Bloomberg BNA

Tax Management
Compensation Planning Journal™

Reproduced with permission from Tax Management Compensation Planning Journal, Vol. 45, 5, p. 143, 05/05/2017. Copyright © 2017 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Health Savings Accounts — A Practical Guide in an Era of Expansion

By Damian A. Myers[*]

INTRODUCTION

There has been a shift in the typical design of employer-sponsored group health plans in recent years. Plan designs that offer generous benefits in terms of low deductibles, coinsurance, and other cost-sharing reductions are becoming less common as plan sponsors have begun to recognize that, that type of design fosters overutilization of unnecessary health care services and does not necessarily enhance the health of the covered population. Sponsors are now moving toward ''consumer-driven'' designs that place on participants more financial responsibility for their health care choices. The theory underlying consumer-driven health care is that when participants have more ''skin in the game,'' they will naturally consider whether a particular health care service is necessary and will seek the most cost-effective manner of obtaining health care.

The typical consumer-driven health plan design takes the form of a ''high-deductible health plan'' (HDHP) with a tax-preferred savings vehicle — most commonly, the health savings account (HSA) — from which participants can offset a portion of the participant cost-sharing requirements of the HDHP or reimburse themselves for other qualifying medical expenses. Both employers and participants can contribute to HSAs and unlike flexible spending arrangements, HSA contributions unused in a given year will carry over to subsequent years.

HSAs have been around since 2004 and although employers have been increasingly adding them as a component to their health benefit offerings,[1] recent developments could accelerate the growth of HSAs. Following the 2016 Presidential election, President Trump and Congress immediately began efforts to replace the Patient Protection and Affordable Care Act (ACA).[2] Repealing the ACA will certainly be no easy task, and it is unclear at the moment what form a replacement will take. Nevertheless, based on prior legislative attempts to repeal and replace the ACA, it appears likely that any replacement will include provisions that would expand the availability of HSAs.

Given that HSAs appear to be on the cusp of a new era of expansion, this article is intended to provide a general overview for plan sponsors considering whether to add a HDHP with an HSA to their benefit packages and for plan administrators that operate HDHPs with an HSA. Following a description of HSAs in general, the article focuses on the core HSA compliance issues related to eligibility, contributions, and distributions.[3] Finally, this article concludes by describing current legislative efforts to expand the availability of HSAs.

HSAs IN GENERAL

HSAs are tax-preferred trusts or custodial accounts to which contributions can be made by, or on behalf of, eligible individuals. The statutory rules governing

[*] Damian Myers is a senior associate in Proskauer Rose's Employee Benefits and Executive Compensation Group and a member of the firm's Health Care Reform Task Force. He practices in all areas of employee benefits law.

[1] *See* The Kaiser Family Foundation and Health Research and Educational Trust (KFF/HRET) 2016 Employer Health Benefits Survey, Exhibit 5.1, http://kff.org/report-section/ehbs-2016-section-five-market-shares-of-health-plans/. According to the KFF/HRET survey, in 2015 and 2016, employer sponsorship of traditional PPO-type plans declined 10% while sponsorship of HDHPs with a savings vehicle increased 8% during that same period. *See* https://kaiserfamilyfoundation.files.wordpress.com/2016/09/employer-health-benefits-2016-summary-of-findings.pdf (Exhibit E).

[2] Pub. L. No. 111-148.

[3] Of course, a comprehensive guide to HSAs would require hundreds of pages of text. This article simply provides a concise overview of key aspects of HSA compliance.

© 2017 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0747-8607

HSAs are found in §223 of the Internal Revenue Code of 1986, as amended (I.R.C.), and the Internal Revenue Service (IRS) has issued various forms of interpretive guidance over the years. The I.R.C. and IRS guidance have established detailed rules related to who is eligible to contribute to an HSA, how and in what amount contributions can be made to an HSA, and distributions from HSAs.

Although many individuals establish HSAs in connection with HDHPs they receive through employment, HSAs can be established and maintained by individuals without regard to their employment. When maintained outside of an employment relationship, an eligible individual's contributions to an HSA will entitle him or her to a tax deduction for the year in which the contributions are made. When the HSA is provided through an employee benefits program, employee contributions are generally withheld from pay on a pre-tax basis through a cafeteria plan.[4] Distributions from HSAs are generally nontaxable as long as the distribution is made to reimburse for eligible medical expenses.

