

Financial Institution Tax-Favored Savings Accounts

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Medicare Bill Includes New Health Savings Account

The Medicare bill passed by Congress last week (the Medicare Prescription Drug, Improvement and Modernization Act of 2003) authorizes the establishment of new Health Savings Accounts (HSAs) effective January 1, 2004. President Bush is expected to sign the bill into law.

HSAs are similar to Archer Medical Savings Accounts (MSAs) in that they permit individuals to save for lifetime health care expenses on a tax-free basis during periods when the individual has high-deductible health insurance coverage. However, there are significant differences between MSAs and HSAs, two of which are worth noting in particular:

- (1) Whereas MSAs could be established only by self-employed individuals or employees of small employers (generally, companies with 50 or fewer employees), HSAs can be established by any eligible taxpayer, without regard to the size of the individual's employer.
- (2) The minimum annual deductible under the high-deductible health insurance coverage that triggers eligibility is significantly lower for HSAs than for MSAs; however, the percentage of the annual deductible that may be contributed is significantly higher for HSAs than for MSAs.

Thus, the new HSAs are designed to be available to a much larger universe of employees than MSAs. Indeed, although certain taxpayers continue to be eligible to contribute to MSAs, MSA contributions would appear to have no significant advantages over HSA contributions.

The following is a brief summary of the HSA rules.

TRUST OR CUSTODIAL ACCOUNT

An HSA must be established under a trust or custodial account. The account is subject to many of the same general requirements that apply to individual retirement accounts and Coverdell Education Savings Accounts. In this regard, the trustee or custodian of the account must be a bank or insurance company or another person approved by the Internal Revenue Service to serve as trustee or custodian. Except for rollover contributions, HSA contributions must be in cash. The assets of the HSA may not be forfeitable, may not be invested in life insurance and may not be pledged as security for a loan. HSAs are subject to the prohibited transaction rules of the Internal Revenue Code that apply to individual retirement accounts.

ELIGIBILITY

An individual is eligible to make deductible contributions to an HSA if he or she has health coverage under a high-deductible health plan. A high-deductible health plan is a health plan that (i) for self-only coverage has an annual deductible of at least \$1,000 and a maximum out-of-pocket expense limit of no more than \$5,000 or (ii) for family coverage, has an annual deductible of at least \$2,000 and a maximum annual out-of-pocket expense limit of no more than \$10,000. These amounts will be indexed to inflation after 2003. The deductible need not apply to preventive care. If the plan uses a network of providers, the annual deductible and the out-of-pocket expense limit need not apply to out-of-network providers.

Notably, a taxpayer's eligibility to make deductible contributions to an HSA is not contingent on the taxpayer's

employer's offering a high-deductible health care plan. A taxpayer can obtain high-deductible health coverage through, for example, an individual insurance policy.

The following individuals are not eligible to make deductible HSA contributions:

- An individual that has health coverage in addition to the high-deductible coverage.
- An individual that is entitled to Medicare benefits.

Workers compensation and tort and property liability insurance, insurance coverage for a specific illness or disease, certain hospitalization insurance, and coverage for disability, dental care or vision care will not be considered health coverage for purposes of these rules.

CONTRIBUTIONS

The maximum annual HSA contribution is, generally, the lesser of (i) 100% of the annual deductible under the individual's high-deductible health plan, or (ii) the maximum deductible amount permitted under an Archer MSA high-deductible health plan (estimated to be \$2,600 for self-only coverage and \$5,150 for family coverage for 2004). The maximum HSA contribution for a tax year is reduced by the amount of MSA contributions made by or on behalf of the individual for the year. The maximum does not apply to rollover contributions from another HSA or from an Archer MSA. A maximum of one HSA rollover per year is permitted.

Individuals age 55 or older may make "catch-up" contributions in excess of the foregoing limits. The maximum catch-up contribution is \$500 for 2004. The maximum catch-up contribution will increase in \$100 increments each year through 2009, at which time the annual catch-up contribution limit will be fixed at \$1,000. The maximum catch-up contribution will not be indexed to inflation after 2009.

