The Top 10 Funding Issues For HSA Account Owners And Employers

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Health Savings Account

- Described in section 223 of the Internal Revenue Code.
- A funded account, similar to an IRA.
- In order to contribute to an HSA, an individual must be covered under a "high-deductible health plan" ("HDHP") and may not participate in any other non-HDHP, subject to certain exceptions.

Funding Rules

- There are specific rules regarding funding the HSA that both account owners and employers should be aware of to maximize tax advantages and avoid tax penalties.

- We will discuss 10 of the most significant funding issues that affect both HSA account owners and employers who offer an HSA option.

#1: Using A Cafeteria Plan To Fund An HSA

- An employer may offer an HSA option as part of its cafeteria plan, allowing an individual to make HSA contributions on a pre-tax basis.
- Contributions may also be made by an individual on an after-tax basis, with a corresponding deduction available.
- Employers may structure *employer* HSA contributions through a cafeteria plan, or make contributions without using a cafeteria plan.

Using A Cafeteria Plan To Fund An HSA (continued)

- Cafeteria Plan contributions not subject to:
  - Withholding from wages for income tax
  - Federal Insurance Contributions Act (FICA),
  - Federal Unemployment Tax Act (FUTA), or
  - Railroad Retirement Tax Act.

- Offering HSA through Cafeteria Plan is convenient way to integrate the HSA into existing benefit options (i.e., Flex Dollar System).

Using A Cafeteria Plan To Fund An HSA (continued)

- Comparable contribution rules under Code section 4980G do not apply (the nondiscrimination requirements of Code section 125 apply instead).
  - Allows “matching” the amounts that an employee contributes.
  - Allows higher contributions for employees who participate in wellness programs.

Using A Cafeteria Plan to Fund An HSA (Continued)

- Must be *reasonable for an employer to believe* at the time a contribution is made that such contribution will not exceed the HSA limits that apply to a particular employee.

#2 Final Comparable Contribution Regulations

- The IRS recently issued final comparability regulations governing employer contributions to HSAs (Treas. Reg. § 54.4980G-1 through 5; 71 Fed. Reg. 43056 (July 31, 2006))
  - Generally require that an employer make similar contributions for all employees who participate in the employer's qualifying HDHP.
  - If the employer's contributions do not satisfy these rules, the employer will be subject to a 35% excise tax on all HSA contributions that the employer makes for a year.

Final Comparable Contribution Rules (continued)

- To fall within the “cafeteria plan exception,” allowing the employer's HSA contributions to be subject to the cafeteria plan nondiscrimination rules under Code section 125 rather than these comparability rules, an employer must:
  - Allow Pre-Tax Salary Reduction to HSA
  - Describe HSA option in written Cafeteria Plan

Final Comparable Contribution Rules (continued)

- Collectively-bargained employees are not subject to the comparable contribution rules.
- Family HDHP coverage may be subdivided into self plus one, self plus two, and self plus three or more, subject to the following:
  - Contributions with respect to the self plus two category cannot be less than contributions made under the self plus one category.
  - Contributions with respect to the self plus three category cannot be less than those made under the self plus two category.

#3 Impact of FSA/HRA Coverage

- An HSA account owner may generally not contribute to an HSA if he or she is also covered by a health Flexible Spending Arrangement and/or Health Reimbursement Arrangement except where:
  - FSA and/or HRA are *limited-purpose* arrangements that only pay or reimburse vision and dental expenses, or preventive care benefits; or
  - FSA and/or HRA only pay or reimburse medical expenses after the minimum annual deductible of the HDHP has been satisfied.

#3 Impact of FSA/HRA Coverage (Continued)

- In addition, an HSA account owner may contribute to an HSA while covered under an HRA where:
  - The employee "suspends" HRA participation by agreeing to forgo the payment or reimbursement from the HRA for medical expenses incurred during a particular HSA coverage period; or
  - An active employee is covered under a *retirement* HRA that only reimburses medical expenses incurred after the individual retires.

#3 Impact of FSA/HRA Coverage (Continued)

- With respect to FSAs, IRS Notice 2005-42 (May 18, 2005) allows a cafeteria plan to provide a maximum extended period of 2-1/2 months beyond the close of the plan year for participants to incur reimbursable claims for a particular plan year.
- IRS Notice 2005-86 (November 22, 2005), describes the interaction of the 2 1/2 month FSA grace period with the HSA eligibility rules.

#3 Impact of FSA/HRA Coverage (Continued)

- Notice 2005-86 states that the availability of the grace period renders *all* FSA participants ineligible to make HSA contributions during the grace period, unless:
  - the employer converts the general health FSA to a post-deductible or a limited-purpose FSA (i.e., an FSA that may be used only for dental, vision, or preventive care expenses), and
  - The limitation applies to *all* FSA participants (even those who do not have HSAs) during the grace period.

