



**Employee Benefits Institute of America Inc.**

"Helping employers and advisors know the law." *sm*

P.O. Box 334  
Seattle, WA 98133-04

Phone: (866) 775-32  
Fax: (866) 775-34  
FEIN#: 20-04117

## EBIA Weekly Archives

### IRS Releases Initial Guidance on Health Savings Accounts (HSAs)

From the December 23, 2003 EBIA Weekly

[IRS Notice 2004-2]

For a copy of IRS Notice 2004-2: <http://www.ustreas.gov/offices/public-affairs/hsa/pdf/notice2004-2.pdf> For a copy of the Treasury News Release: <http://www.ustreas.gov/press/releases/js1061.htm>

IRS Notice 2004-2 was issued on December 22, 2003, providing the first official guidance on health savings accounts (HSAs) since they were created as part of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (signed into law December 8, 2003). HSAs are new tax-favored vehicles that individuals covered by high deductible health plans (HDHPs) can establish (as early as January 1, 2004) to pay for certain medical expenses.

As was expected after the informal, non-binding comments from Treasury officials that we reported on last week (see our article at <http://www.ebia.com/weekly/articles/2003/FB031218ECFC.jsp>), this first round guidance is general in nature and primarily covers the non-controversial aspects of HSAs. The guidance is in question and answer format, and is similar in many ways to the initial guidance issued on medical savings accounts (MSAs) in 1996. Here we highlight some of the significant items, broken down by the subject matter headings contained in the guidance. Anyone interested in HSAs should read the guidance in its entirety.

#### What Are HSAs and Who Can Have Them?

==> Self-Insured Medical Plans. New Code Section 223 (which contains the rules governing HSAs) does not address the question of whether an employer's self-insured medical reimbursement plan can qualify as an HDHP. Here, the IRS gives us a one-word answer: Yes.

==> HDHP Benefits. Except for preventive care (not defined), an HDHP "may not provide benefits for any year until the deductible for that year is met." **[EBIA Comment:** If an HDHP provides benefits for prescription drugs or office visits before the deductible is met, it would fail to be an HDHP unless prescription drugs and office visits are considered to be preventive care. Note that the IRS has requested comments to help it define what constitutes preventive care.]

==> Embedded Deductibles. In defining an HDHP, the guidance confirms that family coverage can be designed with embedded deductibles (that is, a family deductible comprised of one or more individual deductibles) as long as no payments are made from the HDHP before the minimum family deductible required by Code Section 223 (\$2,000) has been met. See the helpful examples contained in Q/A-3 of the IRS Notice. This IRS position on embedded deductibles is consistent with MSA guidance contained in Rev. Rul. 97-20.

==> Other Health Coverage. The guidance (in Q/A-6) addresses other health coverage that an individual may maintain without losing eligibility for an HSA (e.g., coverage for dental and vision benefits, and certain "permitted insurance" like insurance for a specified disease). **[EBIA Comment:** The guidance merely tracks the existing statutory language. It does not address tricky questions like this one: Under a literal reading of Code Section 223(c)(1)(A)(ii)(II), can an individual have a separate low deductible plan that covers prescription drugs if the individual's HDHP does not cover prescription drugs?]

## How Can an HSA Be Established?

==> **Qualified HSA Trustees or Custodians.** Any 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. Otherwise, any person other than a bank or insurance company must request approval in accordance with the procedures set forth in Treas. Reg. Section 1.408-2(e).

==> **Proof of HDHP Coverage.** HSA trustees and custodians "may" require proof or certification that an account beneficiary is covered under an HDHP and is otherwise an "eligible individual." This is not a requirement, but an option.

## Contributions to HSAs.

==> **Timing of Contributions and Corrections.** Contributions to an HSA for a given taxable year can be made all at once or in any number of installments. They must be made no later than the due date for the employee's federal income tax return (without extensions).