Even when an HSA is offered as a component of an employer-sponsored benefit program, the HSA itself is generally not an employer-sponsored plan. Instead, employees own the HSAs (much like IRAs) and may maintain them outside of the employment context, including after termination of employment. Because they are not sponsored by employers, HSAs generally are not subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA), including the requirements of the Health Insurance Portability and Accountability Act (HIPAA) and the Consolidated Omnibus Budget Reconciliation Act (COBRA).[5]

HSA COMPLIANCE

HSA compliance involves three core components — eligibility, contributions, and distributions. Each of these components is described below.

HSA Eligibility

In order to make or receive contributions to an HSA, an employee (1) must be enrolled in an HDHP, (2) cannot be claimed as a dependent on someone else's tax return, (3) cannot be entitled to Medicare, and (4) cannot be enrolled in disqualifying coverage. Eligibility is generally determined as of the first day of each month.[6] If an employee ceases to be HSA-eligible, contributions made by or on behalf of the employee must cease. However, distributions are permitted whether or not an employee is eligible to contribute to an HSA.[7]

Must be Enrolled in HDHP Coverage

Before any employee is permitted to make or receive contributions to an HSA for a given month, he or she must be enrolled in an HDHP on the first day of that month.[8] An HDHP is a health plan that provides ''significant benefits'' and satisfies statutory requirements for minimum annual deductibles and out-of-pocket maximum limits.[9] For 2017, the self-only and family minimum annual deductibles and out-of-pocket maximums are reflected in the table below.[10]

	Minimum Annual Deductible	Out-of-Pocket Maximum
Self-Only	$1,300	$6,550
Family	$2,600	$13,100

There is no specified maximum deductible.[11] If an employee is enrolled in family HDHP coverage, the HDHP cannot include an embedded individual deductible that is less than the minimum annual deductible for family HDHP coverage.[12] For example, if an HDHP is designed with the minimum annual deductibles, no benefits may be paid under the HDHP until the full $2,600 (for 2017) family deductible has been

[4] Although the rules related to HDHPs and HSAs are similar both within the employer-sponsored health plan environment and in the individual market, this article focuses on rules related to employer-sponsored HDHPs with an HSA option.

[5] Although HSAs are generally not subject to ERISA, an employer's involvement in the operation of an HSA can cause the HSA to become subject to ERISA. For example, if an employer places restrictions on the ability of employees to rollover contributions to another HSA, the HSA could become subject to ERISA. Similarly, if an employer designates the available investment options that a custodian will make available to HSA holders, that could trigger application of ERISA. However, Department of Labor guidance does permit employers to designate the same investment alternatives that are available under its §401(k) plan. *See* DOL FAB 2006-02. All section references herein are to the I.R.C., and the regulations thereunder, unless otherwise specified.

[6] §223(c)(1)(A)(i).

[7] Notice 2004-2, 2004-2 I.R.B. 269, Q&A-28.

[8] See the discussion below for the ''full contribution'' rule that would allow an individual to be treated as if he or she was enrolled in an HDHP for the entire year.

[9] The minimum annual deductible and maximum out-of-pocket limit are adjusted annually for inflation.

[10] Rev. Proc. 2016-28, 2016-20 I.R.B. 852.

[11] The ACA initially imposed maximum deductible limits, but that component of the ACA was eventually repealed. Nevertheless, the deductible necessarily cannot exceed the HDHP out-of-pocket maximum.

[12] Notice 2004-2, Q&A-3.

© 2017 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0747-8607

satisfied, even if one member of the family has incurred out-of-pocket costs in excess of $1,300. Plan designs that have annual deductible limits set higher than the statutory minimum can have an embedded individual deductible, but only to the extent the family statutory minimum has been reached. For instance, an embedded individual deductible can be used for a design that has a self-only annual deductible of $3,000 and a family annual deductible of $6,000 because the self-only deductible is in excess of the statutory minimum family deductible.[13]

HDHPs are not required to apply deductibles to preventive care.[14] Prior to the ACA, the IRS provided a definition of preventive care that included annual physicals, immunizations, certain wellness programs, and routine child health services. The ACA, however, included a mandate that all non-grandfathered health plans provide first-dollar coverage of preventive care. Preventive care for ACA purposes is defined using evidence-based guidelines established by various health organizations. The IRS has issued guidance providing that HDHPs may use the ACA's definition of preventive care.[15]