Contributions may be made by the account owner or by his or her employer. Contributions may also be made by other individuals, such as members of the account owner's family. Contributions may be made through a cafeteria plan.

Generally, contributions by individuals are deductible to the HSA account owner unless the account owner may be claimed as a dependent on another person's tax return. Thus, contributions by individuals other than the account owner are treated as a gift from the individual contributor to the account owner (subject to gift tax) and a deductible contribution by the account owner.

Employer contributions are not taxable to the individual. However, if the employer fails to contribute the same dollar amount or the same percentage of the annual deductible under the high-deductible health plan for all employees with comparable coverage (determined by reference to all commonly controlled affiliates of the employer), the employer is subject to an excise tax equal to 35% of the aggregate amount contributed by the employer to the HSAs of its employees for the period. (Comparability is determined separately for part-time employees.) The Internal Revenue Service may waive the excise tax where the failure is due to reasonable cause and not to willful neglect and the excise tax would be excessive relative to the failure involved.

Excess contributions are subject to a 6% cumulative excise tax. Nondeductible contributions (*e.g.*, contributions by an individual who is not eligible to make deductible HSA contributions) are treated as excess contributions.

Contributions for a tax year may be made as late as the due date for the federal income tax return of the account holder for such tax year (generally, April 15th of the year following the year for which contributions are made).

DISTRIBUTIONS

HSA distributions that are used to pay qualified medical expenses of the individual and the individual's spouse and dependents for the year are excluded from the individual's gross income. Qualified medical expenses generally include expenses for which a deduction would otherwise be available under Section 213(d) of the Internal Revenue Code. For individuals who are not eligible for Medicare, qualified medical expenses do not include health insurance premiums (with exceptions for long-term care insurance, COBRA continuation coverage and coverage during certain periods of unemployment). For individuals who are eligible for Medicare, health insurance premiums (other than supplemental Medicare—or Medigap—insurance premiums) are qualified medical expenses.

HSA distributions that are not used to pay the qualified medical expenses of the individual and his or her spouse and dependents are included in the individual's gross income and are subject to a 15% excise tax. The excise tax does not apply if the distributions are made after the individual's death, disability or attainment of eligibility for Medicare (*i.e.*, age 65).

TREATMENT ON DEATH OF INDIVIDUAL

If the named beneficiary of the HSA is the account holder's spouse, the surviving spouse becomes the owner of the HSA upon the death of the account holder, with no federal income or estate tax consequences. This treatment applies only where the account holder specifically names the spouse as beneficiary.

If the account holder's spouse is not the named beneficiary of the HSA, the beneficiary of the HSA (which is the estate if the account holder does not name any beneficiary) must include the HSA account balance in gross income (except that the HSA can be used to pay the account owner's pre-death qualified medical expenses on a tax-free basis). The beneficiary may claim a deduction for the portion of the federal estate tax on the account owner's estate that is attributable to the HSA.

REPORTING REQUIREMENTS

An employer's contributions to its employees' HSAs must be reported on the employees' Forms W-2. The Internal Revenue Service has discretion to require trustees and custodians of HSAs to file periodic reports concerning HSA contributions, distributions and other HSA matters.

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As a result of limited eligibility rules, MSAs have not been a popular health care savings device. It is anticipated that the broader HSA eligibility rules will make HSAs much more popular than MSAs. An individual that has relatively modest annual medical expenses could accumulate significant savings to fund retiree health expenses on a tax-free basis. In addition, because the 15% excise tax on distributions that are not used to pay qualified medical expenses does not apply to distributions after age 65, it is anticipated that some taxpayers may also use HSAs as an additional vehicle for tax-deferred retirement savings.

Of course, for many taxpayers the choice to save in an HSA would involve a fundamental restructuring of their current health care coverage. A taxpayer that chooses to save in an HSA must be covered under a high-deductible health plan, which would presumably reduce the taxpayer's health care premium costs in exchange for increased out-of-pocket risk. It remains to be seen whether lower premiums coupled with the potential for tax-favored savings accumulation will entice significant numbers of taxpayers to abandon traditional "first dollar" health care coverage in favor of high-deductible insurance and HSAs.

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