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Health Savings Accounts: A Primer

By Jennifer R. Noel*

In the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Congress permitted the creation of Health Savings Accounts ("HSAs") by adding section 223. In Notice 2004-50 and Rev. Rul. 2005-25, the Service provided further guidance on the requirements and administration of HSAs. Most recently, in the Health Opportunity Patient Empowerment Act of 2006 (included in the Tax Relief and Health Care Act of 2006), Congress significantly expanded the attractiveness of HSAs. The discussion below is based on the law in effect following the 2006 legislative changes and includes the 2007 inflation-adjusted amounts provided in Rev. Proc. 2006-53.

HSAs are attractive because taxpayers can deduct contributions to them and later withdraw funds tax-free to pay for current and future medical care costs. Taxpayers who wish to take advantage of these benefits must understand HSA terminology, deduction amounts, and other rules.

TERMINOLOGY

An HSA is a trust, created in the United States, to pay the qualified medical expenses of the account beneficiary. Section 223(d). Section 223(d)(3) defines account beneficiary as the individual on whose behalf the HSA was created. The governing instrument creating the trust must meet five requirements. First, contributions, other than rollover contributions, must be in cash and are subject to dollar limitations. The aggregate contributions for a year cannot exceed the sum of the maximum annual amount allowed for family coverage set forth in section 223(b)(2)(B) and any annual additional contribution amount that section 223(b)(3) allows for individuals who are 55 and older. Second, the trustee must be a bank, an insurance company, or some other person able to demonstrate to the satisfaction of the Service that the trust will be administered consistently with the requirements of section 223. Third, none of the trust assets may be invested in life insurance contracts. Fourth, the assets must not be commingled with any other property unless they are invested in a common trust fund or a common investment fund. Fifth, the trust document must provide that the individual has a nonforfeitable right to the account balance.

The section 223 deduction for a contribution to an HSA is available only to an eligible individual. An eligible individual is any individual who is covered under a high deductible health plan as of the first day of a month. As a general rule, the individual must not have other health insurance coverage that is provided through a plan that is not a high deductible health plan and that would provide overlapping coverage for any benefit offered by the high deductible health plan. Section 223(c)(1). Certain types of insurance coverage, however, do not automatically disqualify an individual from being eligible to fund an HSA. If the other insurance coverage falls within the definition of "permitted insurance," or if it provides coverage for accidents, disability, dental care, vision care, or long-term care, it will not make an individual ineligible for the purposes of an HSA. Section 223(c)(3) divides permitted insurance into three categories: (A) coverage that substantially relates to (1) worker's compensation injuries, (2) tort liabilities, (3) injuries occurring as the result of the ownership or use of specific property, or (4) similar liabilities as provided by regulations; (B) insurance for a specific disease or illness; or (C) hospitalization insurance that pays a specific benefit amount based upon the time spent hospitalized. As noted above, an eligible individual may be covered by permitted insurance in addition to a high deductible health plan.

Although they might otherwise qualify as eligible individuals, two groups of taxpayers cannot deduct contributions to HSAs: (1) individuals who are claimed as dependents on the tax return of another, and (2) individuals entitled to Medicare benefits. Section 223(b)(6)-(7).

A high deductible health plan is one that (1) has an annual deductible of not less than $1,100 for single coverage and (2) provides that the sum of the annual deductible and all other out-of-pocket expenses due under the plan, other than the premiums, for covered benefits does not exceed $5,500 for single coverage. Both single coverage amounts are doubled for family coverage, which is defined as any coverage other than self-only coverage. Those plans that fall within the definition of permitted insurance, or provide coverage for accidents, disability, dental care, vision care, or long-term care, are excluded from the definition of a high deductible health plan. Section 223(c)(2).

For insurance plans that provide both a network of providers and benefits for services provided by out-of-network providers, the annual deductible for out-of-network services will not be considered for purposes of determining whether the plan is a high deductible health plan. As a result, the annual out-of-pocket limitations for out-of-network services will not cause a plan to fail to qualify as a high deductible health plan because the limitation exceeds the maximum sum to be paid as provided in section 223(c)(2)(D)(i).

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TAX DEDUCTION

Taxpayers can deduct amounts contributed to HSAs in computing adjusted gross income. The ability to fund HSAs on a pre-tax basis is one of their attractions. In addition, contributions to HSAs do not affect taxpayers' ability to contribute to tax-favored retirement vehicles, thus allowing taxpayers to accumulate funds for the future payment of health-related expenses as well as retirement. Section 223(e) provides that an HSA is exempt from income tax unless it ceases to be qualified as an HSA or it becomes subject to the section 511 tax on unrelated business income.

