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Health Savings Accounts (HSAs)

— by Neil E. Harl*

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003, signed into law on December 8, 2003, is a major piece of legislation by any reasonable measure. The legislation comes with an official $395 billion price tag but the actual cost is believed to be more than 30 percent greater than that. The 415-page bill overhauls and extends the national involvement in health care.

One notable feature of the bill is authorization of Health Savings Accounts or HSAs. HSAs will provide tax-favored treatment of current medical expenses and the opportunity to save on a tax-privileged basis for future medical expenses. HSAs are tax-preferred accounts similar to medical savings accounts (MSA), which were continued through 2003. HSAs allow individuals to save for medical expenses in portable, tax-free, interest-bearing accounts. However, HSAs differ from MSA plans which can only be used by small business employees and the self-employed. Contributions to HSAs, as with MSAs, are deductible for income tax purposes.

**Deductibility**

Beginning January 1, 2004, a family, regardless of income, may establish an HSA and deduct an amount equal to the annual deductible on its health insurance plan. It is necessary for the plan to be a high-deductible plan and the amount cannot exceed the lesser of the annual deductible under the plan or $2250 (for self-only coverage) or $4500 (for family coverage) for those under age 55. For those aged 55 or older, an extra $500 can be contributed in 2004. That amount increases to $600 in 2005, $700 in 2006, $800 in 2007, $900 in 2008 and $1,000 for later years. By 2009, the deposit limits will be $5,500 for those with family coverage, $3250 for those with individual coverage.

A high deductible health plan is a plan with a deductible of at least $2,000 (which is indexed for inflation) for family coverage ($1,000 for self-only coverage) with an out-of-pocket expense limit that is no more than $5,000 for self-only coverage or $10,000 for family coverage.

**Must be a trust**

The new rules require HSAs to be set up as a trust with a bank, insurance company or another qualified person as the trustee. No part of trust assets can be invested in life insurance contracts, the assets of the trust cannot be commingled with other property (except for a common trust fund or common investment fund) and the interests in the account must be nonforfeitable.

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Distributions

Any amount distributed from a health savings account which is used exclusively to pay qualified medical expenses of an account beneficiary is not includible in gross income. If not paid for qualified medical expenses of an account beneficiary, the distributions are taxable.

Distributions not for qualified medical expenses are includible in gross income and are subject to an additional 10 percent tax unless made after death or disability or reaching age 65.

Funds in the plan can be used for qualified medical expenses—expenses for diagnosing, care, mitigation, treatment or prevention of disease, qualified long-term care expenses and prescription drugs. An individual who is covered by both a high deductible health plan (HDHP) that does not apply to prescription drugs and by a separate prescription drug plan or rider providing benefits before the minimum annual HDHP deductible has been satisfied does not qualify as an eligible individual and cannot make HSA contributions. The same result occurs if the prescription drug benefit is provided as a benefit under a health plan or as a benefit for the individual under the spouse’s plan. If no benefits are provided under the separate drug plan or rider until the minimum annual HDHP deductible has been satisfied, or the prescription drug plan is part of an HDHP and is subject to the minimum annual deductible, the individual is considered eligible.

IRS has provided transition relief for individuals covered by both HDHPs and by a separate plan or rider providing prescription drug benefits before the minimum annual HDHP deduction is satisfied. Those persons continue to be eligible and may make contributions to an HSA based on the annual deductible of the HDHP for months before January 1, 2006.

Health insurance cannot be purchased from the plan except for a health plan during any period of continuation coverage required under federal law, a qualified long-term care insurance contract, a health plan during a period in which the individual is receiving unemployment compensation under federal or state law or any Medicare supplemental policy once the individual reaches the age of eligibility.

Death of the beneficiary

In the event of death, if the surviving spouse is the named beneficiary, the HSA passes to the surviving spouse who is subject to income tax only on distributions from the HSA that are not for qualified medical expenses. The surviving spouse is treated as the account beneficiary. For HSAs passing to a beneficiary other than the surviving spouse, the account ceases to be an HSA as of the decedent’s death with the beneficiary required to include the fair market value of the account assets in the beneficiary’s income. A deduction is allowed, in that event, for the income tax paid on the amount as income in respect of decedent.

Divorce

The transfer of an individual’s interest in a health savings account to an individual’s spouse or former spouse under a divorce or separation instrument is not considered a taxable transfer with the spouse or former spouse as transferee treated as the account beneficiary.

Eligibility

To be eligible to make contributions to a Health Savings Account, the individual must be covered by a high deductible health plan and no other health plan.

Eligible individuals who establish an HSA on or before April 15, 2005, have been provided transition relief for calendar year 2004 from the requirement that qualified medical expenses may only be paid or reimbursed by an HSA if incurred after the HSA has been established. For calendar year 2004, an HSA established by an eligible individual on or before April 15, 2005, is authorized to pay or reimburse, on a tax-free basis, an otherwise qualified medical expense that arose on or after the later of (1) January 1, 2004 or (2) the first day of the first month that the individual became eligible.

Employer contributions are permitted and are treated as employer-provided coverage for medical expenses under an accident or health plan to the extent the amounts do not exceed the HSA limits. Employer contributions are income tax deductible and are not subject to FICA taxes. Contributions may also be made by employees from cafeteria plans.

FOOTNOTES

2 Id.
3 I.R.C. § 220.
5 See note 1 supra.
6 I.R.C. §§ 220(a), 220(c)(1), 220(c)(4).
7 I.R.C. §§ 220(a), 223(a).
8 I.R.C. §§ 223(a), (b).
9 I.R.C. § 223(a), (b)(2).
10 I.R.C. § 223(b)(3).
11 Id.
12 I.R.C. § 223(d)(1)(B).
13 I.R.C. § 223(d)(1)(C).
14 I.R.C. § 223(d)(1)(D).
16 I.R.C. § 223(f)(1).
17 I.R.C. § 223(f)(2).
the land was higher, based on a value of the entire property at its highest and best use. The court agreed with the creditor and held that the land had to be valued at its replacement value and the value could not be restricted to the use of the debtor or a similar buyer. *In re Bell*, 304 B.R. 878 (Bankr. N.D. Ind. 2003).

**FEDERAL TAX**

**REFUND.** The debtors’ chapter 13 plan was confirmed and provided for payment of all disposable income to unsecured creditors. The IRS had general unsecured claims and the taxes were to be paid only from plan funds. The debtor became entitled to an income tax refund during the plan which was paid by the IRS. The IRS then sought a turnover of the refund and a modification of the plan to include the refund in the unsecured claims payments. The court denied the IRS motion because the IRS did not provide specific plan revisions to guide the court in determining the amount of the refund eligible for payments to unsecured creditors. *In re Breeden*, 304 B.R. 318 (Bankr. N.D. Ohio 2003).

**TAX LIEN.** The debtor had filed for Chapter 7 and the debtor’s taxes for 1987, 1989 and 1991 were discharged. However, the IRS had filed a pre-petition tax lien for the discharged taxes which attached to the debtor’s interest in a 401(k) pension plan. Five years after the bankruptcy discharge, the IRS filed a notice of intent to levy against the debtor’s interest in the pension plan. The court held that the tax lien survived the discharge of the debtor’s personal liability for the taxes and the lien could be executed by levy against any non-exempt property held by the debtor which was subject to the lien. Because the interest in the 401(k) plan was not exempt from levy, the court held that the levy was proper. *Iannone v. Comm’r*, 122 T.C. No. 16 (2004).