ALSTON+BIRD LLP

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# HEALTH SAVINGS ACCOUNTS (HSAS): NEW OPTION FOR CONSUMER-DRIVEN HEALTH CARE

The widely publicized Medicare Prescription Drug and Modernization Act (the "Act") contains provisions that would amend the Internal Revenue Code to allow medical savings account (MSA) vehicles called Health Savings Accounts (HSAs) for virtually anyone who has coverage under a high deductible health plan. In a surprising twist, the Act allows HSAs to be funded on a pre-tax basis through a cafeteria plan – opening a whole-new avenue for consumer-driven health care. Assuming passage with the HSA provisions intact, we have provided below a summary of the HSA provisions and the tax implications of such accounts. HSAs are included in Title XII, Section 1201 of the Act.

## WHAT IS A HEALTH SAVINGS ACCOUNT?

A "health savings account" (HSA) is an Archer MSA-like trust that is established by an "eligible individual" or by an employer for "eligible individuals" for the purpose of paying the qualified medical expenses of an eligible individual and his or her eligible dependents. HSAs are subject to the following general requirements:

- Participation in the HSA is limited to individuals who are participating in a statutorily defined high deductible health plan (HDHP) and who are not covered under any other health plan that provides the same benefits as the HDHP. Individuals may, however, be covered by "permitted" insurance or coverage in addition to the HDHP. Unlike Archer MSAs, HSAs are not limited to self-employed individuals and employees of small employers.

- HSA contributions can come from employers, eligible individuals or both. Employer contributions are excluded from income and individual contributions are deductible "above-the-line" to the extent such contributions do not exceed certain monthly limits established by the Act.

- HSAs may be offered under an employer's cafeteria plan thereby allowing employees to contribute to an HSA with pre-tax salary reductions. Unused contributions rollover from year to year (even if offered under the cafeteria plan) and are not lost when an employee moves from one employer to another. Archer MSAs are different from HSAs. Only an employer or individual may contribute to an MSA,

but not both, and employee MSA contributions may not be made on a pre-tax salary reduction basis.

- Distributions from an HSA are excluded from an individual's gross income to the extent the distributions are for medical care as defined by Code Section 213(d). Non-medical distributions are includable in gross income and generally subject to an additional 10% tax. The additional 10% tax does not apply in certain situations such as payments made after death, disability, or attaining the age of 65 (i.e. the Medicare eligibility date) and for "rollovers" that meet certain statutory requirements.

If the Act is passed, HSAs will be effective for taxable years beginning January 1, 2004. The following is a more detailed summary of the HSA requirements.

## PARTICIPATION REQUIREMENTS

*Generally*

Participation in an HSA is limited to an "eligible individual". An eligible individual is any individual covered under a high deductible health plan (HDHP) as of the first day of a month to the extent the individual is not also covered under a non-high deductible health plan that provides benefits covered by the HDHP. The individual may also be covered by "permitted" insurance or coverage. Individuals who are eligible for Medicare cannot continue to have contributions made for them and/or make contributions on a tax deductible basis; however, HSA funds that have accrued prior to the time the individual becomes eligible for Medicare may be used on a tax-free basis to pay for the individual's qualified medical expenses. Also, individuals who may be claimed as tax dependents of another individual cannot participate in an HSA. Eligible individuals who participate in an HSA are referred to as "Account Beneficiaries".

*Elements of a HDHP*

A HDHP is a health plan that has an annual deductible of not less than $1,000 for self-only coverage, and $2,000 for family coverage. Presumably, as with MSAs, family coverage with "embedded" individual deductibles will not qualify. The sum of the plan's annual deductible and other annual out-of-pocket requirements (other than premiums) cannot exceed $5,000 for self-only coverage and $10,000 for family coverage. If the HDHP is a network plan, the plan's annual deductible and out of pocket limitations for out-of-network expenses are not considered in determining whether the HDHP satisfies the statute's requirements. A plan will not fail to be treated as a high deductible health plan simply because it does not have a deductible for preventive care.

*"Permitted" Insurance and Coverage*

To be eligible for an HSA, an individual cannot generally have health insurance coverage (other than the HDHP as defined above) that provides coverage for any benefit which is covered under the HDHP. However, an eligible individual may maintain certain "permitted" insurance and/or other coverage in addition to HDHP coverage (even though such insurance or coverage provides benefits also covered by the HDHP).