Section 223(b) imposes limitations on contributions the taxpayer may make to an HSA and amounts the taxpayer may deduct with respect to those contributions. The general rule is that an individual who has established an HSA may deduct an amount equal to the sum of the monthly limitations for the months during which he or she is an eligible individual. The monthly limitation is determined based upon whether the eligible individual has single or family coverage under a high deductible health plan, and will equal one-twelfth of the lesser of the annual deductible or the inflation-adjusted monthly limitation. If the individual has single coverage, the inflation-adjusted monthly limitation for 2007 is $2,850. If the individual has family coverage, the inflation-adjusted monthly limitation for 2007 is $5,650. For taxable years beginning after December 31, 2006, the Health Opportunity Patient Empowerment Act has increased the potential deduction. A taxpayer who is an eligible individual during the last month of the taxable year will be treated as having been an eligible individual during each month of that year. Section 223(b)(8). Individuals who turn 55 before the end of the taxable year may contribute and deduct an additional amount, which increases from $700 for taxable years beginning in 2006 to $1,000 for taxable years beginning in 2009 and thereafter. The 2007 amount is $800.The following example explains how these rules operate. If an individual has a single coverage HSA and a high deductible health plan with a deductible of $1,500, the monthly limitation for the HSA would be $125 per month. If the deductible is increased to $3,000 per year, the monthly limitation for 2007 would be one-twelfth of $2,850, the maximum permitted, or $237.50 per month. If the individual is an eligible individual for December 2007, the maximum permitted contribution and deduction amounts would be the full $1,500 or $2,850. If the individual is 55 or older, the monthly limitation is increased by one-twelfth of the additional contribution amount. In 2007, this is one-twelfth of $800, or $66.67 per month.

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The monthly limitation is reduced by any amounts paid to a section 220 Archer MSA on behalf of the individual or contributed to another HSA for the individual in the same year. Thus, the aggregate amount any individual may contribute to one or more HSAs or Archer MSAs and deduct for tax purposes is limited to the amounts outlined above. Section 223(b)(5) provides additional limits for married individuals. If either spouse maintains family coverage, both spouses are treated as having such family coverage, with the lower of the two deductibles, if the two plans provide for different deductibles. The monthly deduction limitation is divided equally between the two spouses unless they agree on a different division.

Certain additional rules apply to HSAs. No deduction is available for rollover contributions pursuant to sections 223(d)(4)(A) and 219(d)(2). Contributions are deemed to be made on the last day of the preceding taxable year, provided they are made on account of that preceding taxable year and are made not later than the date on which the income tax return for such taxable year is due, excluding extensions therefor, pursuant to sections 223(d)(4)(B) and 219(f)(3). Section 223 is to be applied without regard to any community property laws pursuant to section 223(d)(4)(D). A custodial account may be treated as a trust for purposes of section 223 provided that the account is held by a bank or another person who demonstrates that the account will be appropriately administered, pursuant to section 223(d)(4)(E).

EMPLOYER CONTRIBUTIONS

Section 223(d)(4)(C) refers to sections 106(d) and 219(f)(5) regarding contributions by an employer to an HSA. Section 106(d) provides that if an employee is an eligible individual, a contribution made by an employer to the employee's HSA will be treated as employer-provided coverage for medical expenses under a qualified plan, as long as the amounts contributed do not exceed the limitations set forth in section 223(b). Section 219(f)(5) provides that if section 106(d) does not apply, employer contributions to an HSA are treated as compensation to the employee, includible in the employee's gross income for the taxable year in which the contribution is made, without regard to whether the employee is entitled to a deduction for the payment under section 219.

DISTRIBUTIONS AND ROLLOVERS

Distributions from an HSA that are used to pay qualified medical expenses (as defined in section 213(d)) are excluded from the gross income of the account beneficiary. One important limitation applies: the HSA must be established *before* a medical expense is incurred in order for such expense to be reimbursed from the HSA and excluded from the beneficiary's gross income.

