McGraw Wentworth

SPECIAL Alert

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In This Issue

In this sixth McGraw Wentworth Special Alert for 2008, we overview the IRS's latest guidance on HSAs. The guidance is called the "Grab Bag" guidance because it addresses an assortment of questions the IRS has received about HSAs.

If your organization offers a high deductible plan with an HSA, it is important to understand the rules that apply. Unfortunately, they are fairly complex. This latest round of guidance clarifies some of the gray areas that employers have struggled to administer.

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

"HSA Grab Bag Guidance"

The recently released IRS Notice 2008-59 clarifies various gray areas surrounding health saving accounts (HSAs). HSAs were created by the Medicare Modernization Act of 2003. These individually owned trusts are tax-favored savings accounts meant to cover health care expenses. Among other requirements, health saving account holders must be covered by a qualifying high deductible health plan. For more general information regarding health saving accounts, please read our *Benefit Advisor* at http://www.mcwent.com/Benefit_Advisor/2007/BA_Issue_3.pdf.

This latest guidance answers many questions the IRS has received regarding HSAs. The questions are separated into the following topics:

- Eligible Individuals
- High Deductible Health Plans
- Contributions
- Distributions
- Prohibited Transactions
- Establishing an HSA
- Administration

This *Special Alert* discusses these questions and answers. The practical guidance will be helpful for both employers offering HSAs and individuals contributing to HSAs.

Eligible Individuals

While employers determine the eligibility for the high deductible health plan they sponsor, the IRS sets the rules for the ability to contribute to an HSA. An eligible individual is one that meets the IRS requirements. An eligible individual is anyone:

1. Covered by a qualifying high deductible health plan.
2. Not covered by another health plan that is not a qualifying high deductible health plan (there are exceptions for certain plans providing limited coverage).
3. Not ***enrolled*** in Medicare.
4. Not claimed as a dependent under another person's tax return.

This definition seems simple enough; however, taxpayers have posed a number of questions.

Continued on Page 2

This section clarifies the following situations:

- *Suppose an employer sponsors an HRA (health reimbursement arrangement) that reimburses expenses for vision, dental, preventive care and the premiums for health coverage. Will any covered employees be disqualified from contributing to an HSA because of this HRA coverage?* The answer is no—for the most part. This HRA covers only permitted expenses. It is not considered comprehensive health coverage. The new guidance allows HRAs to cover health plan premiums and the IRS does not consider it to be comprehensive health coverage.

- *Suppose an employee is covered by a mini-med plan. Will the employee still be eligible to contribute to an HSA?* The answer depends on the benefits that the mini-med plan provides. In an example presented, the mini-med plan covered fixed amounts for each day of hospitalization, each office visit with a physician, outpatient treatment at a hospital, each ambulance use, and expenses for treating certain diseases. Anyone this mini-med plan covers cannot contribute to an HSA because of the comprehensive benefits this plan provides. Plans merely covering a fixed dollar amount for each day of hospitalization or a payment for a specified list of diseases, however, do not disqualify an individual from contributing to an HSA because those benefits are considered permitted insurance.
- *Suppose an employer reimburses the employee for expenses incurred under the medical plan before the employee has met the minimum HDHP plan deductible. Is that employee disqualified from contributing to an HSA?* If the employer directly or indirectly reimburses the employee for any medical expense, (other than preventive services) before the employee meets the minimum deductible, the employee is not eligible to contribute to the HSA.
- *Suppose an employee with family HDHP coverage also has a post-deductible HRA or FSA. Can the employee use it to pay or reimburse qualified medical expenses incurred after the employee satisfies the minimum annual HDHP deductible?* Employees can use these accounts to pay those expenses and not be disqualified from contributing to an HSA.
- *Suppose an employee is eligible for Medicare. Can the employee still contribute to an HSA?* Employees are not disqualified from contributing to an HSA merely because they are eligible for Medicare. If an employee ***enrolls*** in any part of Medicare, however, the employee is then disqualified from contributing to an HSA. This includes anyone enrolling in a Medicare Part D plan.
- *Suppose an employee has dual coverage. Would such coverage be permitted?* In the various examples, dual coverage is permitted when both plans meet the requirements of a qualifying high deductible health plan.
- *Suppose an employee qualifies for benefits through the Department of Veteran Affairs. Can that employee still contribute to an HSA?* In general, anyone receiving medical benefits from the Veterans' Administration in the previous three months cannot contribute to an HSA. However, preventive care or other permitted benefits, such as dental and vision services that may be covered by the VA, are disregarded when determining eligibility to contribute to an HSA.
- *Suppose an employee receives free or discounted health care through a clinic on the employer's premises. Is the employee still eligible to*

Continued on Page 3

Notable Thoughts

Don't run too fast through life. You only have one.

