



February 11, 2004

Health Savings Accounts

EXECUTIVE SUMMARY

- Health savings accounts (HSAs) were approved as part of the Medicare Prescription Drug, Improvement and Modernization Act of 2003, which was passed last December. HSAs are tax-exempt accounts established for the purpose of paying qualified medical expenses. Any individual covered by a high-deductible health plan (HDHP) may establish an HSA. HSAs provide another tax-favored savings vehicle, along the lines of an individual retirement account (IRA) or a 401(k) plan, for those individuals who do not have to draw significantly from the accounts for medical needs. Amounts contributed to an HSA belong to the individual and are completely portable.
- **The Medicare reform law states that HSAs can be opened starting on Jan. 1, 2004.**
- Where a trustee or custodian is not the sponsor the HDHP, the trustee or custodian may require proof or certification that the account beneficiary is an eligible individual, including proof that the individual is covered by a plan that meets all of the requirements of an HDHP.
- As employers, credit unions will be allowed to help fund an individual's HSA account, and may over time change their insurance plans to factor in HSAs.
- An eligible individual may establish an HSA with or without the involvement of his or her employer.
- The Treasury Department and Internal Revenue Service (IRS) have issued a notice (IRS Notice 2004-2) providing some guidance on new HSA opportunities. The guidance addresses, in question-and-answer format, issues including:
 - Requirements governing HDHPs that accompany HSAs;
 - Requirements concerning HSA trustees;
 - Tax treatment of HSA contributions and distributions; and
 - Requirements governing rollover of money from existing health accounts and Archer Medical Savings Accounts to the new HSAs.

- The IRS notice states “HSAs are subject to other statutory rules and provisions not addressed in this notice. No inference should be drawn regarding issues not expressly addressed in this notice.” The Treasury and IRS are seeking public comments on what further guidance is necessary on HSAs. Treasury and the IRS plan to issue further guidance on HSAs in the summer of 2004.
- Under the guidance, a bank (or similar financial institution which would include a credit union) or insurance company can be an HSA trustee or custodian.
- **CUNA is advising credit unions to wait on launching HSAs until more information is available.** Before launching HSA programs, credit unions will want answers to some basic questions, including:
 - What disclosures will be needed to explain the terms and conditions of the account such as eligibility, prohibition on pledging and tax consequences?
 - What reporting will be required, both to the accountholder and to the IRS?
 - How do the new HSA provisions fit in with existing rules governing employee cafeteria benefits plans and flexible spending accounts?
- In the situation where a credit union launches an HSA program in early 2004 and a number of members immediately open accounts but later in 2004 better understand the HSA requirements and conclude they are ineligible for HSAs, the IRS Notice provides relief. Normally, HSA contributions that exceed the amount that is eligible for the tax deduction are not only subject to normal income taxation, but also are subject to a 6% excise tax. However, if the excess contribution and the earnings attributable to this excess amount are withdrawn prior to April 15, 2005, the funds will be included in the person's 2004 gross income, but will not be subject to the additional 6% tax.
- CUNA and CUNA Mutual Group staff will meet with Treasury and IRS staff February 12, 2004, to discuss how credit unions can begin to offer HSAs and obtain answers to some of the implementation questions.

- In a letter to credit unions (98-CU-5), NCUA announced that medical savings accounts, a pilot program launched in 1997, would be federally insured by the National CU Share Insurance, so the agency will undoubtedly issue a similar announcement that the new HSAs will be federally insured. NCUA's 1998 letter, however, raises questions about whether federal credit unions can not only hold the funds, but also serve as trustees or custodians of the new HSAs. Although the IRS says that any credit union already serving as a trustee or custodian of individual retirement accounts (IRAs), any federally insured credit union, or any state chartered credit union supervised by the state's banking department automatically qualifies to offer HSAs. Federal and state credit union regulators will have to determine whether the credit unions they supervise can actually serve as HSA fiduciaries. NCUA's current regulation, Section 724, only addresses federal credit unions serving as trustees and custodians of pension and retirement plans under Section 401 and 408 of the Internal Revenue Code, not the new Section 223 which establishes HSAs. CUNA will be also meet with NCUA next week to discuss whether the agency will broaden its regulation. State chartered credit unions need to determine what authority they have under their state law or regulations to actually serve as HSA trustees.
- Comments are due to the IRS by February 27, 2004. **Please send your comments to CUNA by February 24, 2004.** Please feel free to fax your responses to CUNA at 202-638-7052; e-mail them to Associate General Counsel Mary Dunn at mdunn@cuna.com or to Senior Regulatory Counsel Catherine Orr at corr@cuna.com; or mail them to Mary or Catherine in c/o CUNA's Regulatory Advocacy Department, 601 Pennsylvania Avenue, NW, 6th Floor - South Building, Washington, DC 20004-2601. You may also contact us if you would like a copy of IRS Notice 2004-2, or you may access it on the Internet at the following address:

http://www.irs.gov/irb/2004-02_IRB/ar09.html

DESCRIPTION OF HSAs

HDHP Requirements

- Any individual who is covered by a HDHP may establish an HSA. For self-only coverage, an HDHP has an out-of-pocket annual deductible of at least \$1,000 and required out-of-pocket expenses not exceeding \$5,000. For family coverage, an HDHP has an annual deductible of at least \$2,000 and required annual out-of-pocket expenses not exceeding \$10,000. Deductibles, copayments and other amounts constitute out-of-pocket expenses; however, premiums do not constitute out-of-pocket expenses.