Permitted insurance is:

- Insurance for which substantially all of the coverage relates to
  - insurance provided pursuant to workers' compensation law;
  - tort liabilities insurance;
  - property insurance (e.g., auto insurance);
- Insurance for a specified disease or illness (e.g., cancer insurance);
- Insurance that pays a fixed amount per day (or other period) of hospitalization (e.g., hospital indemnity insurance).

Permitted coverage also includes coverage provided (whether through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care. Thus, for example, an HRA or health FSA limited to such disregarded benefits may still be offered alongside an HSA.

*Ineligible Individuals*

Individuals who fall within one of the following categories may not participate in an HSA:

- Individuals covered under a spouse's or dependent's employer's health plan
- Individuals covered under a comprehensive major medical individual insurance policy
- Individuals covered under a Health FSA or HRA unless coverage under such HRA or FSA is limited to permitted benefits or specific benefits not provided by the HDHP.

## TRUST REQUIREMENT

HSA contributions must be deposited into a trust that meets the following requirements:

- The trustee of the trust is a bank, an insurance company, or another person (e.g. a third party administrator) who demonstrates to the satisfaction of the Secretary of the Treasury that the manner in which such person will administer the trust will be consistent with the HSA requirements.

- No part of the trust is invested in life insurance contracts

- The assets of the trust are not commingled with other property except in a common trust fund or common investment fund.

- The interest of an individual in the balance in his account is nonforfeitable.

## TAX TREATMENT OF HSAS

*Deductions of Individual Contributions*

An Account Beneficiary may take an above-the-line deduction (i.e., the amounts may be used to determine the individual's adjusted gross income BEFORE any itemized or standard deductions are considered) for contributions made to an HSA during any month of the individual's taxable year that the individual is an eligible individual. The permitted deduction cannot exceed the sum of the "monthly limitations" for such months. The monthly limitation for any month is 1/12$^{th}$ of the following amounts (subject to the reductions described below):

- For those with single coverage on the first day of the month, the lesser of the annual deductible under the HDHP or $2,250 ($2600 in 2004); or

- For those with family coverage on the first day of the month, the lesser of the annual deductible under the HDHP or $4,500 ($5150 in 2004).[1]

Employers may make an excludable contribution to the HSA subject to the above limits and a non-discrimination requirement. The non-discrimination requirement provides that comparable (e.g., same amount or same percentage of deductible) employer contributions must be made for all employees with the same coverage category (e.g., single/family). The test may be run separately for part-time employees (i.e., those who customarily work fewer than 30 hours). If the non-discrimination test is not satisfied, an excise tax applies.

For married individuals, if either spouse has family coverage, then both spouses are treated as having only that family coverage. If both the Account Beneficiary and the

[1] The monthly limitations are subject to a cost-of-living adjustment based on Code Section 1(f)(3) (but replacing 1992 with 1997)

spouse have family coverage, the lowest annual deductible is used for purposes of determining the monthly limitation. Thus, for example, non-HDHP family coverage (such as an HMO or low-deductible plan) on the part of *either* spouse would make both individuals ineligible for the HSA. The monthly limitation is increased by an "additional contribution amount" for Account Beneficiaries age 55 and older. This "additional contribution amount" is $500 for taxable years beginning in 2004, and increases by $100 each year, up to $1,000 for taxable years beginning in 2009 and thereafter.

The monthly limitation is reduced by the sum of the following two amounts:

- The aggregate amount paid to Archer MSAs by an Account Beneficiary during the taxable year, and

- The aggregate amount contributed to the Account Beneficiary's HSAs by an Account Beneficiary's employer(s) (to the extent such contributions are excluded from income).

*Tax Treatment of Excess Contributions*

Contributions by Account Beneficiaries are not deductible and employer contributions are not excluded from income to the extent that such contributions exceed the limits described above or they are made by or for an Account Beneficiary who is not an eligible individual. In addition, such excess contributions are subject to a 6% excise tax unless the excess contributions and any net income attributable to the excess contributions are returned to the individual before the last day of the period for filing the individual's tax return. Such returned excess contributions are included in the Account Beneficiary's gross income.

*Tax Treatment of Distributions from the HSA*

Distributions from the HSA are excluded from income to the extent that they are for "qualified medical expenses." A "qualified medical expense" is generally an amount for medical care, as defined in Code Section 213(d), for the Account Beneficiary, the Account Beneficiary's legal spouse (in accordance with state law but consistent with the federal Defense of Marriage Act), or the Account Beneficiary's tax dependents (as defined by Code Section 152) to the extent such amounts are not reimbursed by insurance or otherwise. Thus, as with employer-funded arrangements generally, over-the-counter medications (OTCs) could be an eligible medical expense.

