through a HDHP and a HSA is a major change in the way coverage is provided to employees. The employee will have to take more responsibility in funding and spending health care dollars. One question to be

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considered is whether employees will hesitate in obtaining care since they will be spending more of their own funds. HSAs and HDHPs are part of a greater movement to reduce costs for active and retired employees and retirees through the use of “consumer driven health care” plans but employers should thoroughly understand the effects of these plans.

FINAL THOUGHTS

Before any employer establishes a HSA program for its employees, it should first consider the impact it will have on its employees. Additionally, employers will need to communicate to its employees their new responsibilities and duties. Employees should be educated to understand that they will suffer adverse tax consequences if their HSA is not administered properly and that they can not delegate their responsibilities under the HSA to either the employer or the HSA trustee or custodian.

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