

## EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION ADVISORY

*December 2003*

### IRS ISSUES FIRST ROUND OF GUIDANCE ON HSAS

On December 22, 2003, the IRS issued the first of what will likely be several rounds of Health Savings Account (HSA) guidance. The guidance, in the form of Notice 2004-2, can be accessed at <http://www.irs.gov/pub/irs-drop/n-04-2.pdf>. For a copy of the Treasury Department's news release: <http://www.ustreas.gov/press/releases/js1061.htm>. While the Notice does not address several of the more complex HSA issues (later guidance will), it is very helpful in that it restates many provisions of the Medicare Prescription Drug Improvement and Modernization Act of 2003 (the Act) and provides some clarification on a few basic HSA compliance matters. The timing of the Notice couldn't be better in light of the fact that HSAs become effective on January 1, 2004. We also hope that the Notice will prompt the Department of Labor to issue guidance on the applicability (or possible inapplicability) of ERISA to HSAs.

#### The Notice-Generally

The Notice provides basic information in Q&A format and very much resembles Notice 96-53 that the IRS issued several years ago for Archer MSAs. The Notice is divided into five categories:

1. What Are HSAs and Who Can Have Them
2. How Can an HSA Be Established
3. Contributions to HSAs
4. Distributions from HSAs
5. Other Matters

In most cases, the Notice reiterates information addressed in language codified in new Code Section 223 enacted as Section 12 of the Act; however, the Notice addresses a number of significant "gray" issues not clearly addressed by the Act. We provide an overview of a few of

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the key issues addressed in the Notice as well as highlight a few issues that still need to be addressed in subsequent guidance.

## Eligibility for HSAs

In order to be eligible for an HSA, an individual must have qualifying coverage under a high deductible health plan (HDHP). The Notice makes two significant clarifications with regard to the type of HDHP coverage necessary in order for an individual to be eligible for an HSA. First, the Notice clarifies that for individuals with family coverage, no amounts can be paid from the HDHP (other than for exempt preventive care) until the *entire family deductible* has been satisfied. Thus, as with Archer MSAs, an HDHP is not qualified if there is an “embedded” deductible lower than the family deductible threshold. For example, assume that a health plan has a \$2000 deductible for family coverage but provides for reimbursement of covered expenses of any single member of a family if the family member has incurred \$1000 in expenses, even if the entire family as a unit has not incurred \$2,000 in expenses. The health plan in this example is not a qualified HDHP.

Also, while not addressed in the Act, the Notice clarified that a HDHP can be self-insured (i.e. benefits are not paid pursuant to an insurance policy issued by a carrier).

## HSA Implementation

Under the Act, only certain entities can qualify to be an HSA trustee. The Notice clarified that any person or entity that is already approved to be an IRA or Archer MSA trustee is also a qualified HSA trustee and no additional approval from the IRS is needed. For those who wish to become a qualified trustee in the future, the Notice indicates that persons may request approval to be a non-bank trustee in accordance with the procedures set forth in Treas. Reg. 1.408-2(e). The regulations require a written application showing each of the following:

- The ability to act within the accepted rules of fiduciary conduct. This includes but is not limited to a showing of continuity in the event of the death or change of its owners and an established location.
- Experience and competency to account for the interests of a large number of individuals
- Experience and competency to handle funds
- Ability to satisfy other obligations such as employing legal counsel and having adequate net worth.

The Notice also refers to an announcement that lists all of the currently approved non-bank Trustees (see Announcement 2003-54, 2003-40).

### Contributions to HSAs

The Notice clarified that HSA contributions may be made monthly or in one lump sum payment at any time before the tax return becomes due, including the beginning of the applicable tax year. This is beneficial for entities desiring to establish an integrated health plan arrangement incorporating an HSA. Employers and/or employees who wish to make an annual HSA contribution at the beginning of the year should be aware that a portion of such contributions attributable to months in which the individual is not eligible (e.g., because HDHP coverage is lost or other disqualifying coverage is obtained) may be subject to an excise tax unless the contributions attributable to such months are returned to the individual.

The Notice also clarified that amounts cannot be rolled over into an HSA from an IRA, HRA and/or a Health FSA. Also, the Notice addressed an apparent oversight in the Act by providing that employer HSA contributions are not subject to FICA.

### Distributions from HSAs

The Notice clarified several aspects of administering HSA distributions. First, as with Archer MSAs, the Notice confirmed that neither the HSA trustee nor a contributing employer is responsible for ensuring that HSA distributions are for qualifying medical expenses. Distributions from the HSA (and application of its excise tax) can be self-administered and self-reported by the participant. The Notice also clarified that electronic payment cards may be used as a tool for receiving reimbursement from the HSA. Since there is no required substantiation for HSA distributions, the special substantiation rules for electronic payment cards set forth in Notice 2003-43 do not apply. In addition, the Notice also clarified that medical expenses must be incurred *after* the HSA has been established in order to be qualified. Finally, the Notice makes it clear that an individual may continue to use amounts in the HSA even after the individual becomes ineligible for future HSA contributions.

### Cafeteria Plan Implications

The Notice indicates that the discrimination rules under Code Section 4980G (the HSA specific comparability rules for employer contributions) do not apply to contributions made under a Code Section 125 cafeteria plan. Presumably, this means both pre-tax salary reductions and employer matching contributions and/or cashable flex credits escape the HSA comparability rule.

## What the Notice Does Not Address

The Notice left open several issues and requested industry comments. Among the HSA issues requiring additional guidance (some of which were flagged by the Notice) are the following:

- How can HRAs and/or Health FSAs be integrated with HSAs?. For example, it seems permissible to have an integrated HRA and HDHP (i.e. they are the same plan) and an HSA so long as the HRA covers only expenses above the HDHP deductible (e.g. coinsurance and/or amounts above the deductible that exceed R&C).
- Can benefits be carved out of the HDHP and covered below the deductible under a separate limited health plan? For example, assume that the employer specifically carves prescription drug coverage out of the HDHP. Can the employer have a separate limited benefit health plan to cover prescription drugs that are not covered by the HDHP? The Act would seem to allow such a plan design as long as the separate plan does not provide coverage for a medical expense that could be covered under the HDHP.
- What happens if state law mandates require that certain benefits (other than preventive care) be covered without a deductible? Can a health plan still qualify as a HDHP?
- Can employers and/or trustees require individuals to provide substantiation that the expense is a qualified medical expense? The Notice clearly indicates that adjudication is not required but the Notice does not indicate whether such a requirement is a permitted “plan design” option available to employers and/or trustees.
- How will the Code Section 125 nondiscrimination rules apply to HSA contributions? If only highly compensated employees (HCEs) establish HSAs and the HCEs are allowed to contribute on a pre-tax basis, does the cafeteria plan discriminate in favor of HCEs?

The Notice provides detailed instructions on how and where to provide comments on HSA issues (for both written and electronic comments)

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