For purposes of determining whether the out-of-pocket maximum is met, typical expenditures such as deductibles, copayments and coinsurance accumulate toward the total. Penalties or additional payments that must be paid by employees for failing to get preauthorization for a service also accumulates toward the out-of-pocket maximum for HDHP purposes.[16] However, premiums paid for the HDHP coverage do not count toward the out-of-pocket maximum. Also, amounts paid by an employee in excess of usual, customary and reasonable charges do not count toward the out-of-pocket maximum.[17]

The ACA also has an out-of-pocket maximum rule that is applied to expenditures related to ''essential health benefits.''[18] The ACA's out-of-pocket limits for 2017 are $7,150 (self-only) and $14,300 (family).[19] These limits were initially in line with the HDHP out-of-pocket limits, but the method for annually adjusting the limits for inflation differ slightly, resulting in a higher limit under the ACA.

In addition to complying with the statutory deductible and out-of-pocket maximum expenditure requirement, HDHPs must also provide significant benefits.[20] Although some restrictions on benefits are permitted, IRS guidance requires that an HDHP provide ''significant benefits,'' notwithstanding any benefit restrictions.[21] Unfortunately, the IRS has not provided concrete guidance as to what amounts to ''significant benefits,'' but large-scale exclusions for services such as hospitalization would not likely be permitted. Similarly, an HDHP cannot be limited to non-medical benefits such as dental and vision.

Cannot be Claimed as a Dependent

In order to make or receive contributions to an HSA, an employee cannot be claimed as a dependent under another person's federal tax return. Dependent status is determined by reference to §152, which defines ''dependent'' for purposes of the personal exemption. In general, a taxpayer can claim a person as a dependent if they are (1) the taxpayer's child and under age 19, (2) a taxpayer's child and under age 24 if they are a student, and (3) a relative of the taxpayer who is dependent on the taxpayer for more than 50% of his or her support for the year and who does not earn in excess of the personal exemption.[22] An employee's spouse is generally not treated as a tax dependent for HSA eligibility purposes.

Cannot be Entitled to Medicare

An employee who is entitled to Medicare cannot make or receive contributions to an HSA.[23] Medicare entitlement can occur due to age, disability or the presence of end-stage renal disease (ESRD). For certain employees, Medicare entitlement will occur automatically while for others entitlement requires an actual application for enrollment in Medicare. Though Medicare entitlement will prevent an employee from making or receiving HSA contributions, amounts contributed to an HSA prior to Medicare entitlement may be distributed at any time.[24]

Disqualifying Coverage

Except for enrollment in an HDHP and certain permitted insurance and coverage, an employee cannot be enrolled in any other health coverage.[25] The statute defines permitted insurance as insurance that sub-

---

[13] Notice 2004-2, Q&A-3.

[14] §223(c)(2)(C).

[15] Notice 2013-57, 2013-40 I.R.B. 293.

[16] Notice 2004-50, 2004-33 I.R.B. 196, Q&A-18.

[17] Notice 2004-50, Q&A-16.

[18] The essential health benefits that must be covered by a plan vary by state, but they must include the following: ambulatory patient services, emergency services, hospitalization, maternity and newborn care, mental health and substance abuse, laboratory services, preventive care, rehabilitative and habilitative services, and prescription medication.

[19] *See* HHS Notice of Benefit and Payment Parameters for 2017, 81 Fed. Reg. 12,203 (Mar. 8, 2016).

[20] Notice 2008-59, 2008-29 I.R.B. 123, Q&A-14.

[21] *Id.*

[22] §152.

[23] Note that *eligibility* for Medicaid does not disqualify an individual from HSA eligibility. Medicare *entitlement* occurs when an individual is both eligible and enrolled in Medicare.

[24] See below for the tax implications of receiving distributions, including distributions made after attaining age 65.

[25] §223(c)(1)(A)(ii).

© 2017 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0747-8607

stantially covers liabilities related to workers' compensation laws, tort liabilities and liabilities relating to ownership of property, insurance for a specified disease or illness, or hospital indemnity insurance.[26] Permitted coverage is generally defined as coverage for accidents, disability, dental care, vision care, or long-term care.[27]

All other insurance that covers health services (other than preventive care) prior to the satisfaction of the applicable HDHP minimum annual deductible is disqualifying coverage that would render an employee ineligible to make or receive HSA contributions. The types of coverage that could disqualify an employee from HSA eligibility are numerous. Set forth below are some of the common issues faced by plan sponsors and administrators.