- A plan would not be disqualified as an HDHP simply because it has no deductible – or has a small deductible – for preventive care.
- HSAs will not lose eligibility solely because the out-of-pocket provision limits would be violated for outside network services. The plan's annual deductible for out-of-pocket services is not taken into account for purposes of the annual contribution limit. Instead, the contribution limit is determined by reference to deductible services within the network.
- An employer's self-insured medical reimbursement plan can be a qualified HDHP.
- An HSA does not have to be opened at the same institution that provides the HDHP.

HSA Contributions

- The HSA contribution limit for individuals with self-only coverage in 2004 is the lesser of 100 percent of the HDHP's annual deductible or \$2,600. For 2004, the contribution limit for eligible individuals with family coverage under an HDHP is the lesser of 100 percent of the annual deductible, but not more than \$5,150.
- If a married individual has family coverage, then both spouses will be treated as having family coverage. However, if both spouses have family coverage under separate plans, both spouses are treated as being covered under the plan with the lowest deductible. The contribution limit is the lowest deductible amount, divided between the spouses equally, unless they agree otherwise. If the married spouses have only self-coverage, then the contribution limits are determined by reference to their respective plan deductibles.
- Although lump sum annual contributions are permissible, the maximum contribution allowable is calculated monthly based on current eligibility (divided between spouses).
- To encourage savings for health expenses after retirement, provision is made for catch-up contributions for workers between the ages 55 and 65. The contribution limit is raised by \$500 in 2004 and will increase \$100 annually thereafter to \$1,000 in 2009.

- Contributions by eligible individuals are deductible in determining adjusted gross income – regardless of who makes the contribution or whether the individual itemizes deductions. They are “above-the-line” deductions that may be taken by all taxpayers. In other words, the contribution is tax-free to the employee. However, the individual cannot also deduct the contributions as medical expenses under IRS Code Section 213. Section 213 basically states that a deduction is allowed on the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent, to the extent that such expenses exceed 7.5 percent of adjusted gross income. Medical care means amounts paid for: the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body; transportation primarily for and essential to such medical care; and qualified long-term care services.
- Employers may offer HSAs either as a stand-alone plan or through a cafeteria plan. A contribution by an employer is made on a pre-tax salary reduction basis on behalf of the employee and will also generate a tax deduction for the employer. The contributions are excluded from the employee’s gross income and are not subject to wage withholding, Federal Insurance Contributions Act (FICA) or Federal Unemployment Tax Act (FUTA). Employers making contributions must report those amounts on the employee’s W-2 (Wage and Tax Statement). The IRS will also require information reporting similar to that required for Archer Medical Savings Accounts (MSAs). Information on this will be released at some point in the future.
- HSA contributions must be made in cash – not in the form of stock or other property. Payments for the HDHP and contributions to the HSA can be made through a cafeteria plan.
- Contributions may be made in one or more payments at any time prior to the time prescribed by law for filing of the individual’s federal income tax return for the year. The deadline for calendar year taxpayers is generally April 15 following the year for which the contributions are made.

Distributions

- HSA holders can receive distributions at any time. Distributions made exclusively for the purpose of paying “qualified medical expenses” are excluded from gross income (not taxed), even after the HSA account holder reaches age 65 and is no longer qualified to make contributions.

- The term “qualified medical expenses” is defined in the IRS Code and includes prescription drugs. According to the guidance, the only premiums that count as qualified medical expenses are qualified long-term care insurance premiums, COBRA health care continuation coverage premiums, and premiums for health care coverage while an individual is receiving unemployment compensation. “Qualified expenses” also generally include costs incurred to diagnose, cure, treat or prevent disease. In addition, for individuals age 65 and older, HSAs can be used to pay premiums for Medicare Part A, Medicare Part B, Medicare HMO, and the employee share of premiums for employer-sponsored health coverage. Premiums for Medigap policies are not considered “qualified medical expenses.”
- Distributions used for expenses that are not qualified is includable in the recipient’s gross income and may result in the imposition of a 10 percent excise tax, unless the distribution is made after the HSA holder reaches age 65, becomes disabled or dies.
- There is no substantiation requirement. HSA trustees or custodians are not required to determine/verify whether HSA distributions are used for “qualified medical expenses.” Individuals must keep records demonstrating the expense is qualified.
- Eligible individuals may use debit, credit or stored-value cards to receive distributions from an HSA for a “qualified medical expense.”

