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IRS Issues Guidance on 2006 HSA Changes, General HSA Issues and Excise Tax Returns

The IRS separately issued three pieces of guidance relating to health savings accounts (HSAs) – a notice on 2006 law changes relating to HSAs, a notice providing questions and answers on various issues that have arisen in connection with HSAs, and proposed regulations addressing how and when employers must file excise tax returns when HSA comparability and other requirements are not met.

Background

Health savings accounts are tax-exempt savings vehicles funded by individual and/or employer cash contributions that may be used to pay for qualified medical expenses. HSA contributions may generally be made by or on behalf of individuals with no health coverage other than that under a high-deductible health plan (HDHP). The first HSAs were implemented in 2004, and since then many questions have arisen. The IRS has issued numerous installments of guidance and Congress made HSA "improvements" in 2006.

The IRS has now issued Notice 2008-52, which provides guidance on how the 2006 statutory changes are to be administered. It also issued Notice 2008-59, which provides 42 frequently asked questions on a wide range of issues such as HSA eligibility, HDHPs, and contributions to and distributions from HSAs. Most recently, the IRS issued proposed regulations addressing how HSA comparability requirements apply in light of the 2006 statutory changes and the filing of excise tax returns when comparability and other requirements relating to health plans are not met.

Notice 2008-52

To be an "eligible individual" for purposes of making HSA contributions, an individual must be covered under an HDHP as of the first day of the applicable month and generally have no other health coverage. Under the law as initially enacted, an individual who was not an eligible individual for the entire year generally could only contribute an amount equal to the sum of the monthly limits (i.e., 1/12 of the statutory maximum plus any applicable catch-up contribution for individuals age 55 and older) for those months in which he or she was an eligible individual.

The Tax Relief and Health Care Act of 2006 amended the law to allow an eligible individual enrolled in an HDHP on the first day of the last month of his or her taxable year (December 1 for calendar year taxpayers) to be treated as having been enrolled in that HDHP and eligible for HSA contributions during each month of that year. Under this "full contribution rule," an individual who is HSA-eligible for only part of the year may contribute up to the annual limit. The 2006 law also provided that if the individual ceases to be an eligible individual within 12 months

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after the last month of the taxable year (the "testing period") for reasons other than death or disability, the contributions that otherwise could not have been made are taxable as ordinary income and subject to a 10% additional tax.

Notice 2008-52 provides useful guidance on how the full contribution rule applies to individuals who are HSA-eligible for only a portion of the year and the treatment of contributions made under this rule when an individual ceases to be eligible during the testing period.

Full Contribution Limit. For an individual who is an eligible individual on the first day of the last month of the taxable year, the contribution limit is the maximum annual contribution limit (plus any applicable catch-up contributions) if this amount is greater than the sum of the monthly contribution limits. The individual is treated as enrolled in whatever coverage (i.e., individual or family) he or she has on that day for the entire year.

The guidance clarifies that the full contribution rule applies only to individuals who are HSA-eligible on the first day of the last month of the taxable year. The maximum annual contribution of an individual who is not HSA-eligible on that day is limited to the sum of the monthly contribution limits.

> ***BUCK COMMENT**. Although the full contribution rule would enable mid-year hires to have the full year's HSA contribution made on their behalf, employers should carefully consider whether they want to permit this through their plans. Those employees who do not retain eligibility through the following tax year may suffer significant adverse tax consequences, which an employer would need to communicate carefully.*

Failure to Remain Eligible During the Testing Period. The notice clarifies that the testing period begins on the first day of the last month of the taxable year and ends on the last day of the 12th month following that month (e.g., the testing period for an individual who is eligible on December 1, 2008 will end on December 31, 2009). An individual who ceases to be eligible for HSA contributions during the testing period will have a portion of the contribution made in the prior taxable year included in income and will also have to pay a 10% penalty tax, unless the ineligibility is due to disability or death. Examples illustrate that this result applies when an individual becomes ineligible due to reaching age 65 and enrolling in Medicare (unless he or she becomes disabled before enrolling in Medicare).