Health Flexible Spending Arrangements

Coverage under a general-purpose health flexible spending arrangement (HFSA) is disqualifying coverage. Therefore, an employee cannot make contributions to or receive benefits from a general-purpose HFSA and also make or receive contributions to an HSA. A ''general-purpose'' HFSA means that the HFSA can be used to reimburse an employee for all eligible health expenses (i.e., medical, dental, and vision). To give HSA-eligible employees some access to flexible spending benefits, many employers provide for ''limited-purpose'' HFSAs. These limited-purpose HFSAs are not disqualifying coverage because they are designed to reimburse or pay only for dental and vision expenses or for preventive care.

Difficult situations arise when employers switch from offering non-HDHP coverage to HDHP coverage with an HSA, or when employers offer multiple benefit options and employees switch coverage from a non-HDHP option to the HDHP with HSA option. Often employers will offer traditional health plans along with HDHPs tied to HSAs. If, prior to this type of coverage change, an employee was covered by a general-purpose HFSA, HSA eligibility may be delayed for a few months following the change to HDHP coverage. The reason for this is that HFSAs often allow for grace periods during which contributions made in a prior year can be used to reimburse expenses incurred during a short period following the start of a subsequent year. If an HFSA has this grace period feature and an employee has an HFSA balance at the end of the year, he or she cannot make or receive contributions to an HSA until the end of the grace period. If there is no HFSA balance at the end of the year, there would be no delay in HSA eligibility (assuming other eligibility requirements are met).[28]

Potentially more problematic than the HFSA grace period is the rule allowing HFSA participants to carry over up to $500 in unused HFSA contributions to the subsequent year. Such a carryover could disqualify an employee from HSA eligibility for the entire next year. To avoid this result, plans could be designed to allow carryovers from a general-purpose HFSA to a limited-purpose HFSA if necessary to maintain HSA eligibility.[29] Employees should also be able to waive their right to the carryover.[30]

On-Site Medical Clinics

Many employers provide on-site medical clinics for their employees and, some, their families. Some on-site medical clinics provide care only for minor illnesses and workplace injuries, whereas others provide comprehensive care of the type that could be obtained at a primary care physician. If an on-site medical clinic provides ''significant'' medical benefits at no cost or at a reduced cost, the on-site medical clinic likely would be considered disqualifying coverage. A clinic that provides insignificant medical benefits, however, likely would not be disqualifying coverage. IRS guidance provides that employees may receive the following insignificant services at an on-site clinic without jeopardizing HSA eligibility: physicals and immunizations, allergy injections, receipt of aspirin and other nonprescription pain relievers, and treatment of injuries caused by accidents at the worksite.[31]

If an employer provides an on-site medical clinic that provides significant medical benefits, there are a few design options for employers that wish to avoid disqualifying employees from HSA eligibility. First, access to the on-site medical clinic can be restricted to only those employees who are either not enrolled in the HDHP or have already satisfied the applicable statutory minimum annual deductible under the HDHP. Second, HDHP enrollees can have limited access (i.e., insignificant services only) to the on-site medical clinic until the statutory minimum annual deductible is satisfied. Third, an employer could require that HDHP enrollees pay the full fair market value of the services until the statutory minimum annual deductible is satisfied.

Telemedicine

Telemedicine refers to health programs, whether stand-alone or part of a health plan, whereby participants can receive medical services telephonically or

[26] §223(c)(3).
[27] §223(c)(1)(B).
[28] Notice 2007-22, 2007-10 I.R.B. 670.
[29] CCA 201413005.
[30] *Id.*
[31] Notice 2008-59, Q&A-10.

© 2017 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0747-8607

through the internet. Although not every medical service can be obtained through telemedicine, participants can generally be diagnosed for certain medical conditions and can obtain prescriptions for appropriate medications. In most cases, telemedicine benefits would likely be considered significant benefits and, therefore, could disqualify an employee from making or receiving HSA contributions.

Because telemedicine, in most cases, is not likely permitted coverage under HSA rules, employers need to be careful when offering this benefit to employees enrolled in an HDHP option with an HSA. In many telemedicine programs, participants are required to pay a modest copayment for each consultation. If the copayment is subsidized or is otherwise less than the fair market value of the consultation, the benefit could be considered disqualifying coverage. Employers could take steps similar to those described above for on-site medical clinics to prevent HSA disqualification.

