

## INTERNAL REVENUE SERVICE ISSUES MORE GUIDANCE REGARDING HEALTH SAVINGS ACCOUNTS (“HSAs”)

In Notice 2004-50, the Internal Revenue Service issued extensive guidance regarding health savings accounts (“HSAs”). The guidance addresses such topics as eligibility to contribute to an HSA, permissible features of a high-deductible health plan, contributions to and distributions from an HSA, and non-discrimination requirements. Some highlights follow.

### Background

Generally, HSAs are tax-exempt trust accounts or custodial accounts to which pre-tax or deductible contributions are made by or on behalf of an eligible individual. Amounts accumulated in an HSA may be withdrawn tax-free to pay for the qualified medical expenses of the individual and the individual's spouse and dependents. (Amounts withdrawn for other purposes are taxable and may be subject to an excise tax.)

Although HSAs may be offered as part of a cafeteria plan and funded with pre-tax salary reduction contributions, HSAs are not subject to the same “use it or lose it” rule that applies to contributions to a health flexible spending account. HSA contributions that are not used in the year(s) of contribution, therefore, may be accumulated over a period of years and used in future years, including years after retirement. In addition, because HSAs are considered personal to the eligible individual, HSAs are portable (meaning that an eligible individual may use the same HSA even if the individual changes jobs). For further information regarding the general requirements, advantages and disadvantages of HSAs, see the Bond, Schoeneck & King, PLLC *Employee Benefits Law Information Memo* published in December 2003.

### Eligible Individual

Only “eligible individuals” are eligible to make or receive contributions to an HSA. The term “eligible individual” means, among other things, an individual who is covered under a “high-deductible health plan.”

In Notice 2004-50, the Internal Revenue Service clarified that only coverage for which the individual is actually enrolled will be considered in determining whether the individual is covered by a high-deductible health plan. This means that, although an individual may choose among available health coverage options, only the health coverage option in which the individual actually is enrolled will be considered. This is also true for individuals who are eligible for, but who are not actually enrolled in, Medicare Part A or Part B. If otherwise eligible, such individuals may contribute to an HSA. (Special rules apply in the case of health coverage and benefits provided to active and former members of the armed services.)

Although the high-deductible health plan generally must be the only health plan in which an individual is enrolled, an individual will not be disqualified from making contributions to an HSA merely because the individual has one or more insurance contracts for one or more specific diseases or illnesses, such as cancer, diabetes, asthma or congestive heart failure. Coverage under workers' compensation laws and tort liability insurance also may be provided without disqualifying an otherwise eligible individual.

Further, the Internal Revenue Service clarified that an individual may be covered by an employee assistance program, a disease management program and/or a wellness program without disqualifying an otherwise eligible individual. This will be true so long as the program does not provide significant benefits in the nature of medical care or treatment. Thus, coverage under most employee assistance programs and wellness programs will not render an individual disqualified for HSA contribution purposes.

### **High-Deductible Health Plan**

A high-deductible health plan generally must provide for a deductible that is at least \$1,000 for individual coverage and \$2,000 for family coverage. A high-deductible health plan also must have an out-of-pocket maximum (not counting premiums) of no more than \$5,000 for individual coverage and \$10,000 for family coverage.

In Notice 2004-50, the Internal Revenue Service indicated that a health plan can still qualify as a high-deductible health plan, even if the plan imposes a reasonable maximum on lifetime benefits. Amounts paid by the covered individual above the lifetime limit will not be treated as out-of-pocket expenses in determining the health plan's annual out-of-pocket maximum. Out-of-pocket maximums also do not include amounts paid for covered services that are in excess of usual, customary and reasonable amounts, "penalties" for failing to obtain pre-certifications for specific procedures, and increased co-insurance amounts for "out-of-network" services. Thus, a high-deductible health plan may actually require a covered individual to incur expenses in excess of the applicable \$5,000 or \$10,000 maximum.

### **Preventive Care**

Although a high-deductible health plan generally must impose a minimum deductible amount, certain "preventive care" may be provided with a lower or no deductible. Any specific treatment that is incidental or ancillary to a preventive care service also may be characterized as preventive care. For example, the removal of polyps during a diagnostic colonoscopy would be considered preventive care that can be paid for or reimbursed before the deductible in a high-deductible health plan has been satisfied.

Preventive care also can include drugs or medication, if taken by a person who has developed risk factors for a disease that has not yet presented itself or to prevent the recurrence of a disease from which a person has recovered. For example, the treatment of high cholesterol with cholesterol-lowering medications to prevent heart disease, or the treatment of recovered heart attack or stroke victims with enzyme inhibitors to prevent a recurrence, would constitute preventive care. Drugs or medications used as part of procedures providing preventive care services, including obesity weight-loss and tobacco cessation programs, also are preventive care.

### **Contributions and Distributions**

While contributions to an HSA on behalf of an eligible individual generally will be made by the individual and/or by his or her employer, any person may make contributions to the HSA of an eligible individual. This includes the eligible individual's spouse or other family members.

In cases where an eligible individual's employer makes contributions to the individual's HSA, the employer also must make "comparable" contributions on behalf of other eligible individuals. For this purpose, contributions must be made in the same dollar amount or in a uniform percentage of the deductible imposed by the high-deductible health plan. In

cases where employer contributions are made to an HSA through the employer's cafeteria plan, the non-discrimination rules applicable to cafeteria plans will govern.

With respect to distributions, the Internal Revenue Service clarified that distributions from an HSA to pay the qualified medical expenses of a spouse or dependent of an eligible individual are excluded from the individual's gross income, even if the spouse or dependent is covered by another health plan. Further, an HSA of one spouse may be used to pay for the qualified medical expenses of the other spouse, even if the other spouse has his or her own HSA. Distributions from an HSA, however, will not be excludible from income, if used to pay expenses already reimbursed by another health plan or by another HSA.

HSA account balances generally may not be used for the payment of insurance. Exceptions to this prohibition apply in the case of payments for retiree health insurance, COBRA premiums, long-term care premiums and health insurance while receiving unemployment. Whatever HSA balances are used for, an account beneficiary will be obligated to report both taxable and non-taxable uses as part of the beneficiary's individual income tax return.

### Further Guidance Expected

Although Notice 2004-50 addresses a number of HSA issues, further guidance will be provided by the Internal Revenue Service. That guidance is expected in late 2004 or early 2005.

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