SEGAL Bulletin

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First Guidance on Health Savings Accounts

The Medicare legislation that enacted a new outpatient prescription drug benefit also created health savings accounts (HSAs), a new tax-preferred personal savings account that, when coupled with a high-deductible health plan (HDHP), can be used to pay medical expenses.[1] The Treasury Department recently issued Notice 2004-2, which provides guidance on using HSAs.[2] The Notice addresses several common questions about HSAs.

BACKGROUND

HSAs, which can be offered effective January 1, 2004, permit an individual (except those eligible for Medicare), family member or employer to make tax-deductible contributions to an account that can be used to pay qualified medical expenses. Individuals must be covered by an HDHP with a minimum deductible of $1,000 for an individual and $2,000 for a family, indexed. The maximum out-of-pocket expense for an HDHP is $5,000 for an individual and $10,000 for a family. Individuals cannot be enrolled in another health plan that is not a high-deductible plan that provides any benefit covered under the HDHP, even if through a spouse's health plan.

Annual contributions to the HSAs are limited (determined on a monthly basis) to the lesser of 100 percent of the deductible under the HDHP or the Archer MSA maximum high deductible for the year in which the contribution is made. (For 2004, the Archer MSA maximum high deductible is $2,600 for an individual and $5,150 for a family). There is an additional catch-up contribution for those age 55 and older of $500 in 2004, increasing by $100 annually until it reaches $1,000 in 2009. Employers that contribute to an HSA must make comparable contributions on behalf of all employees covered by a HDHP. Amounts in Archer MSAs may be rolled over into HSAs. There are no limits on amounts that can accumulate in HSAs.

In addition to qualified medical expenses under Internal Revenue Code (IRC) Section 213(d), HSAs can be used to pay for:

- Health insurance for individuals receiving unemployment compensation,
- Continuation coverage under the Consolidated Omnibus Budget Reconciliation Act (COBRA),
- Retiree health insurance for those over age 65 (including Medicare Part B premiums), but not Medigap premiums, and
- Long-term care insurance premiums.

Distributions for non-health expenses would be subject to income tax and a 10 percent penalty. However, the penalty does not apply after death, disability or an individual attains Medicare eligibility. Except when the spouse is the designated beneficiary of an individual with an interest in an HSA, the HSA ceases to be an HSA as of the individual's date of death and becomes immediately taxable to the beneficiary.

GUIDANCE CLARIFIES THE BASICS

The guidance clarifies some points that were ambiguous in the law, including the following:

- Plan sponsors and trustees have no obligation to substantiate that distributions from an HSA were for qualified medical expenses. That is

[1] The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 is Public Law No. 108-173.

[2] The guidance, which was issued on December 22, 2003, is available online at http://www.irs.gov/pub/irs-drop/n-04-2.pdf

determined by the individual, subject to an audit by the Internal Revenue Service (IRS).

- HSAs must be funded through a trust or custodial account. Permissible trustees and custodians include banks, insurers and any entity that has been approved by the IRS to be a trustee of an individual retirement account or Archer MSA.
- HSAs may pay for both prescription and non-prescription drugs.
- An HDHP may be either insured or self-insured.
- Employer contributions are not subject to withholding from wages for income taxes and are not subject to FICA, FUTA or the Railroad Retirement Tax Act.
- Interest on earnings on amounts in an HSA generally may not be included in gross income while held in the HSA but is taxable (and may be subject to a 10 percent penalty) when distributed if not used for qualified medical expenses.
- HSAs are not subject to COBRA, but the HDHP would likely be subject to COBRA.
- Individuals can establish their own HSAs.

In preparation for regulations that Treasury expects to issue by June 2004, the Notice requests comments on several complex issues, including:

- How should HSAs be integrated with health flexible spending arrangements (FSAs) or health reimbursement arrangements (HRAs)?
- When HSAs are offered through a cafeteria plan, what is the relationship between the rules governing HSAs and those governing cafeteria plans (*e.g.*, rules regarding uniform coverage and coverage periods)? How would nondiscrimination rules apply?
- What preventive care benefits can be offered without being subject to the high deductible?
- What is the relationship between out-of-pocket expenses and reasonable lifetime maximums in health insurance plans?
- What corrective procedures must be followed when employer contributions exceed the statutory contribution maximum limit?
- Should there be transition relief in cases of inappropriate coordination of an HDHP with other coverage?

IMPLICATIONS

Because 2004 benefit elections are already final, sponsors are considering HSAs for possible implementation in 2005. They should examine whether an HSA plan option (instead of or as an alternative to a group health plan) makes sense for their workforce. Among the factors that they may wish to consider are the age and income level of the workforce, whether older employees may appreciate a retiree health savings vehicle, and what impact implementing an HSA option would have on the plan sponsor's existing benefit plans. Another consideration is that plan sponsors that set up an HSA (unlike an HRA) must make cash contributions.

Employers should consider HSAs as a vehicle for financing health expenses. An employer that plans to introduce them will need to be committed to new communications and administrative demands. Sponsors that want to introduce HSAs should begin looking at possible products and design options this spring.

As with all issues involving the interpretation or application of laws, plan sponsors should rely on their attorneys for authoritative advice on the new Medicare law. The Segal Company can be retained to work with plan sponsors and their attorneys to explore the possibility of setting up HSAs.

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