Wellness Programs

The typical wellness program is one that provides participants with a financial incentive, such as a premium discount, for completion of a health-related questionnaire or program. The IRS has indicated that wellness programs will not disqualify an employee from HSA eligibility if the program does not provide significant benefits in the nature of medical care or treatment.[32] Preventive care and other screenings are not considered significant benefits for this purpose. Therefore, common wellness programs that involve health risk assessments or biometric screenings will not likely disqualify an employee from making or receiving HSA contributions.

HSA Contributions

Once an employee is HSA-eligible, he or she (and any family members if enrolled in family HDHP coverage) may make contributions to the HSA and an employer may make contributions on the employee's behalf, subject to annual limitations. This section describes various rules related to HSA contributions.

Contribution Limitations

HSA contributions are subject to annual limits — for 2017, the limits are $3,400 (self-only) and $6,750 (family).[33] Employees who are age 55 or older are permitted to make catch-up contributions up to an additional $1,000.[34] All contributions (employee and employer) count toward the annual limit. There are two methods for determining the annual contribution limit applicable to an employee — the monthly limitation method and the full contribution method.

In general, the annual contribution limit for an employee is the aggregate of the monthly limits applicable to those months in which the employee is HSA eligible. For example, if an employee younger than age 55 is enrolled in self-only HDHP coverage and is HSA-eligible for six months of a year, the maximum annual contribution for that employee is $1,700 ($283.33 × 6). The employee would be permitted to contribute up to that maximum at any time until the due date for his or her income tax return (generally April 15th of the following year), even if he or she is no longer HSA-eligible when the contributions are made.[35]

An alternative to the monthly contribution rule described above is the ''full contribution'' rule. Under this rule, if an employee is enrolled in HDHP coverage and is HSA-eligible for only part of the year, he or she is permitted to make and/or receive contributions up to the full annual contribution limit for that year as long as he or she is HSA-eligible on December 1.[36] For example, an employee who enrolls in family HDHP coverage in June 2017 is permitted to make and/or receive the full $6,750 (for 2017) HSA contribution as long he or she is HSA-eligible on December 1 of that year. The full contribution rule also applies to an employee that changes from self-only HDHP coverage to family HDHP coverage mid-year — that person is permitted to contribute the full $6,750 (for 2017) HSA contribution provided he or she is HSA-eligible on December 1 of that year.[37]

Although an HSA-eligible employee may be able to take advantage of the full contribution rule, there is a catch — the employee must remain HSA-eligible for a 13-month period ending on the last day of the year immediately following the December 1 for which the HSA contributions were made (in the example above, until December 31, 2018).[38] The failure to maintain HSA eligibility during this period will require that the employee include in income the contribution in excess of the amount that would have been permitted under the standard monthly rule and pay a 10% penalty tax on that amount.[39]

Determining the HSA contribution limit for married employees can be complicated, as the statute is de-

[32] Notice 2004-50, Q&A-10.

[33] Rev. Proc. 2016-28.

[34] §223(b)(3)(B).

[35] §223(b)(1); Notice 2008-59.

[36] §223(b)(8).

[37] *Id.* Note that the opposite — a switch from family to self-only HDHP coverage — will not prevent an individual from contributing the full family HSA contribution.

[38] §223(b)(8)(B).

[39] *Id.*

© 2017 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0747-8607

signed to prevent duplication of tax benefits.[40] Therefore, if both spouses are HSA-eligible and one of the spouses has family HDHP coverage, the aggregate maximum contributions of both spouses to both HSAs is $6,750 (for 2017).[41] This is true regardless of whether or not the family HDHP coverage excludes the other spouse from coverage. If one spouse has self-only HDHP coverage and the other spouse has non-HDHP coverage, the HSA-eligible spouse can make or receive HSA contributions up to the self-only limit, and the ineligible spouse is not able to make or receive any HSA contributions. Alternatively, if both spouses are separately enrolled in self-only HDHP coverage, the self-only contribution limit will apply to each.[42]

Employer Contributions

Employers may contribute to HSAs established by or on behalf of current and former employees. Employer contributions to HSAs are nonforfeitable and distribution of the contributions generally cannot be subject to restrictions.[43] However, in limited circumstances described in below, employers may be able to recoup mistaken contributions.