==> **Tax Withholding.** The guidance confirms that employer contributions to an HSA will not be taxable income to the employee and will not be subject to withholding for federal income taxes or be subject to FICA, FUTA or the Railroad Retirement Tax Act. **[EBIA Comment:** There is an express statutory carve-out from income tax withholding and FUTA tax for employer contributions to HSAs (but no express carve-out from FICA tax). The statutory language contains a "reasonable to believe" standard that the Notice fails to mention. For example, with respect to income tax withholding, Code Section 3401(a)(22) provides that there is no withholding tax for "any payment made to or for the benefit of an employee if at the time of such payment it is reasonable to believe that the employee will be able to exclude such payment from income under section 106(d)."]

==> **Rollovers.** The new Code Section 223 provides that an HSA can accept rollovers from Archer MSAs and other HSAs. The guidance adds that rollover contributions do not need to be made in cash, presumably allowing for investments to be transferred without liquidation. Rollovers cannot be accepted from IRAs, health FSAs or HRAs.

==> **Catch-up Contributions.** The guidance offers helpful examples about the nuts and bolts of the HSA catch-up contributions that are available to eligible individuals who are age 55 or older. One example illustrates how a catch-up is calculated for an individual who is only eligible for part of the year (see Q/A-14). Another depicts how the catch-up rules would apply to a married couple (one of whom is over age 55) who each have family coverage (see Q/A-15).

## Distributions From HSAs.

==> **When Expenses Are Incurred.** In defining "qualified medical expenses" the guidance clarifies that the expenses have to be incurred after the HSA is established for the corresponding HSA distribution to be tax-free. But once the HSA exists, tax-free distributions can be used for qualified medical expenses even after the HSA account holder is no longer eligible to make HSA contributions. Medical care is defined in Code Section 213(d), and includes distributions for over-the-counter drugs (as described in Rev. Rul. 2003-102). The guidance also addresses the limited extent to which certain insurance premiums will be considered qualified medical expenses.

==> **No Third-Party Claims Determination.** One of the most anticipated items contained in this Notice is the confirmation that, like Archer MSAs, it is the individual account holder who is responsible for determining if an HSA distribution is for a qualifying medical expense, not the HSA trustee or custodian and not the employer.

## Other Matters.

==> **Non-Discrimination.** Employers who make contributions to their employees' HSAs must make comparable contributions on behalf of all comparable participating employees. The guidance provides an

example of comparability and confirms that the requirement does not apply to contributions made through a cafeteria plan (i.e., employee pre-tax salary reduction elections). **[EBIA Comment:** The guidance does not address whether, and to what extent, other cafeteria plan non-discrimination rules under Code Section 125 will apply to HSAs.]

**EBIA Comment:** There are no surprises in this first official word on HSAs, but with January 1, 2004, looming large, it is nice to have something more to go on than the statute itself. Recognizing that more guidance will be needed, the IRS requests comments on seven unanswered issues, including, for example: the appropriate standard for preventive care; the relationship between HSAs and health FSAs or HRAs; and the application of the non-discrimination rules in Code Section 125 to HSAs offered under a cafeteria plan. We will look forward to detailed guidance on the more complex HSA issues, which the Treasury Press Release indicates is planned for the summer of 2004. Also included in the Treasury Press Release is a press release from the Office of Personnel Management (OPM) declaring its intention to "identify opportunities" for including HSAs within the Federal Employees Health Benefits Program (FEHB). For more information on HSAs, subscribe to our new Fringe Benefits Manual, covering HSAs, HRAs, Archer MSAs, and more (more information and an order form are available at <http://www.ebia.com/static/publications/bookstore.html>).

Contributing Editors: EBIA Staff.

Copyright and Use Notice: The content of this article was current as of the date shown above (the date the article appeared in the EBIA Weekly). You should check with your legal counsel for up-to-date information and advice. EBIA does not provide legal advice. This article is copyrighted by EBIA and may not be reproduced, forwarded, posted on a website, or otherwise used without an EBIA-granted license to do so.

© Copyright 2006, Employee Benefits Institute of America Inc.