

American Select Health Savings Accounts (HSA's) Informational Q & A:

General Information

Starting January 1, 2004 the new innovative Health Savings Accounts (HSA's) changed the way millions of Americans save for their health care needs.

HSA's were established to receive tax-favored contributions by or on behalf of eligible individuals and amounts in an HSA may be accumulated over the years or distributed on a tax-free basis to pay or reimburse qualified medical expenses.

An HSA is established for the benefit of an individual, is owned by that individual, and is portable. Thus, if the individual is an employee who later changes employers or leaves the work force, the HSA does not stay behind with the former employer, but stays with the individual.

When setting up the actual Health Savings Account we recommend using either American Health Value at 800-914-3248, www.americanhealthvalue.com or MSA Bank at 866-357-5232, www.msabank.com. Both of these vendors are HSA qualified trustees or custodians. Information and application materials to set up your HSA account will be sent to you with your policy.

Who should consider an HSA?

Not everyone who qualifies for an HSA is pre-disposed to enroll in one. After all, an HSA requires a new way of thinking about an old problem—funding one's health care program. There are no co-pays for routine expenses such as those available in most group plans, and the "deductible" mechanism is certainly different than what is found on "traditional" plans.

We believe these traits to be common amongst people who are happy with their HSA. Check the list to see whether your clients meet the profile.

- ◆ A desire not to pay high health insurance premiums
- ◆ A desire to reduce federal income taxes
- ◆ The willingness to assume the risk inherent with a higher "deductible" amount (offset by lower premiums & taxes)
- ◆ The discipline to fund the savings account instead of over-paying for traditional health insurance

American Select Insurance Management Corporation, Empire Insurance Companies, and our associates are not licensed tax advisors. For tax-related questions, please consult your attorney or accountant for advice.

Questions & Answers:

What is an HSA?

An HSA is a tax-exempt trust or custodial account established exclusively for the purpose of paying qualified medical expenses of the account beneficiaries who, for the months for which contributions are made to an HSA, is covered under a high-deductible health plan.

Who is eligible to establish an HSA?

An "eligible individual" means, with respect to any month, any individual who: (1) is covered under a high deductible health plan (HDHP) on the first day of such month; (2) is not also covered by any other health plan that is not an HDHP (with certain exceptions for plans providing certain limited types of coverage); (3) is not entitled to benefits under Medicare (generally, has not yet reached age 65); and (4) may not be claimed as a dependent on another person's tax return.

What is a "high-deductible health plan" (HDHP)?

Generally, a high deductible health plan (HDHP) is a health plan with a minimum deductible of \$1,000 for self-only coverage and a \$2,000 for Family coverage for 2005. The maximum out-of-pocket expenses for allowed costs must not be more than \$5,100 for self-only coverage and no more than \$10,200 for family. The calendar year deductible and stop-loss maximum amounts are subject to annual cost of living adjustments as may be required by the Federal Government to coincide with the Consumer Price Index (CPI).

What kind of other health coverage makes an individual ineligible for an HSA?

Generally, an individual is ineligible for an HSA if the individual, while covered under an HDHP, is also covered under a health plan (whether as an individual, spouse, or dependent) that is not an HDHP.

What other kinds of health coverage may an individual maintain without losing eligibility for an HSA?

Permitted insurance is insurance under which substantially all of the coverage provided relates to liabilities incurred under workers' compensation laws, tort liabilities, liabilities relating to ownership or use of property (e.g., automobile insurance), insurance for a specified disease or illness, and insurance that pays a fixed amount per day (or other period) of hospitalization. In addition to permitted insurance, an individual does not fail to be eligible for an HSA merely because, in addition to an HDHP, the individual has coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care. If a plan that is intended to be an HDHP is one in which substantially all of the coverage of the plan is through permitted insurance or other coverage as described in this answer, it is not an HDHP.

How does an eligible individual establish an HSA?

Beginning January 1, 2004, any eligible individual can establish an HSA with a qualified HSA trustee or custodian, in much the same way that individuals establish a qualified IRA. No permission or authorization from the Internal Revenue Service (IRS) is necessary to establish an HSA. An eligible individual who is an employee may establish an HSA with or without involvement of the employer.

Who is a qualified HSA trustee or custodian?

Any insurance company or any bank (including a similar financial institution as defined in 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 MSA's is automatically approved to be an HSA trustee or custodian.

Does the HSA have to be opened at the same institution that provides the HDHP?

No. The HSA can be established through a qualified trustee or custodian who is different from the HDHP provider. Where a trustee or custodian does not sponsor the HDHP, the trustee or custodian may require proof or certification that the account beneficiary is an eligible individual, including that the individual is covered by a HDHP.

Who may contribute to an HSA?