Employers are permitted to contribute as much as they would like to their employees' HSAs, provided that the combined employee and employer contributions do not exceed the annual contribution limit. Nevertheless, employer HSA contributions that are not made through a §125 cafeteria plan are subject to a comparability requirement that restricts the variability of contributions among comparable groups.[44] Those comparable groups consist of current full-time employees, current part-time employees, and former employees (excluding COBRA enrollees).[45] Within these comparable groups, employer HSA contributions may vary based on up to four HDHP coverage tiers — self-only, self plus one, self plus two, and self plus three or more.[46] Within each comparability group, employees enrolled in the same HDHP coverage tier must receive the same employer HSA contribution.[47] The chart below provides an example of a permitted employer HSA contribution design.

	Part-Time Employees	Full-Time Employees
Self-Only	$150	$300
Self + 1	$250	$500
Self + 2	$350	$700
Self + 3 or more	$500	$1,000

When assessing comparability, employers may exclude employees subject to a collective-bargaining agreement, self-employed individuals, independent contractors, and COBRA enrollees.[48]

If an employer makes HSA contributions that are not comparable, all HSA contributions made by the employer for a calendar year are subject to 35% excise tax.[49] This excise tax can be avoided by correcting the non-comparable contributions no later than April 15th of the following year or by seeking a waiver from the excise tax based on reasonable cause.[50]

Although the comparability requirement may appear to be relatively straightforward, various facts and circumstances can make the requirement quite burdensome. It is therefore helpful that the regulations include an exception to the comparability requirement — employer HSA contributions made through a cafeteria plan are not subject to the comparability requirement (but they are subject to cafeteria plan discrimination testing).[51] Whether the employer HSA contribution is made in the form of a matching contribution, a one-time ''seed money'' payment, or as an incentive under a wellness program, comparability rules will not apply if the contribution is made through the cafeteria plan. The key is that employees must have the ability to contribute a portion of their compensation to the HSA on a pre-tax basis through a cafeteria plan. If so, any employer HSA contributions will generally also be made through the cafeteria plan.

Tax Treatment

Eligible employees making HSA contributions outside of a cafeteria plan are able to take a deduction for

[40] §223(b)(5).

[41] Notice 2008-59.

[42] *Id.*

[43] §223(d)(1)(E); Notice 2004-50. As described below, distributions prior to age 65 for non-eligible medical expenses will result in a tax penalty.

[44] §4980G; Reg. §54.4980G-1–§54.4980G-5.

[45] Reg. §54.4980G-3, Q&A-5. No other comparability groups may be established for purposes of the comparability requirement. For example, other classifications such as salaried versus hourly or based on location are not permitted.

[46] Reg. §54.4980G-4, Q&A-1.

[47] *Id.* Although an employer could make the same HSA contribution for all coverage tiers, the employer HSA contribution for higher tiers cannot be less than the contribution for lower tiers.

[48] Reg. §54.4980G-1, Q&A-1, §54.4980G-3, Q&As-1-4.

[49] Reg. §54.4980G-1, Q&A-4.

[50] Reg. §54.4980G-4, Q&A-12.

[51] Reg. §54.4980G-5, Q&A-1–§54.4980G-5, Q&A-3.

© 2017 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0747-8607

the contributions on their annual tax returns.[52] HSA contributions made through a cafeteria plan are made on a pre-tax basis and are not subject to withholding for employment taxes. Employer contributions to an HSA on behalf of an HSA-eligible employee are not subject to income tax and or withholding for employment taxes.[53] Employers are generally able to deduct these contributions as ordinary and necessary business expenses.[54]

Contribution Errors

Occasionally, errors occur with respect to HSA contributions. IRS guidance addresses the implications of contribution errors and provides limited methods of correction. Common HSA errors are described below.

Ineligible Employee Contributes to an HSA

As noted above, in order to contribute to an HSA, an employee must meet certain eligibility requirements. If an employee never meets the eligibility conditions, but contributes to an HSA anyway, the IRS takes the position that the HSA never existed. Thus, the employee should be able to withdraw the contributions from the custodial account and would need to include the amount in gross income.[55] This same rule applies to employer contributions that are made to an employee that never satisfied the HSA eligibility requirements.[56] Because no HSA would have been created, the nonforfeitability rule would not be applicable.

