



## Kiplinger Financial Services' COMMON CENTS MATTERS

SEPTEMBER, 2004

### HEALTH CARE (Part 2 of 2)

In an effort to gain a better understanding of the health care benefits available to us during retirement, we are looking at the highlights of the health care coverage available under the Medicare Prescription Drug, Improvement and Modernization Act of 2003 signed by President Bush on December 8 2003. In *Health Care, Part 1 of 2*, we reviewed Medicare which included eligibility, structure, type of service plans and enrollment as well as costs, coverage, and changes with the new law.

In Part 2 of 2, we will take a look at the newly created Health Savings Accounts (HSAs) that were designed to help individuals save for future qualified medical and retiree expenses on a tax-free basis.

#### **WHAT IS A HEALTH SAVINGS ACCOUNT?**

A HSA is a tax-deferred savings account used in combination with a high deductible health plan to pay for qualified medical expenses until the high deductible is met. Deductible contributions to HSAs, by eligible individuals, began as of January 1, 2004.

Contributions must be made in cash. If funds contributed are not withdrawn, they compound on a tax-advantaged basis over time. Thus, there is no "use it or lose it" provision.

#### **ELIGIBILITY FOR A HSA**

An individual must meet the following criteria to be eligible for a HSA:

- ❖ be covered by a High Deductible Health Plan (HDHP),
- ❖ must not be covered by other health insurance (does not apply to specific injury insurance and accident, disability, dental care, vision care, long-term disability),
- ❖ is not eligible for Medicare, and
- ❖ cannot be claimed as a dependent on someone else's tax return.

Eligibility is determined on a monthly basis.

#### **WHAT IS A HIGH DEDUCTIBLE HEALTH PLAN (HDHP)?**

A HDHP is a health insurance plan with a minimum deductible of \$1,000 (individual coverage) or \$2,000 (family coverage). The annual out-of-pocket costs (including deductibles and co-pays) cannot exceed \$5,000 (individual coverage) or \$10,000 (family coverage). HDHPs can have first dollar coverage (no deductible) for preventive care and higher out-of-pocket costs (copays and coinsurance) for non-network services. Deductible and out-of-pocket cost limitations will be indexed for inflation in future years.

#### **ESTABLISHING A HSA**

Beginning January 1, 2004, any eligible individual can establish a HSA with a qualified HSA trustee or custodian, similar to the way individuals establish an Individual Retirement Account (IRA). An eligible individual who is an employee may establish a HSA with or without involvement of the employer.

Any insurance company or financial institution, such as a bank, that is already approved by the Internal Revenue Service (IRS) to be a trustee or custodian of IRAs are automatically approved to be a HSA trustee or custodian.

#### **CONTRIBUTIONS TO A HSA**

HSA contributions can be made by the employer or the employee, or both. If contributions are made by the employee, they can receive an "above-the-line" deduction when computing adjusted gross income (AGI). Thus, it is not necessary to itemize to get the deduction.

If contributions are made by the employer, it is not taxable to the employee. If the employer makes HSA contributions, the employer must make available comparable contributions on behalf of all comparable participating employees during the same period. Both a HSA and a HDHP can be offered as options under a cafeteria plan. Employer contributions to a HSA must be reported on the employee's Form W-2. The IRS has

forms and instructions on how to report HSA contributions, deductions and distributions.

Contributions can also be made by others on behalf of an eligible individual and deducted by the individual (not the contributing person.) All contributions are aggregated.

Similar to IRAs, contributions can be made any time between January 1<sup>st</sup> and April 15<sup>th</sup> of the following tax year. A 6% excise tax will be imposed annually on excess contributions. No excise tax will be imposed, however, if the excess contribution and any earnings attributed to the excess contribution are withdrawn prior to the filing of the individual's income tax return.

### **CONTRIBUTION LIMITS TO A HSA**

The 2004 maximum contribution is the lesser of the deductible amount under the HDHP, or \$2,600 for individuals and \$5,150 for family coverage. These dollar limits will be adjusted for inflation each year. Contribution limits are computed each month based on the individual's eligibility on the first day of each month.

Individuals 55 and older who are covered by a HDHP can make additional catch-up contributions as follows:

- 2004 - \$500	- 2007 - \$800
- 2005 - \$600	- 2008 - \$900
- 2006 - \$700	- 2009 and after - \$1,000

If both spouses are eligible individuals, both may make catch-up contributions. Contributions must stop once an individual is eligible for Medicare.

The HSAs were modeled after the Archer Medical Savings Accounts (MSAs). However, the HSA contribution rules are more generous than the Archer MSAs. Contributions to Archer MSAs are limited to 75% of the deductible amount for a family (65% for individual plans), employee's compensation or self-employment income. In addition, if an employer made a contribution, an employee could not. Rollovers are permitted from Archer MSAs and other HSAs.

### **DISTRIBUTIONS FROM THE HSA**

Amounts distributed can be used for either qualified medical expenses or other expenses. The distribution is tax free if the funds are used for qualified medical expenses. The distributions will be taxed and subject to a 10% tax penalty if the amount distributed is used for other than qualified medical expenses for individuals who are not disabled or over age 65.

Generally, HSAs cannot be used to pay insurance premiums. However, they can be used to pay qualified long-term care insurance, COBRA coverage and health care premiums while a person is receiving unemployment compensation.

Account holders are responsible for determining whether or not expenses are qualified. Qualified medical expenses are defined in Internal Revenue Code Section 213(d) and generally include expenses related to the diagnosis, treatment, cure or prevention of a disease. Dental and orthodontia expenses would qualify, as would laser eye procedures. Most cosmetic procedures are not covered, but there are some exceptions.

Recordkeeping, i.e., maintaining receipts, for HSA distributions is important to prove any or all of the following to the IRS:

- that distributions from a HSA were for qualified medical expenses,
- deductibles were met under the HDHP, and
- expenses paid out of the HSA that were not charged against the deductible were for other qualified expenses such as dental or vision care.

### **WHAT HAPPENS TO THE MONEY IN A HSA AT AGE 65?**

At age 65, the amounts remaining in a HSA can be used for health expenses and to pay certain insurance premiums like Medicare, Parts A and B, Medicare HMO and the employee's share of retiree medical insurance premiums. It cannot be used to purchase a Medigap policy. If the funds are used for medical expenses, the amounts can come out of the account tax free. If, however, the account is used to pay for other expenses, the amount received will be taxable.

### **WHAT HAPPENS TO THE MONEY IN A HSA IF THE ACCOUNT HOLDER DIES?**

A beneficiary can be named for the account. If the beneficiary is the surviving spouse, the account becomes the HSA of the surviving spouse. Distributions will be tax free if the spouse subsequently uses the HSA for qualified medical expenses. Distributions will be taxable without a 10% penalty if the withdrawals are used for other purposes.

If the beneficiary is not a spouse, the account ceases to be a HSA and the fair market value of the account as of the date of death is taxable income to the beneficiary and is included in the estate of the individual.

Preparing for retirement includes evaluating health care coverage available, options to choose from and action needed to fill in the gaps for health care. In *Health Care, Part 1 of 2*, we provided you with an overview of Medicare and what it has to offer. In this edition, we disclosed the tax-advantaged HSAs which may provide you with another tool to help with medical expenses for you and your family.