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The Top 10 funding issues for HSA account owners and employers

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Regulation of Health Savings Accounts has been a hot topic since their creation in 2004, and it is likely that the HSA law will continue to evolve in 2006. New regulations and other guidance are expected from the IRS, and guidance may also be issued by other federal agencies. Also, it is possible that new state laws governing the tax consequences of HSAs will be passed.

A Health Savings Account, described in section 223 of the Internal Revenue Code (Code), is a funded account, similar to an IRA. Contributions may be made within specified limits by individuals who meet certain eligibility requirements and/or by employers or others on behalf of such individuals. Amounts in an HSA grow on a tax-deferred basis, and, if used for qualified medical expenses, may be distributed on a tax-free basis. 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.

Although the tax advantages of an HSA can be attractive, 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. Below is a discussion of 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 a 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. Alternatively, contributions may also be made by an individual on an after-tax basis, with a corresponding deduction available to the individual at year-end on the individual's tax return. Similarly, employers may structure employer HSA contributions through a cafeteria plan, or make contributions without using a cafeteria plan.

For an employer, there are several advantages to allowing employees to make HSA contributions through its cafeteria plan. First, HSA contributions by an employee through a cafeteria plan (provided they are within statutory limits) are treated as employer contributions that are not subject to withholding from wages for income tax or subject to the Federal Insurance Contributions Act (FICA), the Federal

Unemployment Tax Act (FUTA), or the Railroad Retirement Tax Act. Thus, by allowing employees to make HSA contributions through the cafeteria plan, the employer will reduce its liability for these taxes, as long as it is 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.

Second, offering an HSA through an existing cafeteria plan provides the employer with a convenient way to integrate the HSA into existing benefit options. For example, if the employer currently offers a flex dollar system, the employer could allow employees to use flex dollars to fund the HSA.

Finally, if the employer wants to use a creative method for establishing the level of HSA contributions that it will make, such as matching the amounts that an employee contributes or contributing more to employees who participate in wellness programs, an HSA must be offered through a cafeteria plan to avoid violating the comparable contribution rules under Code section 4980G, as described below. In that event, the nondiscrimination requirements of Code section 125 would have to be satisfied.

2. New proposed Comparable Contribution rules

The IRS recently issued proposed comparability regulations governing employer contributions to health savings accounts (HSAs). (Prop. Treas. Reg. 54.4980G-1 through 5; 70 Fed. Reg. 50233 (Aug. 26, 2005)). These rules apply only to employers who make contributions to employee HSAs, and 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.

These proposed regulations clarify many issues, but do not allow as much flexibility in plan design as employers will likely want. For example, under the proposed regulations, an employer cannot vary HSA contributions for employees who have different categories of family HDHP coverage (such as employee plus one versus employee plus family) without linking the contributions to a percentage of the deductible. Similarly, an employer cannot make additional contributions for employees who exhibit healthy behavior, such as completing a health risk assessment, or even make additional contributions for employees who suffer from illness or chronic conditions.

These restrictions on HSA contributions make the issue of how to make employer contributions through the cafeteria plan a significant one, because, according to guidance that the IRS issued in 2004, contributions that are made through a cafeteria plan are not subject to these rules (IRS Notice 2004-50, Q&A-47; 49). However, the proposed comparability regulations do not clearly establish what requirements must be satisfied for an employer to make a contribution through a cafeteria plan. It is expected that IRS will address this after it reviews public comments on its proposal, which were due at press time.

3. Impact of FSA/HRA coverage on ability to contribute to an HSA (including 2 1/2 month rule issue)

As a general rule, an HSA account owner may not contribute to an HSA if he or she is also covered by a health Flexible Spending Arrangement and/or Health Reimbursement Arrangement. However, Rev. Rul. 2004-45 (May 11, 2004), provides that an FSA and/or an HRA may be used with an HSA where:

the FSA and/or HRA are limited-purpose arrangements that only pay or reimburse vision and dental expenses, or preventive care benefits; or

- the FSA and/or HRA only pay or reimburse medical expenses after the minimum annual deductible of the HDHP has been satisfied. The FSA and/or HRA may have separate deductibles different from that provided under the HDHP. In that case, contributions to the HSA are limited to the lower of the deductibles.

In addition, the guidance provides that it is possible for an individual to be covered under both an HRA and an HSA where:

- an individual who is covered under an HRA "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 individual who is an active employee is covered under a retirement HRA that only reimburses medical expenses incurred after the individual retires.

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. After that time, any remaining FSA amounts must be forfeited. A plan is not required to adopt this rule, or to provide the full 2 1/2 month extension (i.e., a lesser period is acceptable). However, if the extension is made available, recent IRS guidance addresses how the extension affects an individual's ability to make HSA contributions during that period.

In Notice 2005-86 (November 22, 2005), the IRS describes the interaction of the 2 1/2 month FSA grace period with the HSA eligibility rules. The Notice takes the position 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) for all FSA participants (even those who do not have HSAs) during the grace period.