Excess Contributions

If an HSA-eligible employee makes or receives HSA contributions in excess of his or her annual contribution limit, the excess contributions should be included in that employee's gross income.[57] Additionally, unless the employee withdraws the excess contributions (and income thereon) by no later than the filing deadline for that year's tax return (including deadline extensions), the excess contributions will be subject to a 6% cumulative excise tax.[58]

Employer Contribution Errors

Other than verifying whether an employee is enrolled in the employer's HDHP, employers are generally not required to take additional steps to verify an employee's HSA eligibility.[59] Therefore, employers occasionally contribute to HSAs on behalf of employees who were never HSA-eligible or who lost HSA eligibility during the year. As noted above, when an employee is never HSA-eligible, the IRS takes the position that no HSA ever existed. In that case, an employer can recoup the incorrect employee contributions. When an employee is HSA-eligible for part of the year, employer contributions made on the mistaken belief that the employee continued to be eligible for the full year *cannot* be recouped by the employer due to the nonforfeitability rule. In this case, the employee will be responsible for determining whether the mistaken employer contribution will result in excess HSA contributions based on the partial-year annual maximum limit, withdrawing any excess contributions and including the appropriate amount in gross income.

When an employer contributes more than the HSA-eligible employee's annual maximum in error, it is possible for the employer to request a return of the excess contributions.[60] However, under IRS guidance, the recoupment is limited only to the amount in excess of the annual maximum. Suppose that an employee elected through a cafeteria plan to contribute $2,500, but the employer allows contributions up to the applicable annual limit of $3,400 for 2017. Under the IRS guidelines, it does not appear that the employer can request the HSA custodian to return the additional contributions.[61]

Notwithstanding the IRS rule described above, the IRS has indicated that there is flexibility when there is clear evidence of an administrative error. Thus, in the example above, if the employer's clerical staff inadvertently entered the wrong contribution amount into the payroll system, the IRS may permit the employer to recoup the mistaken contributions.

HSA Distributions

No Restrictions on Distributions

An employee is permitted to receive distributions from his or her HSA at any time whether or not that employee is HSA-eligible at the time of the distribution and whether or not the distribution is used to reimburse eligible medical expenses.[62] However, as described below, if the employee is younger than age 65, there are tax implications if a distribution is not used to reimburse qualifying medical expenses. The HSA

---

[52] Contributions made by family members are also deductible. Note that some states, such as Alabama, California, and New Jersey, tax contributions to HSAs.

[53] §106(d).

[54] §162.

[55] *See, e.g.,* IRS Info. Letter 2017-0003 (providing that individual entitled to Medicare could not have created HSA).

[56] Notice 2008-59, Q&A-23.

[57] Notice 2004-2, Q&A-22.

[58] §4973(g). The excise tax is cumulative in the sense that excess contributions that are not distributed will be subject to the 6% tax each year they remain the HSA.

[59] Notice 2004-50, Q&A-81.

[60] Notice 2008-59, Q&A-24.

[61] *Id.*

[62] Notice 2004-2, Q&A-24.

© 2017 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0747-8607

custodian may place limited restrictions, such as minimum distribution levels, on HSA distributions.[63]

Tax Treatment

Neither the contributions made to an HSA nor investment gains are subject to federal income tax when they are distributed to reimburse or pay for qualified medical expenses.[64] Distributions that are not made to reimburse or pay for qualified medical expenses must be included in gross income in the year of distribution and are subject to a 20% penalty tax.[65] The 20% penalty tax does not apply to non-medical expense distributions made after the HSA holder's death, disability, or attainment of age 65.[66]

Distributions from HSAs that are not for qualifying medical expenses can avoid income inclusion and the 20% penalty tax if the distribution is rolled over into another HSA within 60 days of the distribution.[67] However, an employee is only permitted to make one rollover contribution to an HSA during a 12-month period.[68]

In limited circumstances, distributions made for non-medical expenses that are not rolled over to another HSA can avoid income inclusion and the 20% penalty tax if the distribution was made in error. IRS guidance provides that, if there is clear and convincing evidence that a distribution was made because of a mistake of fact due to reasonable cause, the HSA holder is allowed to return the distributed funds within a prescribed period of time in order to avoid income inclusion and the 20% penalty tax.[69] The HSA custodian, however, is not obligated to accept the return of mistaken distributions.[70]