The amount included in income and subject to the 10% additional tax is the difference between the actual amount contributed (i.e., the full contribution amount) and the contribution amount for which the individual was eligible (based on months of actual HSA-eligibility during the prior taxable year). Unlike excess contributions, this amount does not have to be withdrawn and, if left in the HSA, will continue to grow on a tax-free basis and may be used for medical expenses without incurring further taxes. Earnings on the amount are not included in gross income or subject to the 10% additional tax as long as they remain in the HSA or are used for qualified medical expenses. The notice clarifies that the 10% penalty applies even if the individual has reached age 65 (the 10% additional tax on distributions made for other than medical expenses discussed below is not imposed after an individual reaches age 65).

Excise Taxes. A 6% excise tax under Section 4973 applies to HSA contributions in excess of the maximum contribution limit unless withdrawn by the individual's tax filing due date (with extensions). The notice clarifies that

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this excise tax does not apply to amounts taxed and remaining in the plan due to an individual becoming ineligible to contribute to an HSA during the testing period and therefore cannot be withdrawn under the excess contribution rules.

Taxation of HSA Distributions not Used for Medical Expenses. Distributions from an HSA that are not used for qualified medical expenses are includible in income and subject to an additional 10% tax (unless the individual has reached age 65, is disabled or dies). The notice clarifies that amounts that are included in income and subject to the 10% penalty imposed when an individual ceases to be HSA eligible during the testing period will still be subject to these additional taxes if they are subsequently withdrawn and not used to pay for qualified medical expenses.

Timing for Establishing HSA. The notice indicates that the HSA may be established any time after the individual becomes eligible to contribute and contributions may be made in one or more payments before the individual's tax filing deadline for the taxable year. It also makes clear that although individuals may be treated as eligible individuals on the first day of the taxable year for purposes of the full contribution rule, expenses incurred before an HSA is established are not qualified medical expenses.

Reporting HSA Ineligibility. The IRS states that neither employers nor trustees are responsible for reporting an individual's becoming ineligible to contribute to an HSA.

Notice 2008-59

Notice 2008-59 contains 42 Q&As on various issues surrounding HSAs. Some of the more significant guidance is summarized below.

Effect of On-Site Clinic on Eligibility. To be eligible for HSA contributions, an individual can have no health plan coverage (other than HDHP) except for disregarded coverage and permitted coverage like dental, vision, and preventive care. The guidance provides that access to an on-site clinic that provides free or discounted health services will not cause an individual to be ineligible as long as the clinic does not provide "significant" benefits. Examples of services that are not considered significant are physicals, immunizations, allergy shots, non-prescription drugs and treatment of plant accidents. A hospital that provides free care to its employees who do not have health insurance or waives copays or deductibles for those with health insurance for care at its own facility would be considered to provide significant benefits and all employees would be ineligible for HSA contributions even if they did not utilize those services.

> ***BUCK COMMENT.*** *This guidance is welcome news for employers with on-site clinics who may have delayed offering an HSA program due to the uncertainty surrounding this issue. Nonetheless, the examples of services that are not significant are fairly limited and employers who offer a broader range of medical services through an on-site clinic or other healthcare facility may want to consider making HSA enrollees ineligible for those services.*

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Examples of Disregarded Coverage. The guidance indicates that a "mini-med" plan that provides both disregarded coverage (such as a fixed amount per day of hospitalization and coverage of specified diseases), and benefits that are not disregarded coverage or preventive (such as a fixed amount per out-patient treatment or a fixed amount per ambulance use) will cause an individual to be ineligible for HSA contributions.

> ***BUCK COMMENT.*** *This clarifies that disregarded coverage is limited to that specified in the law. Some employers offer mini-med plans to employees to supplement HDHPs that may include a broader range of fixed payments than just a fixed amount per day of hospitalization. Employers should review the benefits provided under any plans that supplement the HDHP to ensure they do not affect HSA eligibility.*

Medicare Eligibility vs. Enrollment. An individual enrolled in Medicare, including a Medicare Part D plan, is not an eligible individual for HSA contributions. The guidance clarifies that Medicare eligibility without actual enrollment does not affect eligibility to make HSA contributions.