#4 Cost of Living Adjustments For 2007

- Each year, certain key figures relating to the amount that an individual can contribute to an HSA, and relating to the HDHP accompanying the HSA, are adjusted for inflation.
- The IRS (Income Tax & Accounting Branch) publishes a Revenue Procedure each year that contains the cost of living adjustments (COLA) for various Code sections, including Code section 223 (HSAs).
- The COLA increase is based upon information from the Bureau of Labor and Statistics - specifically, the consumer price index (CPI) for all urban consumers between the months of September and August.

#4 Cost of Living Adjustments For 2007 (continued)

- The HSA cost-of-living increases for 2007 are as follows:
  - The HSA contribution limits will be the lesser of: (i) $2,___ (self-only coverage) or $5,___ (family coverage), or (ii) the deductible under the HDHP. Also, as specified in Code section 223, individuals who are age 55 or over will be eligible for an additional catch-up contribution of $800 for 2007.
  - An "HDHP," will be defined as a plan with a minimum annual deductible of $1,___ for self-only or $2,___ for family coverage and an annual out-of pocket cap that does not exceed $5,___ for self-only coverage or $10,___ for family coverage.

#5 Approved HSA Trustees or Custodians

- The HSA account owner and employer should verify that the company with which it establishes a relationship to serve as an HSA trustee or custodian is a bank, insurance company or approved non-bank trustee or custodian.
- If not, the IRS could easily find that the account established is not an HSA, and that contributions to the account, as well as earnings, are taxable.

#6 Reporting to IRS (Form 8889 and others)

- Trustees or custodians are required to file a Form 1099 to report HSA distributions, and a Form 5398 to report HSA contributions.
- Employers are required to file a Form W-2.
  - Code "W" instructs the employer to report amounts contributed to the HSA.
- The employers and trustees/custodians file these forms with the IRS and provide a copy to the HSA account owner as well.
- The HSA account owner uses this information to complete the Form 8889, which the account owner sends to the IRS with the Form 1040.

#7 State Tax Issues

- If an HSA satisfies applicable federal requirements, a participant will not necessarily have the same favorable tax consequences under state law as under federal law.
- There are currently FOUR states in which the state tax consequences of HSA participation differ from the federal tax consequences:
  - Alabama,
  - California,
  - New Jersey, and
  - Wisconsin.
- Employers should be aware that payroll systems may need to be programmed to treat HSA contributions as taxable wages to comply with the law in those states.

#8 Impact of A Spouse's Health Coverage

- An account owner's ability to contribute to his or her HSA may be affected by his or her spouse's health coverage.
- If a spouse has separate health coverage, the following special rules may apply:
  - The account owner could be prohibited from contributing to an HSA at all.
  - The account owner could be required to limit the amount contributed to the HSA to the lowest of the two family deductibles.
  - The account owner could be required to limit the amount contributed to the HSA to the amount of the account owner's family HDHP deductible less the amount that is allocated to the spouse.

#8 Impact of a Spouse's Health Coverage (continued)

- These rules, and other variations, are described in IRS Notice 2004-50, Q&A-31, Examples 1-6.
- The spouse's medical expenses will always be considered "qualified medical expenses," allowing the account owner to take a tax-free distribution from his or her HSA to pay for such expenses, as long as the expenses are not reimbursed by another health plan.

#9 Impact of a Domestic Partner's Health Coverage

- Unlike a spouse, it appears that a domestic partner's health coverage will generally not affect an account owner's ability to contribute to his or her HSA, even where the employee covers the domestic partner under his or her HDHP.
- No rule requires domestic partners to divide an HSA contribution in the manner that married individuals are required to.
- It appears that a domestic partner who is covered under an account owner's HDHP could:
  - open his own HSA, and
  - contribute the full amount of the deductible or the statutory maximum (whichever is less).

#9 Impact of a Domestic Partner's Health Coverage (continued)

- Neither Treasury nor the IRS has indicated that there is any problem with an account owner covering a domestic partner under an HDHP and having the domestic partner's expenses count toward satisfying the family deductible under the HDHP, notwithstanding that these individuals are not related.
- However, unlike a spouse, an account owner may not take a tax-free distribution from his or her HSA to pay for his domestic partner's expenses, unless the domestic partner is a dependent under Code section 152.

#10 Deadline For Withdrawing Excess Contributions

- It is important for an account owner to be aware that if contributions to an HSA exceed the maximum, those contributions must be withdrawn before the due date for that individual's tax return (including extensions) in order to avoid a 6% excise tax.
- An excess contribution is recovered by taking a distribution from the HSA in an amount equal to the excess contribution and associated interest before the day that the income tax return for that year is due (including extensions).

Questions