With certain exceptions, qualified medical expenses also do not include payments for health insurance premiums. Therefore, neither the Account Beneficiary nor his or her

spouse or dependent can pay for HDHP coverage or other health coverage from the HSA. The exceptions are premiums for the following:

- COBRA coverage,
- A qualified long-term care insurance contract,
- Any health plan maintained while the individual is receiving unemployment compensation, or
- For those age 65 or over (i.e. those eligible for Medicare), any health insurance other than a Medicare supplemental policy.

If a distribution is made from the HSA for other than a qualified medical expense, (be it for the Account Beneficiary or his or her spouse or dependent) the distribution is included in the Account Beneficiary's gross income and is generally subject to an additional 10% tax. The 10% additional tax does not apply to any distributions from the HSA that are made in the following instances (however regular income tax does still apply):

- Payments made following the Account Beneficiary's death. See below for additional information concerning the status of HSAs following the death of the Account Beneficiary.
- Payments made after the Account Beneficiary becomes eligible for Medicare. This seems to give Medicare eligible individuals the option to use accrued HSA funds for medical expenses on a tax free basis or to receive the funds in cash without the additional 10% tax.
- Payments made after the Account Beneficiary becomes disabled as defined in Code Section 72.
- The return of excess contributions to the extent returned in accordance with the statute's requirements (see above).
- Rollover contributions to the extent the contribution is paid into an HSA within the statutory time frames (see below for additional information on rollover distributions).

Distributions attributable to employer contributions are not considered "wages" for income and employment tax purposes if it was reasonable to believe that such amounts would not be included in gross income. Practically speaking, employers (or perhaps the trust) will have no tax withholding responsibility on any distributions made from the HSA.

*Rollover Option*

Although amounts distributed from an HSA that are not used exclusively for qualified medical expenses are generally includible in gross income and subject to an additional 10% tax, "rollover" contributions are exempt from this requirement. A rollover contribution is any amount distributed from an HSA to an Account Beneficiary that is deposited into an HSA for the benefit of that beneficiary within 60 days after the distribution is received. Account Beneficiary's may take advantage of this rollover exception only once every twelve months.

In addition, rollovers between HSAs are permitted on a tax-free basis. Amounts from an Archer MSA can also be rolled into an HSA.

*Transfer of HSA to Another Individual*

An Account Beneficiary's interest in an HSA can be transferred under a divorce or separation instrument, and to the individual's spouse upon death, without being subject to taxation. However, if the interest is transferred to someone other than the beneficiary's spouse upon death, the account ceases to be an HSA and an amount equal to the fair market value of the account assets as of the date of the beneficiary's death is taxable income. Whether the amount is subject to income or estate tax depends upon whether the interest is transferred to the beneficiary's estate.

## INCLUSION OF HSAS IN A CAFETERIA PLAN

One of the fundamental requirements of the Code Section 125 cafeteria plan rules is that a cafeteria plan may not include a benefit that defers the receipt of compensation. This prohibition against benefits that defer the receipt of compensation would seem to prohibit the inclusion of HSAs in cafeteria plans because contributions made to the HSA can be carried over from year to year; however, the Act amends Code Section 125 to allow HSAs to be offered under a cafeteria plan. Therefore, individuals may make contributions to the HSA with pre-tax salary reductions even though such contributions may be carried over from year to year (which would otherwise violate the deferred compensation prohibition). The pre-tax salary reductions are treated as "employer" contributions and may not be deducted by an individual on his or her tax return.

One area of concern with regard to funding HSAs via pre-tax salary reduction is how the HSA non-discrimination test applies under (new) Section 4980G. Under 4980G, employers who make contributions to an HSA of an employee covered under a HDHP of the employer must make the same contributions to HSAs of all employees eligible for coverage under the employer's HDHP. If applied literally (without regard to the distinction between employer and employee pre-tax contributions) very few employers will be able to satisfy the non-discrimination requirement because participants may elect different

HSA amounts (i.e. the only way to pass under a literal interpretation is for each employee to elect to reduce the same amount). Fortunately, the Conference Committee Report indicates that the test should not apply to rollover amounts and amounts contributed through a cafeteria plan. Presumably, the IRS will also apply this standard.