Bo Jackson

contribute to an HSA? In general, health care available at an onsite health clinic does not disqualify the employee from contributing to an HSA. However, the clinic must not provide significant medical benefits. The notice describes an employer clinic that offered the following free health care services to employees:

1. Physicals and immunizations.
2. Injecting antigens provided by the employee (allergy injections).
3. A variety of aspirin and other non-prescription pain relievers.
4. Treatment for injuries caused by accidents at the plant.

This type of onsite medical clinic would not disqualify an employee from contributing to an HSA.

On the other hand, the guidance also describes a different situation where the employer is a hospital. The employer has a plan that allows employees to receive care at the hospital. Under the plan, if an employee does not have health insurance, the care is free. If the employee has health insurance, any deductible or coinsurance requirements are waived. This type of plan would disqualify an individual from contributing to an HSA because these health benefits are considered significant.

High Deductible Health Plans

This section clarifies several issues relating to high deductible health plans and provisions that may affect the plan's qualifying status:

- Suppose an employee switches from family coverage to self-only coverage in the middle of a plan year and the carrier applies the family coverage deductible credits to the single deductible. Would the plan still qualify as a high deductible health plan? An HDHP may use any reasonable method to allocate the covered expenses incurred during the period of family coverage to satisfy the self-only deductible. The guidance lists a number of acceptable ways to allocate deductible credits:

  - Plan may allocate only expenses incurred by the employee to the self-only deductible for the year.
  - Plan may allocate expenses incurred during the family coverage for each person covered under the family arrangement.
  - If the family deductible was satisfied before the change to self-only coverage, the plan may treat the individual deductible as satisfied for the remainder of the plan year.

  The guidance requires the deductible expenses to be allocated reasonably and consistently and, except in the case of COBRA continuation, each deductible credit cannot be assigned to more than one person. The plan year must be 12 months.

- Suppose specific benefits have a separate or higher deductible. Are these expenses treated as out-of-pocket when determining the maximum out-of-pocket limits? For example, suppose a qualifying HDHP with a $3,000 deductible has a $5,000 separate deductible for substance abuse expenses and the substance abuse benefits are capped at $10,000. This plan would still qualify as a high deductible health plan. The limited substance abuse benefits do not disqualify the plan.
- In order to be considered a qualifying high deductible health plan, the plan must offer significant health plan benefits. A high deductible health plan that covers only inpatient hospital expenses would not be considered a qualifying high deductible health plan because the plan limits benefits to inpatient hospital care.

Continued on Page 4

Contributions

This section answers some of the questions the IRS has received on HSA contributions. Contributions to HSA accounts have a number of restrictions, so it is important for employers to understand the rules:

- *The maximum annual HSA contribution depends on the health plan coverage - is it self-only or family coverage?* The family contribution maximum applies even if covered dependents have other comprehensive health coverage. The key is that the accountholder cannot have any comprehensive health plan coverage other than the HDHP; if that were the case, the employee would not be allowed to contribute to an HSA.

- *How can employees determine the maximum contribution limit if they have self-only HDHP coverage at work and family HDHP coverage through their spouses?* In this situation, the official contribution limit would be the family coverage limit. If the husband and wife have separate HSAs, they can split the family limit between the two HSAs in any way they want; the key is that their combined annual contributions to their HSAs cannot exceed the annual family contribution limit.
- *If the married couple above both have family coverage but choose not to cover each other under their respective plans, what would the annual contribution maximum be in that situation?* The family maximum applies even if the family members are covered by two different HDHPs.
- Anyone currently not eligible to contribute to an HSA can still roll funds from one HSA to another HSA. No penalties will apply if the individual owns both HSAs and the funds are deposited into the new HSA without delay.
- As in the past, an employer may allow any contributions made from January 1 through the employee's tax filing deadline to be allocated to the previous year. This rule also applies to contributions made through Section 125. If the employer allows contributions beyond the December 31 end of the plan year, the employee must inform both the HSA custodian and the employer that certain contributions apply to the previous year. The employer should include only the contributions made during the actual calendar year in the employee's W-2. The employee must then report the contributions that apply to the previous tax year on Form 8889. The amounts may not line up with the amounts reported on the W-2. While it is nice the new guidance clarifies this situation, employers should be wary of allowing employees to credit HSA contributions to the previous year. The rules are fairly complex and easily misunderstood.
- If an employee and spouse are over 55 and both qualify for catch-up contributions, they should both establish HSAs. Because only the account owner can make catch-up contributions, they would each need to establish a separate HSA in order to contribute the maximum amount allowable under the catch-up contribution rules.
- An employer can ask a financial institution to return HSA contributions for an employee if the employee never became eligible to contribute. If the employer does not recover these contributions by the end of the tax year, then the amounts must be included on the employee's W-2 as gross income and wages for the year in which the employer made the contribution.
- An employer can also ask the financial institution to return contributions made in error if the contributions exceeded the annual maximum amount

Continued on Page 5

Notable Thoughts

A problem is a chance for you to do your best.