Rollovers

- Contributions to HSAs grow tax-free and roll over from year to year, allowing a significant build-up as employees age.
- Rollover contributions from Archer MSAs and other HSAs into an HSA are allowed. Such contributions do not need to be in the form of cash. Further, rollover contributions are not subject to the annual HSA contribution limits.
- Rollovers from an IRA, a health reimbursement arrangement or a flexible spending account to an HSA are not permitted.

Portability

- HSAs are portable. Therefore, younger employees may build up large amounts in HSAs and carry those funds with them as they change jobs throughout their careers. Every year the money not spent would stay in the account and gain interest tax-free, just like an IRA.

QUESTIONS REGARDING HSAs

Credit Unions as Depository Institutions

- 1. What should the relationship (coordination) be between HSAs and health Flexible Spending Arrangements (FSAs) and Health Reimbursement Arrangements (HRAs)? For example, should a credit union be able to offer all three together?**

Health FSA reimbursements typically provide coverage for medical care expenses not otherwise covered by the employer's primary group health plan. They are used to reimburse medical expenses, but not health insurance premiums or long-term care. Reimbursements are also excludable from an employee's gross income. FSAs may be offered as part of a cafeteria option allowing for contributions to be made on a salary reduction basis. Employees may also make contributions to an FSA if the FSA is a stand-alone plan. The employee will determine the amount to be contributed to the plan, although employers will often impose a limit. This amount can be altered on an annual basis by the employee. However, any unused contribution cannot be rolled over; any unused portion will be lost if not used by the end of the year. Contributions are not subject to either income or employment taxes. Generally, FSAs are not portable. FSAs do not have a qualifying health insurance requirement.

An HRA is an employer-funded plan that allows employees to pay for medical expenses, health insurance premiums and long-term care, though the employer may establish additional limitations. The employer determines the amount of the annual contribution, but as a general rule, contributions are set below the annual deductible of the accompanying health plan. Reimbursements from an HRA are excluded from the employee's gross income. The unused portion of the account rolls over from year to year, though an employer may restrict the amount of the carryover. HRA funds are generally not portable. Qualified HRAs cannot be linked to a deferred compensation arrangement or salary reduction plan. An HRS, therefore, cannot be used in conjunction with a cafeteria plan in such a way that the HRA is funded through salary reductions. Reimbursements from HRAs must be substantiated. The IRS has authorized the use of debit and credit cards for reimbursement purposes.

2. Do you agree with the corrective procedures in instances where employer contributions exceed the statutory contribution limits?

Such contributions are included in the gross income of the employee to the extent they exceed the limits mentioned above or if they are made on behalf of an employee who is not an eligible individual. In addition, an excise tax of 6 percent for each taxable year is imposed on the account holder for excess 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 for filing the account beneficiaries federal income tax return for the taxable year, then the net income is 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.

Yes _____ No _____

If not, what should the corrective procedures be?

- 3. What do you believe the corrective procedures should be in instances where employee contributions exceed contribution limits?**

- 4. What do you believe would constitute reasonable information reporting requirements?**

The IRS will issue guidance as to what information will have to be reported to accountholders and the IRS. For example, if the IRS adopts information reporting requirements similar to the medical savings accounts pilot program (Form 1099-MSA), credit unions should expect to have to report a reason for an HSA distribution.

Credit Unions and Employers

5. Should transition relief be provided in cases of inappropriate coordination of an HDHP with other coverage?

Yes _____ No _____

If yes, what relief should be provided?

6. How should the rules governing health FSAs in cafeteria plans under IRS Code Section 125 and the proposed and final regulations under that section in Proposed Treasury Regulation (Prop. Treas. Reg.) Section 1.125-2 Q&A 7 be applied to HSAs?

Under IRS Code Section 125, a cafeteria plan which provides health benefits shall not be treated as discriminatory if: (1) contributions under the plan on behalf of each participant include an amount which equals 100 percent of the cost of the health benefit coverage under the plan of the majority of the highly compensated participants similarly situated OR equals or exceeds 75 percent of the cost of the health benefit coverage of the participant (similarly situated) having the highest cost health benefit coverage under the plan AND (2) contributions or benefits under the plan in excess of those described in (1) bear a uniform relationship to compensation.

Under Prop. Treas. Reg. Section 1.125-2 Q&A 7, a health FSA generally is a benefit program that provides employees with coverage under which specified, incurred expenses may be reimbursed (subject to reimbursement maximums and any other reasonable conditions) and under which the maximum amount of reimbursement that is reasonably available to a participant for a period of coverage is not substantially in excess of the total premium (including both employee-paid and employer-paid portions of the premium) for the participant's coverage. Coverage and reimbursements provided to an individual under a group health plan that is a health FSA and that conforms to the generally applicable rules for accident or health plans qualify for the same tax-favored treatment that generally is extended to coverage and reimbursements under employer-provided accident or health plans.

7. Should HDHPs that accompany HSAs be allowed to impose lifetime limits on benefits?

Yes _____ No _____

If not, why not?

8. What should the relationship be between limits on out-of-pocket expenses with respect to HSAs and reasonable lifetime maximums on benefits in health insurance plans?

9. Other comments?

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