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Amounts that are withdrawn from an HSA but are not used for qualified medical expenses will be included in the beneficiary's gross income. If a beneficiary contributes amounts that exceed the annual contribution limits, but such excess contributions are returned before the due date of the beneficiary's income tax return for the year of contribution, the excess is not treated as a contribution or as a distribution. The returned amount itself is neither included in gross income as a distribution for non-medical purposes nor deductible as an HSA contribution. The net income attributable to the excess contribution must also be distributed with the excess contribution. The returned net income is included in gross income of the account beneficiary. If an excess contribution is made to an HSA and is not distributed from the HSA to the beneficiary prior to the above deadline, section 4973 imposes an additional six percent tax on the excess contribution.

The beneficiary will be subject to an additional excise tax equal to ten percent of any distributions that are not used for qualified medical expenses. The excise tax will not be imposed if a distribution is made after the beneficiary becomes disabled or dies, or after the beneficiary has reached the age for Medicare eligibility. Section 223(f)(4).

If an account beneficiary receives a distribution from an HSA and, within 60 days following the date of receipt, contributes the funds to a new HSA, those funds will be treated as a rollover contribution and will not be included in the beneficiary's gross income. An HSA beneficiary may make only one rollover during any one-year period, ending on the date that is one year after the date of receipt of the previous rollover distribution from an HSA. In other words, if an individual receives a distribution from an HSA on April 15, 2007, and rolls it into another HSA, any further distribution from an HSA for non-medical reasons prior to April 16, 2008, cannot be treated as a rollover contribution to an HSA.

Special rules apply for divorce and death. A transfer of an interest in an HSA that is made pursuant to divorce is not treated as a taxable event. The spouse who receives the interest is treated as having an HSA. When an account beneficiary dies, the HSA may be handled in one of two ways. If the designated beneficiary is the surviving spouse of the original account beneficiary, the HSA will be treated as if the surviving spouse had been the original account beneficiary. If someone other than the surviving spouse receives the deceased beneficiary's interest in the account, the account ceases to be an HSA as of the date of death. The account is then deemed to have been distributed for non-medical reasons. The amount is included in the recipient's gross income if the recipient is not the beneficiary's estate. The account is included in the deceased beneficiary's gross income for the beneficiary's last taxable year if the recipient of the account is the beneficiary's estate. If the deceased beneficiary incurred qualified medical expenses prior to death that were paid after death from the HSA, the amount included in the gross income of the recipient of the account is reduced by those payments. A recipient who must include the amount of the HSA in gross income can deduct the estate taxes attributable to the HSA's inclusion in the decedent's gross estate.

DISTRIBUTIONS TO HSAs FROM OTHER PLANS

The Health Opportunity Patient Empowerment Act added section 106(e) to cover distributions from flexible spending accounts and health reimbursement accounts to HSAs. One such distribution can be made before January 1, 2012, without causing the FSA or HRA to lose its status for purposes of sections 105 and 106. That act also added section 408(d)(9) to allow a limited trustee-to-trustee transfer from an individual retirement plan to an HSA. Only one such tax-free transfer may be made in the beneficiary's lifetime.

TERMINATION

If the beneficiary of an HSA engages in a prohibited transaction as defined in section 4975, the account will cease to qualify as an HSA as of the first day of the year in which the prohibited transaction occurs. Upon such termination, the account is deemed to have been distributed to the beneficiary. An account created by an individual and an account created by an employer for the same individual will be treated as two separate accounts. The effect of engaging in a prohibited transaction will apply only to the account that was directly affected. If the beneficiary of an HSA uses the account as security for a loan, that portion of the account that was used as security will be deemed to have been distributed to the beneficiary. The deemed distributions provided for in section 223(e)(2) are treated as amounts not used for qualified medical expenses, with the result that such deemed distributions will be subject to income tax and the additional ten percent excise tax discussed above.

CONCLUSION

The availability of HSAs provides an attractive planning opportunity for funding future health care costs. Individuals using HSAs can set funds aside on a pre-tax basis for health care expenses that may be incurred at any point following the creation of the account. Funds contributed to the HSA grow on a tax-deferred basis. Distributions, both before and after retirement, for health-related expenses are excluded from the taxpayer's gross income.

High-income individuals may find HSAs particularly attractive because contributions to HSAs are not subject to the section 213 medical expense deduction limitations, pursuant to which deductible medical expenses are limited to those that exceed 7.5% of AGI (and 10% of AGI for the alternative minimum tax). As a result, HSAs may be a useful planning tool available to individuals with the ability to create and fund them. ■