As noted above, it is clear that HSA funds can be used to pay for long term care coverage. Presumably, this will be the case even if the HSA is funded with pre-tax salary reduction. However, this conclusion seems to run counter to the express exclusion of long-term care as a qualified benefit in Section 125(f). Presumably, these provisions can be reconciled by concluding that it is the HSA – not long-term care -- that is the "qualified benefit." As long as long term care is paid from the HSA account Section 125(f) would not be violated. Confirmation of this point from the IRS would be welcome.

Another area to be addressed by the IRS is what, if any, election changes are allowable with regard to HSA salary reduction elections. Historically, the IRS has been restrictive with regard to the kinds of election changes allowable for health FSAs. Will the same restrictions apply to HSA elections? If an HSA is offered mid-plan year can other elections be changed. These issues will need to be addressed.

## REVISIONS TO HR 2596 FROM THE CONFERENCE REPORT

If you have been following the status of HSAs, you should know that the Conference Report released on November 20, 2003 contains significant changes that have been made to the original HSA legislation contained in H.R. 2596. These changes include the following items:

- Health Savings Security Account ("HSSA"), which would have been available to individuals who were covered under a health plan meeting minimum deductible requirements, as well as to uninsured individuals, were eliminated.

- The original version established deductible limits from $1,000 to $2,500 for self-only coverage and $2,000 to $5,050 for family coverage. Also, the maximum out-of-pocket expense limitation under the HSA was originally $3,350 for self-only coverage and $6,150 for family coverage.

- The tax imposed on a distribution made for non-qualified medical expenses was originally 15%.

- The original version of H.R. 2596 contained a provision that would allow a rollover of up to $500 of unused Health FSA funds. This provision has been dropped.

## HSA ISSUES IN NEED OF FURTHER GUIDANCE

As with any new legislation, the Act leaves a few loose ends that require further IRS, DOL and related agency clarification.

One significant issue is the scope of third-party review that may be required to ensure that this valuable new employer-funded (e.g., via salary reduction) tax-free benefit is used for claims that satisfy the applicable statutory definition of medical care. One approach (as is the case with MSAs) would be to let participants adjudicate their own claims. Inappropriate withdrawals would be subject to an excise tax. On the other hand, the rules governing medical care under Section 213 are both confusing and subject to participant abuse.

The substantiation issue is, of course, not new with regard to salary reduction funded benefits. The IRS addressed this concern over participant abuse in its health FSA regulations. The preamble to proposed Regulation §1.125-2 states that the substantiation requirements imposed on health FSAs " are intended to protect the integrity of the distinction between the taxable treatment of personal medical expenses [under Code § 213] and the more favorable tax treatment of employer-provided health plan coverage..." Under Code § 213, personal medical expenses are subject to a 7.5% floor. In contrast, amounts that are excluded from gross income through Code §105 and §106 are not subject to such a floor. The IRS has recently re-affirmed the necessity for expense substantiation for employer-funded benefits in its recent "electronic payment card" and "OTC Drug" rulings. The same concerns that arise under FSAs arise (with even greater impact) with regard to HSAs.

With the recent growth of consumer-centric health plans in the market place and the expected proliferation of HSAs (as contrasted with the limited appeal of Archer MSAs), the stakes are high. HSAs (unlike Archer MSAs) can be funded with employee pre-tax salary reduction. Under HSA/cafeteria arrangements, taxable wages are converted to tax-free benefits. Left unchecked, salary reductions filtered through an HSA may be drawn on for non-medical expenses without proper application of income and excise tax provisions. It may be counter-productive to consumer-driven health care if HSA participants can withdraw funds at will for non-medical personal expenses. Given the interrelationship between HSAs and cafeteria plan funding under the Act it would seem that a good case can be made that HSAs (like FSAs and other cafeteria plan eligible employer provided coverage) should be treated differently than MSAs and that third party claims review is in order.

Other issues abound under other benefit provisions. For example, are the HSAs subject to ERISA? It seems that ERISA would apply (somehow) when the HSA is funded with employer (or employee pre-tax) contributions. Do the DOL claims rules apply to HSAs – presumably not. What, if any, annual reporting will be required for an HSA? Based on the MSA treatment under Section 106, it seems that a COBRA continuee (other than the covered employee) would not be entitled to a portion of the HSA upon a qualifying event. But clear direction on this issue would be helpful. Also, is the entity handling the HSA funds subject to HIPAA's privacy requirements (as a business associate or otherwise)? Presumably merely handling trust distributions would not raise HIPAA privacy issues – unless the entity is involved with claim adjudication.

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