Qualified Medical Expenses

As noted above, HSA distributions are not subject to federal income tax if they are made to reimburse or pay for qualified medical expenses incurred after the HSA is established.[71] Qualified medical expenses are expenditures for medical care of an HSA holder and his or her tax dependents. Section 213(d) generally defines "medical care" as amounts paid for "the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure of the body."[72] With certain exceptions, premiums for health insurance are not qualifying medical expenses and cannot be paid from or reimbursed by an HSA.[73]

Prior to the ACA, HSAs could be used to reimburse for eligible medications purchased over-the-counter. However, the ACA limited the ability to use HSAs for medications by requiring that medications (other than insulin) be prescribed by a person authorized to issue prescriptions, even if the medication is otherwise available over-the-counter.[74]

HSA EXPANSION EFFORTS

As noted earlier in this article, members of Congress are currently pushing for HSA expansion in connection with ACA repeal and replacement efforts. The extent to which HSA availability is expanded is yet to be seen, as efforts to repeal and replace the ACA have so far failed. Nevertheless, prior legislative attempts to repeal the ACA and current pending legislation provide insight into what can be expected.

American Health Care Act

On March 6, 2017, the House of Representatives' Ways and Means Committee and Energy and Commerce Committee released budget reconciliation recommendations that were intended to form the American Health Care Act (AHCA).[75] The AHCA was intended to be the bill that repealed and replaced the ACA. However, the AHCA faced strong opposition from the start and, on March 24, 2017, the legislation was withdrawn from consideration.

Compared to prior attempts to repeal the ACA, the AHCA contained limited provisions related to HSA expansion. The AHCA would have increased the self-only and family HSA contribution limits to $6,550 and $13,100, respectively. Spouses would have been able to make catch-up contributions to the same HSA. Over-the-counter medications would have been qualifying medical expenses, even if purchased without a prescription. The 20% penalty tax for distributions made prior to age 65 for non-qualified medical expenses would be reduced back to its original 10%.

Health Savings Account Expansion Act

Although the AHCA failed to gain traction, members of Congress continue to introduce legislation that

---

[63] Notice 2004-50, Q&A-80.

[64] §223(f)(1). Note that two states, New Hampshire and Tennessee, subject investment gains and dividends to state income tax.

[65] §223(f)(4). The ACA increased the penalty tax from 10% to 20%, effective for distributions made after 2010, unless the distribution occurred after the individual became eligible for Medicare (age 65), or on account of the individual's death or disability.

[66] Notice 2004-2, Q&A-25.

[67] §223(f)(5); Notice 2004-50, Q&A-55.

[68] Notice 2004-50, Q&A-55.

[69] Notice 2004-50, Q&A-37.

[70] Notice 2004-50, Q&A-76.

[71] Notice 2002-4, Q&A-26.

[72] A comprehensive list of qualified medical expenses can be found in IRS Publication 502.

[73] §223(d)(2)(B). However, certain premiums, such as for COBRA and long-term care insurance, can be paid for or reimbursed by an HSA.

[74] §223(d)(2)(A).

[75] American Health Care Act, H.R. 1628, 115th Cong. (2017).

© 2017 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0747-8607

would expand the availability of HSAs. For example, currently pending in Congress is the Health Savings Account Expansion Act of 2017 (Expansion Act).[76] Similar to the AHCA, the Expansion Act would increase the contribution limits, but to a higher level — $9,000 for self-only and $18,000 for family. Also like the AHCA, over-the-counter medications would be qualifying medical expenses and the 20% penalty tax would be reduced to 10%.

However, the Expansion Act also contains provisions that would greatly alter the current operation of HSAs. Most striking is a provision that would no longer require employees to be enrolled in HDHPs to be eligible to make or receive contributions to HSAs. Additionally, health insurance premiums would be qualifying medical expenses eligible for payment or reimbursement from HSAs.

CONCLUSION

Driven by market forces and a desire to encourage employees to become better consumers of health care, employers are quickly moving toward HDHPs as a primary health benefit plan design. As a result, HSAs are becoming more common. The prevalence of HSAs is expected to increase as legislative efforts are underway to expand the availability of HSAs by relaxing many of the current restrictions described in this article. Although draft legislation provides some insight into the changes ahead, it appears likely that the core compliance considerations described in this article will remain relevant (with, perhaps, some minor modifications). As always, plan sponsors considering whether to adopt an HDHP with an HSA option or seeking compliance assistance should consult with counsel and other benefits advisors.

---

[76] Health Savings Account Expansion Act of 2017, H.R. 247, 115th Cong. (2017).

© 2017 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0747-8607