Effect of Dependents' Coverage. The guidance provides that an individual with family HDHP coverage may contribute the statutory maximum for family coverage even if the individual's dependents have non-HDHP coverage, as long as the individual is not also covered under that non-HDHP plan.

High-Deductible Health Plans. An HDHP must have a maximum out-of-pocket limit, after which medical expenses are covered in full. The guidance indicates that an HDHP can have a separate (or higher) deductible for specific benefits that does not apply to the out-of-pocket limit as long as significant other benefits remain available under the HDHP. For example, a plan with a $3,000 deductible pays 100% of expenses after the deductible is satisfied up to a $1,000,000 lifetime maximum. However, benefits for substance abuse treatment are subject to a separate $5,000 deductible and are limited to $10,000. As long as the HDHP covers significant other benefits, no expense other than the $3,000 general deductible is treated as an out-of-pocket expense.

> ***BUCK COMMENT.*** *This is welcome guidance for employers who want to limit benefit coverage for certain treatments, consistent with coverage under other medical plans. However, the HDHP must provide significant benefits. According to the guidance, a plan that restricts benefits to expenses for hospitalization and in-patient care does not provide significant benefits and is not an HDHP.*

Expense Allocation on Coverage Switch. If an individual switches mid-year from a family HDHP to a self-only HDHP, the HDHP may use any reasonable and consistent method of allocating covered expenses incurred during the period of family coverage to satisfy the self-only deductible. The guidance provides several examples of possible approaches.

Post-Deductible FSA or HRA. With the exception of permissible benefits, a post-deductible FSA or HRA cannot reimburse any medical expense – even expenses not covered by the HDHP – until the HDHP deductible or statutory deductible has been satisfied.

> ***BUCK COMMENT.*** *Employers offering post-deductible FSAs or HRAs should ensure that their claims administration is consistent with this requirement.*

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Spouses' HSA Contributions. If both spouses are eligible individuals and one or both of the spouses have family HDHP coverage, the maximum annual HSA contribution limit for the couple is the statutory maximum for family coverage (regardless of whether each spouse's HDHP family coverage covers the other spouse). The contribution limit is divided between the spouses by agreement.

Becoming Ineligible for HSA Contributions. An individual who becomes ineligible to make HSA contributions may still make contributions through the date for filing a return (without an extension) with respect to the period during which he or she was eligible.

Contributions for Ineligible Individuals. An employer that contributes funds to the HSA of an employee who was never an eligible individual may request that the financial institution return those funds. However, if the funds are not returned before the end of the employee's taxable year, they must be reported by the employer as gross income on the employee's Form W-2.

Excess Contributions in Error. If an employer contributes funds to an employee's HSA that exceed the maximum allowable contribution due to an error, the employer may request that the financial institution return the excess amounts to the employer. Otherwise, the funds must be reported by the employer as gross income on the employee's Form W-2 for the year in which the contributions were made. However, if the amounts contributed in error are less than the maximum allowable contribution, the employer may not recoup any amounts from the HSA.

> ***BUCK COMMENT.*** *Presumably, the excess amounts must also be recovered by the end of the employee's taxable year. In any event, the guidance underscores employers' limited ability to secure refunds of HSA contributions, even when those contributions exceed statutory limits.*

Contributions for Individuals Who Become Ineligible. An employer may not recover amounts it contributes to an HSA after an employee becomes ineligible.

Distributions from HSAs. With regard to HSA distributions, the guidance provides that –

- An HSA can be administered through a debit card that restricts payment to health care as long as HSA funds are otherwise readily available through other means such as checks, online transfers or withdrawals from automatic teller machines.
- An HSA beneficiary can designate other individuals to withdraw funds from an HSA, subject to requirements of the trustee or custodian of the HSA.
- Once an account beneficiary has attained age 65, Medicare Part D premiums are qualified HSA medical expenses for the beneficiary, spouse and dependents. However, if the account beneficiary has not reached age 65, Medicare premiums for the spouse, even if the spouse has attained age 65, are not qualified medical expenses. (Previous guidance addressed Medicare Parts A and B premiums.)

