

Health savings accounts

The following outlines the significant changes taking effect in 2007 to health savings accounts (HSAs). For eligible individuals, HSAs offer a tax-favorable way to set aside funds (or have their employer do so) to meet future medical needs. Here are the key tax-related elements:

- contributions you make to an HSA are deductible, with limits,
- contributions your employer makes aren't taxed to you,
- earnings on the funds within the HSA are not taxed, and
- distributions from the HSA to cover qualified medical expenses are not taxed.

Who is eligible? To be eligible for an HSA, you must be covered by a "high deductible health plan" (discussed below). You must also not be covered by a plan which (1) is not a high deductible health plan, and (2) provides coverage for any benefit covered by your high deductible plan. (It's okay, however, to be covered by a high deductible plan along with separate coverage, through insurance or otherwise, for accidents, disability, or dental, vision, or long-term care.)

For 2007, a "high deductible health plan" is a plan with an annual deductible of at least \$1,100 for self-only coverage, or at least \$2,200 for family coverage. Additionally, annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits cannot exceed \$5,500 for self-only coverage or \$11,000 for family coverage.

An individual (and the individual's covered spouse as well) who has reached age 55 before the close of the tax year (and is an eligible HSA contributor) may make additional "catch-up" contributions for 2007 of up to \$800.

A high deductible health plan does not include a plan if substantially all of the plan's coverage is for accidents, disability, or dental, vision, or long-term care, insurance for a specified disease or illness, or insurance paying a fixed amount per day (or other period) of hospitalization.

HSAs may be established by, or on behalf of, any eligible individual.

Deduction limits. You can deduct contributions to an HSA for the year up to the total of your monthly limitations for the months you were eligible. Beginning in 2007, the monthly limitation on deductible contributions for a person with self-only coverage is 1/12 of \$2,850. For an individual with family coverage, the monthly limitation on deductible contributions is 1/12 of \$5,650. Thus, deductible contributions are no longer limited by the amount of the annual deductible under the high deductible health plan.

Also beginning in 2007, taxpayers who are eligible individuals during the last month of the tax year are treated as having been eligible individuals for the entire year for purposes of computing the annual HSA contribution.

However, if an individual is enrolled in Medicare, he is no longer an eligible individual under the HSA rules, and so contributions to his HSA can no longer be made.

Contributions may be made to an HSA by or on behalf of an eligible individual even if the individual has no compensation, or if the contributions exceed the individual's compensation. Contributions made by a family member on behalf of an eligible individual

to an HSA (which are subject to the limits described above) are deductible by the eligible individual in computing adjusted gross income.

Rollovers from IRAs, FSAs, and HRAs. For a limited period (beginning August 17, 2006, and ending December 31, 2011) an eligible individual can make a one-time transfer of amounts from a health flexible spending arrangement (health FSA) or health reimbursement arrangement (HRA) to an HSA. The amount transferred is limited to the lesser of (i) the account balance of the individual's health FSA or HRA as of August 21, 2006, or (ii) the account balance of the health FSA or HRA on the transfer date.

Similarly, beginning in 2007, on a once-only basis, taxpayers can withdraw funds from an IRA, and transfer them tax-free to an HSA. The amount transferred can be up to the maximum deductible HSA contribution for the type of coverage (individual or family) in effect at the time of the transfer. The amount so transferred is excluded from the taxpayer's gross income, and is not subject to the 10% early withdrawal penalty.

Employer contributions. If you are an eligible individual, and your employer contributes to your HSA, the employer's contribution is treated as employer-provided coverage for medical expenses under an accident or health plan and is excludable from your gross income up to the deduction limitation, as described above. Further, the employer contributions are not subject to withholding from wages for income tax or subject to FICA or FUTA. The eligible individual cannot deduct employer contributions on his federal income tax return as HSA contributions or as medical expense deductions.

An employer that decides to make contributions on its employees' behalf must make comparable contributions to the HSAs of all comparable participating employees for that calendar year. If the employer does not make comparable contributions, the employer is subject to a 35% tax on the aggregate amount contributed by the employer to HSAs for that period.

Contributions are comparable if they are either: (1) the same amount; or (2) the same percentage of the annual deductible limit under the high deductible health plan covering the employees. For these purposes, comparable participating employees (1) are covered by the employer's high deductible health plan and are eligible to establish an HSA; (2) have the same category of coverage (either self-only or family coverage); and (3) have the same category of employment (either part-time or full-time). (IRS regs provide detailed guidelines for comparable contributions.)

Beginning in 2007, an exception to the comparable contribution requirements applies for contributions made on behalf of nonhighly compensated employees. Under this exception, an employer may make larger HSA contributions for nonhighly compensated employees than for highly compensated employees.

Employer contributions are also excludable if made at the election of the employee under a salary reduction arrangement that is part of a cafeteria plan (i.e., a plan which allows you to elect to use part of your salary towards a variety of benefits). Although contributions to an employee's HSA through a cafeteria plan are treated as employer contributions, the comparability rule does not apply to contributions made through a cafeteria plan.

Earnings. If the HSA is set up properly, it is generally exempt from taxation, and there is no tax on earnings. However, taxes may apply if contribution limitations are exceeded, required reports are not provided, or prohibited transactions occur.

Distributions. Distributions from the HSA to cover an eligible individual's qualified medical expenses, or those of his spouse or dependents, are not taxed. Qualified medical expenses for these purposes generally mean those that would qualify for the medical expense itemized deduction. If funds are withdrawn from the HSA for other reasons, the withdrawal is taxable. Additionally, an extra 10% tax will apply to the withdrawal, unless it is made after reaching age 65, or in the event of death or disability.

Distributions from an HSA exclusively to pay for qualified medical expenses are excludable from the gross income of the account beneficiary even though the beneficiary is no longer an "eligible individual," e.g., the individual is over age 65 and entitled to Medicare benefits, or no longer has a high deductible health plan.