4. Cost of Living adjustments for 2006

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). This year, Revenue Procedure 2005-70, which announced COLA adjustments for 2006 was released on October 28, 2005. 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. This information is released mid-September, and it is possible to project at that time what the COLA increases are likely to be.

The HSA cost-of-living increases for 2006 are as follows:

- The HSA contribution limits will be the lesser of: (i) $2,700 (self-only coverage) or $5,450 (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 $700 for 2006.
- A "HDHP," will be defined as a plan with a minimum annual deductible of $1,050 for self-only or $2,100 for family coverage and an annual out-of pocket cap that does not exceed $5,250 for self-only coverage or $10,500 for family coverage.

5. Approved HSA trustees or custodians

It is important for both the HSA account owner and employer to 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 contributions to the account, as well as earnings, are taxable.

In IRS Notice 2004-2, Q&A-9 the IRS provides that any insurance company or any bank (including a similar financial institution as defined in Code section 408(n)) can be an HSA trustee or custodian. In addition, any other person already approved by the IRS to be a trustee or custodian of IRAs or Archer MSAs is automatically approved to be an HSA trustee or custodian. Other persons may request approval to be a trustee or custodian in accordance with the procedures set forth in Treas. Reg. 1.408-2(e) (relating to IRA nonbank trustees). The IRS publishes an annual list of all approved non-bank trustees and custodians (the most recent list was published in Announcement 2005-59).

6. Reporting to IRS (Form 8889 and others)

The IRS receives information about annual HSA contributions and distributions from three sources – the account owner, the employer, and the trustee. Accordingly, if the IRS identifies a discrepancy among these sources, it is likely that it will request further explanation from the account owner.

With respect to employer reporting obligations, the HSA legislation adds a W-2 reporting requirement. Code "W" instructs the employer to report amounts contributed to the HSA. In addition, trustees or custodians are required to file a Form 1099 to report HSA distributions, and a Form 5398 to report HSA contributions. 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.

Although most states follow the federal tax law with respect to determination of taxable income, some states do not provide tax benefits for HSA participation. There are currently seven states in which the state tax consequences of HSA participation differ from the federal tax consequences (e.g., where HSA employer contributions that are excludable for federal tax purposes are required to be included in income, where interest earned on the HSA is taxed, or where deduction for state tax purposes is not available). These are Alabama, California, Maine, Massachusetts, New Jersey, Pennsylvania, and Wisconsin. Accordingly, account owners in these states should be aware that, unless state law is changed, HSA contributions are currently subject to state income tax. In addition, 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. How a spouse's health coverage impacts contribution limits

An account owner's ability to contribute to his or her HSA may be affected by his or her spouse's health coverage. Specifically, 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. This would occur, for example, if the spouse has family coverage (i.e., coverage that includes the account owner) that does not satisfy the minimum deductible under Code section 223, making the account owner an "ineligible individual." (See IRS Notice 2004-50, Q&A-31, Example 4.)
- The account owner could be required to limit the amount contributed to the HSA to the lowest of the two family deductibles. This would occur, for example, if the spouse has other family coverage that satisfies the minimum deductible and out-of-pocket limitations under Code section 223 (making the spouse an "eligible individual"), but the spouse's other coverage has a lower deductible than the account owner's coverage. (See IRS Notice 2004-50, Q&A-31, Example 3.) This would also require the account owner to divide the amount that could be contributed to the HSA with the spouse, in accordance with Code section 223(b)(5).
- 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. This would occur, for example, if the spouse has other self-only coverage that satisfies the minimum deductible and out of pocket limitations under Code section 223 (making the spouse an "eligible individual"). In that event, both the account owner and the spouse are "eligible individuals" who are entitled to divide a contribution that is equal to the account owner's family deductible. (See IRS Notice 2004-50, Q&A-31, Example 2.)

These rules, and other variations, are described in IRS Notice 2004-50, Q&A-31, Examples 1-6. Whether or not the account owner's spouse is covered under the HDHP and/or has other coverage, the spouse's medical expenses will 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. See IRS Notice 2004-50, Q&A-36.

9. How a domestic partner's health coverage impacts contribution limits

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. Because 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).

Further, 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. Thus, in the absence of further guidance from IRS or Treasury, this appears permissible. Note, however, that 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). The following example illustrates how this would work.

Example: Joe contributes $100 more than the applicable contribution limit

or Joe's HSA for 2005 on a pre-tax basis through his employer's cafeteria plan. The $100 contribution earned $1 of interest during the year. If Joe takes a distribution from the HSA of $101 before April 15, 2006 (the due date for Joe's 2005 income tax return), then Joe will need to include the $100 in income for 2005, but will not need to pay the additional tax ($6) associated with making an excess contribution. Joe is required to include the $1 in interest that he received in 2006 in his tax return for 2006.

Although staying abreast of rules and developments in the HSA area can be a challenge, HSA account owners and employers must do so if they wish to obtain the maximum tax advantages that the accounts offer and to avoid tax and penalties.

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