Any eligible individual may contribute to an HSA. For an HSA established by an employee, the employee, the employee's employer or both may contribute to the HSA of the employee in a given year. For an HSA established by a self-employed (or unemployed) individual, the individual may contribute to the HSA. Family members may also make contributions to an HSA on behalf of another family member as long as that other family member is an eligible individual.

How much may be contributed to an HSA in calendar year 2005?

The maximum annual contribution to an HSA is the sum of the limits determined separately for each month, based on status, eligibility and health plan coverage as of the first day of the month. For calendar year 2005, the maximum monthly contribution for eligible individuals with self-only coverage under an HDHP is 1/12 of the lesser of 100% of the annual deductible under the HDHP (minimum of \$1,000) but not more than \$2,650. For eligible individuals with family coverage under an HDHP, the maximum monthly contribution is 1/12 of the lesser of 100% of the annual deductible under the HDHP (minimum of \$2,000) but not more than \$5,250.

How is the contribution limit computed for an individual who begins self-only coverage under an HDHP on June 1, 2005 and continues to be covered under the HDHP for the rest of the year?

The contribution limit is computed each month. If the annual deductible is \$5,000 for the HDHP, then the lesser of the annual deductible and \$2,650 is \$2,650. The monthly contribution limit is \$220.83 ($\$2,650 / 12$). The annual contribution limit is \$1,545.83 ($12 \times \220.83).

What are the “catch-up contributions” for individuals age 55 or older?

For individuals (and their spouses covered under the HDHP) between ages 55 and 65, the HSA contribution limit was increased by \$500 in calendar year 2004. For 2005 an additional \$100 may be added. This catch-up amount will increase in \$100 increments annually, until it reaches \$1,000 in calendar year 2009. As with the annual contribution limit, the catch-up contribution is also computed on a monthly basis. After an individual has attained age 65 (the Medicare eligibility age), contributions, including catch-up contributions, cannot be made to an individual's HSA.

If one or both spouses have family coverage, how is the contribution limit computed?

In the case of individuals who are married to each other, if either spouse has family coverage, both are treated as having family coverage. If each spouse has family coverage under a separate health plan, both spouses are treated as covered under the plan with the lowest deductible. The contribution limit for the spouses is the lowest deductible amount, divided equally between the spouses unless they agree on a different division. The family coverage limit is reduced further by any contribution to an Archer MSA. However, both spouses may make the catch-up contributions for individuals age 55 or over without exceeding the family coverage limit.

Example (1): Jack and Jill are married. Jack is 58 and Jill is 53. Jack and Jill both have family coverage under separate HDHPs. Jack has a \$3,000 deductible under his HDHP and Jill has a \$2,000 deductible under her HDHP. Jack and Jill are treated as covered under the plan with the \$2,000 deductible. Jack can contribute \$1,600 to an HSA ($1/2$ the deductible of \$2,000 + \$600 in catch up contributions) and Jill can contribute \$1,000 to an HSA (unless they agree to a different division).

Example (2): John and Sue are married. John is 35 and Sue is 33. John and Sue each have a self-only HDHP. John has a \$1,000 deductible under his HDHP and Sue has a \$1,500 deductible under her HDHP. John can contribute \$1,000 to an HSA and Sue can contribute \$1,500 to an HSA.

In what form must contributions be made to an HSA?

Contributions to an HSA must be made in cash. For example, contributions may not be made in the form of stock or other property. Payments for the HDHP and contributions to the HSA can be made through a cafeteria plan.

What is the tax treatment of an eligible individual's HSA contributions?

Contributions made by an eligible individual to an HSA are deductible by the eligible individual in determining adjusted gross income. The contributions are deductible whether or not the eligible individual itemizes deductions. However, the individual cannot also deduct the contributions as medical expense deductions under section 213 of the Internal Revenue Code.

What is the tax treatment of contributions made by a family member on behalf of an eligible individual?

Contributions made by a family member on behalf of an eligible individual to an HSA (which are subject to limitations) are deductible by the eligible individual in computing adjusted gross income. The contributions are deductible whether or not the eligible individual itemizes deductions. An individual who may be claimed as a dependent on another person's tax return is not an eligible individual and may not deduct contributions to an HSA.

What is the tax treatment of employer contributions to an employee's HSA?

In the case of an employee who is an eligible individual, employer contributions (provided they are within the limitations) to the employee's HSA are treated as employer-provided coverage for medical expenses under an accident or health plan and are excludable from the employee's gross income. The employer contributions 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. Contributions to an employee's HSA through a cafeteria plan are treated as employer contributions. The employee cannot deduct employer contributions on his or her federal income tax return as HSA contributions or as medical expense deductions under section 213 of the Internal Revenue Code.

What is the tax treatment of an HSA?

