

CLIENT ACTION BULLETIN

July 9, 2008

CAB 08-15

IRS Issues New Q's and A's on Health Savings Accounts

SUMMARY The IRS has issued new guidance on a range of issues relating to health savings accounts (HSAs). *Notice 2008-59* provides answers to 42 questions concerning eligible individuals, high deductible health plans (HDHPs), contributions, distributions, prohibited transactions, HSA establishment, and HSA administration. The guidance clarifies issues raised since the IRS released *Notices 2004-2* and *2004-50*, which were updated in August 2004, and responds to calls from practitioners and HSA sponsors for additional information.

DISCUSSION **Background on HSAs**

HSAs are individual accounts available to employees who participate in a high-deductible health plan (HDHP). An HDHP is a plan that, for 2008, has a minimum deductible of \$1,100 for self-only coverage (or \$2,200 for family coverage) and total out-of-pocket expenses limited to \$5,600 for an individual (or \$11,200 for a family). Contributions to HSAs, whether made by employees or their employers on a pretax basis, are limited this year to \$2,900 for an individual with self-only coverage (\$5,800 for family coverage), with a \$900 "catch-up" amount available for persons age 55 or older. Amounts from an HSA are distributed tax free when used to pay for qualified medical expenses.

To be eligible for an HSA, an individual must not be covered by any other health plan that is not an HDHP, although coverage by certain "limited purpose" HDHPs – such as limited-purpose health flexible spending accounts (FSAs) under a cafeteria plan or limited-purpose health reimbursement arrangements (HRAs) – would not disqualify an individual. An individual also must not be enrolled in Medicare and not be claimed as a dependent on another person's tax return.

Highlights of the New Guidance

Key issues covered by the IRS's *Notice* include:

- *Access to an employer's low- or no-cost, on-site health clinic* – An employee's eligibility for an HSA is not affected if the services provided at such a clinic are: permitted coverage (e.g., dental or vision benefits); preventive care; and not "significant" medical benefits. The IRS specifies that annual physicals, immunizations, allergy injections, nonprescription pain relievers, and treatment of on-the-job injuries are not significant benefits, but points out that hospital employees who receive all of their medical care at the hospital's facilities at no charge or with any insurance deductible waived would be ineligible for HSAs.
- *Employer recoupment of mistaken HSA contributions* – An employer may attempt to recover HSA contributions erroneously made to an employee under two circumstances: if an employee was not eligible for an HSA or if the amount contributed to an employee's HSA exceeds the statutory annual maximum permitted. In such cases, the employer is permitted to request the funds from the financial institution holding the money. If the amount is not recovered by the end of the taxable year, the employer must include the amount on the employee's Form W-2 as gross income for the year of the erroneous contribution. An employer may not recoup contributions made in error to an employee's HSA if the amounts do not exceed the annual limit, nor may it recoup amounts from an employee who ceases to be an HSA-eligible individual during a year.
- *Debit card restrictions* – An HSA may provide a debit card that restricts use for healthcare expenses, but enrollees must be able to access their HSAs for other purposes through online transfers, withdrawals from automatic teller machines, or writing

a check. Employers must notify employees about the availability of such other access to the HSA funds.

- *Paying Medicare Part D premiums, COBRA, and other medical coverage* – If HSA enrollees are at least age 65, they may use the funds to pay the premiums for Medicare Part D prescription drug coverage for themselves, their spouses, and their dependents. If the enrollee is younger but has a spouse older than 65, the spouse's Medicare Part D premiums are not eligible medical expenses, requiring that distributions used for such purposes be included in the enrollee's taxable income.

In addition, an enrollee may use the HSA to pay for a spouse's or dependent's premiums for healthcare continuation coverage (i.e., COBRA coverage) or for health insurance during a period when the spouse or dependent is receiving unemployment compensation.

- *"Mini-med" plans* – Coverage of an individual by an HDHP and a mini-med plan that pays for medical expenses incurred before the minimum HDHP deductible is satisfied will disqualify an individual from being eligible for an HSA, if the mini-med plan provides any disqualifying benefits. Thus, an individual will be ineligible for an HSA if he or she is covered by a mini-med plan that provides permitted benefits such as a fixed amount per day for a period of hospitalization and coverage for expenses for certain diseases, as well as impermissible benefits such as fixed amounts for doctor office visits, outpatient treatment, and ambulance usage.
- *State trust law application* – For purposes of determining when an HSA is "established," state trust laws apply. Thus, only qualified medical expenses incurred on or after the date an HSA is established may be paid on a tax-favored basis, not when HDHP coverage began.

Additional Areas Addressed

Among other topics the IRS's guidance addresses are: coverage under an HRA that pays health plan premiums for the employer's HDHP; permissible methods for an individual to switch from family to self-only HDHP coverage; medical expenses that a post-deductible health FSA or HRA may cover when determining whether the HDHP's deductible or the statutory minimum HDHP deductible has been met; reporting of employer contributions to an HSA that are made after the end of a tax year; designation of persons who may withdraw funds from an individual's HSA; the prohibition on individuals to take out loans from their HSAs and on HSA trustees to lend money or extend a line of credit to an HSA; the consequences to the HSA beneficiary and the employer sponsoring the HSA for engaging in a prohibited transaction; and the reporting of HSA administration and maintenance fees.

ACTION Employers that sponsor HSAs or that are contemplating sponsorship should familiarize themselves with the IRS's new guidance, for it answers many practical, administrative, and operational questions that have been raised since HSAs first became available in 2004 and expanded in 2007. Plan sponsors will have different responses to *Notice 2008-59*, depending upon the type of HSA established, the features and coverage it offers, the interaction with other health programs available to an individual, and how the HSA is administered. One key issue that must be taken into account, however, is the need for plan sponsors and individuals to establish an HSA in accordance with state trust laws, which generally require that a trust be funded. Plan sponsors also may have to assess their administrative systems and employee communications materials, modifying them if necessary.

For more information about the IRS's newest guidance on HSAs, please contact your Milliman consultant.