> ***BUCK COMMENT.*** *Note that the determination of whether Medicare premiums are qualified expenses is based solely on the account beneficiary attaining age 65 and not actual enrollment in Medicare. If an account beneficiary is under age 65 but enrolled in Medicare due to disability, Medicare premiums are not a*

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qualified medical expense. Similarly, if the account beneficiary has attained age 65 but is not enrolled in Medicare, the Medicare premiums for the beneficiary's spouse would be a qualified medical expense.

- COBRA premiums for the account beneficiary's spouse and dependents, as well as for the account beneficiary, are qualified medical expenses.
- The account beneficiary may pay qualified HSA medical expenses for the beneficiary's child who is claimed as a dependent by the beneficiary's former spouse.

Prohibited Transactions. An account beneficiary may not borrow funds from his or her HSA, nor may an HSA trustee lend funds to an HSA, without violating the prohibited transaction rules. However, the guidance clarifies that an HSA trustee may offer a line of credit to an account beneficiary as long as it is not secured by the HSA and amounts in the HSA cannot be used to repay the loan.

Establishing an HSA. State law determines the date on which an HSA is established and a trustee generally cannot treat an HSA as being established before that date.

IRS Proposed Regulations on Comparability and Excise Tax Returns

Under Section 4980G, an employer who fails to make comparable contributions to the HSAs of all comparable participating employees will be subject to an excise tax equal to 35% of the aggregate amount contributed by the employer to the HSAs during the calendar year. The IRS has now issued proposed regulations that provide guidance on these HSA comparability requirements in light of the 2006 law changes and that also address how and when group health plans must file excise tax returns when comparability rules are not met. This filing guidance also applies to payment of other excise taxes imposed when an employer fails to satisfy requirements under Section 4980B (COBRA), Section 4980D (the HIPAA portability rules, the Mental Health Parity Act, the Newborns' and Mothers' Health Protection Act) or Section 4980E (failure to make comparable Archer MSA contributions).

BUCK COMMENT. *The comparability requirements do not apply to employers that offer their employees the opportunity to make HSA contributions on a pre-tax basis through a Section 125 cafeteria plan.*

Application of Comparability Requirements. The proposed regulations incorporate the change made in the 2006 law that permits, but does not require, an employer to make greater contributions with respect to nonhighly compensated employees than for highly compensated employees without violating the comparability rules. They also clarify that an employer does not have to utilize the full contribution rule for mid-year eligible employees, but if it does, it must do so consistently for all comparable participating mid-year eligible employees. For example, if an employer chooses to make only a pro-rata contribution for some mid-year hires (i.e., based on the actual number of months of eligibility), it may not use the full contribution rule for other mid-year hires.

The proposed regulations also clarify that an employer that limits qualified HSA distributions from a health FSA or health reimbursement account (i.e., the one-time rollover from an FSA or HRA to an HSA before January 1, 2012) to employees enrolled in its own HDHP does not have to offer qualified HSA distributions to employees that are

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not covered by its HDHP. If it does not impose this type of limit, it must permit all employees who are eligible individuals under any HDHP to make qualified HSA distributions.

Excise Tax Returns. The proposed regulations provide that Form 8938 must be used when an excise tax is imposed for failure to satisfy any of the requirements of Sections 4980B, 4980D, 4980F, or 4980G, and prescribe the timing requirements for filing the forms.

Effective Date. The proposed regulations are to be effective for calendar years beginning after they are published in final form, but the rules on the comparability requirements may be relied on for contributions made after January 1, 2007.

Conclusion

Notices 2008-52 and 2008-59 further clarify the operation of HSAs, and address a number of areas where guidance was needed. Employers should review this guidance and ensure that their programs, including claims and HSA administration, are in compliance. Employers also have the opportunity to take advantage of the additional flexibility provided in some areas.

The proposed regulations on comparability are of interest mainly to those who do not provide employees the opportunity to make HSA contributions through a cafeteria plan, but they also provide information on filing excise tax returns.

Buck's consultants are available to discuss this new guidance in more detail with you and review your HSA program's compliance.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.

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