An HSA is generally exempt from tax (like an IRA or Archer MSA), unless it has ceased to be an HSA. Earnings on amounts in an HSA are not included in gross income while held in the HSA (*i.e.*, inside buildup is not taxable).

When may HSA contributions be made? Is there a deadline for contributions to an HSA for a taxable year?

Contributions for the taxable year can be made in one or more payments, at the convenience of the individual or the employer, at any time prior to the time prescribed by law (without extensions) for filing the eligible individual's federal income tax return for that year, but not before the beginning of that year. For calendar year taxpayers, the deadline for contributions to an HSA is generally April 15 following the year for which the contributions are made. Although the annual

contribution is determined monthly, the maximum contribution may be made on the first day of the year.

Example: Dave has self-only coverage under an HDHP with a deductible of \$1,500 and also has an HSA. Dave's employer contributes \$200 to his HSA at the end of every quarter in 2004 and at the end of the first quarter in 2005 (March 31, 2005). Dave can exclude from income in 2004 all of the employer contributions (*i.e.*, \$1,000) because his exclusion for all contributions does not exceed the maximum annual HSA contributions.

What happens when HSA contributions exceed the maximum amount that may be deducted or excluded from gross income in a taxable year?

Contributions by individuals to an HSA, or if made on behalf of an individual to an HSA, are not deductible to the extent they exceed the limits. Contributions by an employer to an HSA for an employee are included in the gross income of the employee to the extent that they exceed the limits or if they are made on behalf of an employee who is not an eligible individual. In addition, an excise tax of 6% for each taxable year is imposed on the account beneficiary for excess individual and employer contributions.

However, if the excess contributions for a taxable year and the net income attributable to such excess contributions are paid to the account beneficiary before the last day prescribed by law (including extensions) for filing the account beneficiary's federal income tax return for the taxable year, then the net income attributable to the excess contributions is included in the account beneficiary's gross income for the taxable year in which the distribution is received but the excise tax is not imposed on the excess contribution and the distribution of the excess contributions is not taxed.

Are rollover contributions to HSAs permitted?

Rollover contributions from Archer MSAs and other HSAs into an HSA are permitted. Rollover contributions need not be in cash. Rollovers are not subject to the annual contribution limits. Rollovers from an IRA, from a health reimbursement arrangement (HRA), or from a health flexible spending arrangement (FSA) to an HSA are not permitted.

When is an individual permitted to receive distributions from an HSA?

An individual is permitted to receive distributions from an HSA at any time.

How are distributions from a HSA taxed?

Distributions from an HSA used exclusively to pay for qualified medical expenses of the account beneficiary, his or her spouse, or dependents are excludable from gross income. In general, amounts in an HSA can be used for qualified medical expenses and will be excludable from gross income even if the individual is not currently eligible for contributions to the HSA.

What are the “qualified medical expenses” that are eligible for tax-free distributions?

The term “qualified medical expenses” are expenses paid by the account beneficiary, his or her spouse or dependents for medical care as defined in section 213(d) (including nonprescription drugs as described in Rev. Rul. 2003-102, 2003-38 I.R.B. 559), but only to the extent the expenses are not covered by insurance or otherwise. The qualified medical expenses must be incurred only after the HSA has been established. For purposes of determining the itemized deduction for medical expenses, medical expenses paid or reimbursed by distributions from an HSA are not treated as expenses paid for medical care under section 213 of the Internal Revenue Code.

Are health insurance premiums qualified medical expenses?

Generally, health insurance premiums are not qualified medical expenses except for the following: qualified long-term care insurance, COBRA health care continuation coverage, and health care coverage while an individual is receiving unemployment compensation. In addition, for individuals over age 65, premiums for Medicare Part A or B, Medicare HMO, and the employee share of premiums for employer-sponsored health insurance, including premiums for employer sponsored retiree health insurance can be paid from an HSA. Premiums for Medi-gap policies are not qualified medical expenses.

Must HSA trustees or custodians determine whether HSA distributions are used exclusively for qualified medical expenses?

No. HSA trustees or custodians are not required to determine whether HSA distributions are used for qualified medical expenses. Individuals who establish HSAs make that determination and should maintain records of their medical expenses sufficient to show that the distributions have been made exclusively for qualified medical expenses and are therefore excludable from gross income.

Can an HSA be offered under a cafeteria plan?

Yes. Both an HSA and an HDHP may be offered as options under a cafeteria plan. Thus, an employee may elect to have amounts contributed as employer contributions to an HSA and an HDHP on a salary-reduction basis.

What reporting is required for an HSA?

Employer contributions to an HSA must be reported on the employee’s Form W-2. In addition, information reporting for HSAs will be similar to information reporting for Archer MSAs. The IRS will release forms and instructions, similar to those required for Archer MSAs, on how to report HSA contributions, deductions, and distributions.