Duke Ellington (1899-1974)

permitted. If the employer does not recover these contributions by the end of the tax year, then the amounts must be included on the employee's W-2 as gross income and wages for the year in which the employer contribution was made.

- An employer cannot recoup contributions to an HSA if the employee ceases to be eligible to contribute to the HSA in midyear. The example cited had the employer making contributions to an employee's HSA as of January 1. In April, the employee's spouse enrolled in a comprehensive medical flexible spending account which disqualified the employee from HSA eligibility. The employee informed the employer in July to stop contributing because he or she was no longer eligible to contribute to an HSA. The employer cannot recoup contributions to the employee's HSA in this example. The employee is responsible for determining whether the contributions made to the HSA before losing eligibility are permitted. If the contributions exceed the amounts permitted, then, the employee is eligible to withdraw the excess contributions to avoid tax penalties.
- Any funds contributed to a spouse's HSA (who is not an employee of the employer) must be included in the employee's gross income. Pre-tax contributions through a Section 125 plan to a spouse's HSA are also considered gross income.

Distributions

Funds withdrawn from an HSA for qualified medical expenses are tax-free. Funds can be withdrawn for non-medical expenses as well. However, when funds are withdrawn for a non-medical expense, they are considered income and, in many cases, an additional 10% tax penalty will apply. The new guidance clarifies the following issues relating to distributions:

- Employees may use a debit card to access HSA funds to pay health care providers as long as the employees can also access their HSA funds in other ways. Other acceptable ways to access HSA funds may include online transfers, withdrawals from ATMs or checks. An employer must inform employees of all means to access their HSA funds.
- An HSA beneficiary may authorize someone else to withdraw funds from an HSA account. To obtain those funds, the authorized person must follow any procedures the account trustee or custodian specifies.
- Funds withdrawn to pay premiums for Medicare Part D plans are a tax-favored qualified medical expense only if the HSA account holder has turned 65. If the account holder has not turned 65 but the spouse has, any HSA funds withdrawn to pay the spouse's Medicare premiums are not considered tax-favored. The account holder must be 65 for Medicare premiums to be considered a tax-favored HSA expense.

Prohibited Transactions

The HSA regulations do define certain transactions prohibited under federal law. The new guidance offers the following clarifications:

- An account holder cannot directly or indirectly borrow funds from an HSA.
- An account holder cannot use HSA funds as collateral on a loan.
- If an account holder participates in a prohibited transaction, the HSA becomes disqualified. This means, the HSA stops being an HSA as of the first day of the tax year in which the prohibited transaction occurs. Any funds in the account are deemed distributed and both income tax and the additional 10% tax penalty apply.

Establishing an HSA

The new guidance also clarifies when an HSA is considered established. It might not seem like an important issue, but for an expense to be considered tax-favored under an HSA, the expense must be incurred after the HSA is established.

Continued on Page 6

The following information clarifies how to determine the date an HSA is established:

- Since the HSA is a tax-exempt trust, it is established according to state law. In general and in most states, for a trust to exist, an asset must be held in that trust. Therefore in most states, some funds must be deposited in the account for the trust to be established. State law also determines whether a trust can be established without the owner's signature.

- State laws determine the establishment date; earlier dates cannot be considered. For example, if HDHP coverage is effective before funds are set aside in the HSA, the effective date of HDHP coverage cannot be used as the effective date for the HSA.
- If the account holder establishes a second HSA, the second HSA is deemed established as of the first HSA effective date, providing the account holder has funds in the first HSA at any time during the previous 18 months.

Administration

The guidance addressing administration only includes one issue. HSA administrative and maintenance fees are not considered distributions. These fees are typically withdrawn directly from the HSA and are reported on the IRS Form 5498-SA in the fair market value of the HSA at the end of the taxable year.

Concluding Thoughts

Consumer driven health plans paired with HSAs are becoming a more accepted option in many workplaces. HSAs are certainly complex and the IRS is frequently asked questions about them. Reading this latest guidance may not be the most fun you have had all summer, but it certain clarifies some of IRS rules on managing HSAs.

If you have any questions about consumer driven health plans or health savings accounts, please contact your McGraw Wentworth Account Director. MW

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