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MEMORANDUM

April 2, 2004

TO: Clients

FROM: Groom Law Group

RE: IRS Health Savings Account Guidance

IRS Provides Preventive Care Safe Harbor and Helpful Transition Relief for HSAs.

On March 30th, the IRS issued the following guidance (Notice 2004-23, Notice 2004-25, Rev. Rul. 2004-38, and Rev. Proc. 2004-22) on Health Savings Accounts ("HSAs") that provides:

- A safe harbor list of services that are included within the term "preventive care," which are not subject to a deductible under the high deductible health plan. Preventive care does not include any service or benefit intended to treat an existing illness, injury, or condition.
- Transition relief for individuals who are covered by a high deductible health plan and wish to participate in an HSA for 2004. These individuals have until April 15, 2005 to establish and contribute to an HSA. Upon establishing an HSA, these individuals may take tax-free distributions for all qualified medical expenses incurred during the time period that the individuals were covered under the high deductible health plan (even if the expenses were incurred before the HSA was set up).
- A general rule that an individual who has prescription drug coverage that is not subject to a minimum deductible of \$1,000 self-only or \$2,000 family is disqualified from contributing to an HSA. However, until January 1, 2006, non-high deductible prescription drug coverage may be provided through a separate rider or plan without disqualifying a covered individual from contributing to an HSA.

A brief background of the HSA law and previous IRS guidance (Notice 2004-2) is provided below, followed by a more detailed discussion of this guidance, a summary of upcoming guidance, and our conclusions.

I. Background

A. HSA Statute

The "Medicare Prescription Drug, Improvement and Modernization Act of 2003" Pub. L. No. 108-173 (December 8, 2003), created a new type of tax-favored savings vehicle for health expenses known as a Health Savings Account. The HSA legislation, contained in new section 223 of the Internal Revenue Code, became effective January 1, 2004. The HSA is a funded account, similar to an IRA, to which individuals under age 65 and/or employers may make annual contributions within specified limits. For 2004, the contribution limits are the lesser of (i) the annual deductible or (ii) \$2,600 self-only or \$5,150 family coverage. The earnings in the account grow on a tax-free basis, and, if used for medical expenses, may be withdrawn on a tax-free basis. When an individual becomes Medicare-eligible, or in the event of death or disability, amounts in the account may be used for any purpose without incurring a tax penalty (although these amounts must be included in income).

In order to participate in an HSA, an individual must be covered under a "high deductible health plan," and such individual is restricted from participating in any other non-high deductible health plan, subject to certain exceptions. For 2004, a high deductible health plan is defined as a plan with a minimum annual deductible of \$1,000 for self-only or \$2,000 for family coverage. The annual out-of-pocket cap for the high deductible health plan must also not exceed \$5,000 for self-only or \$10,000 for family coverage.

B. Notice 2004-2

In an effort to facilitate adoption of HSAs in 2004, the IRS issued Notice 2004-2 on December 22, 2003. That guidance provides basic clarification of statutory rules and addresses a handful of new issues not covered by the statute. These issues include:

- **Self-substantiation:** The notice clarifies that neither a trustee nor an employer is responsible for verifying whether an HSA is used for qualified medical expenses. Rather, an HSA participant is responsible for making this determination and maintaining appropriate records. (Q&A-29, 30)
- **Not a "Welfare Benefit Fund":** The notice clarifies that an HSA is not a

welfare benefit fund within the meaning of section 419 of the Code. Accordingly, the rules under section 419(a) of the Code, which limit employer deductions, do not apply. (Q&A-36)

- Self-insured: The notice clarifies that a high deductible health plan that accompanies an HSA may be self-insured. (Q&A-7)
- The notice clarifies that the HSA and the high deductible health plan provider need not be the same entity. (Q&A-10)
- Nonprescription drugs: The notice clarifies that expenses for nonprescription drugs will be considered qualified medical expenses that are eligible for tax-free reimbursement from an individual's HSA. (Q&A-26)
- Use of debit cards: The notice clarifies that a debit card may be used with an HSA. (Q&A-37)
- Loss of eligibility: The notice clarifies that if an individual who establishes an HSA ceases to be an eligible individual (e.g., because that individual ceases to maintain high deductible health plan coverage as required), the individual may continue to use the HSA, but may not make further contributions. (Q&A-28)

The IRS requested public comment on the positions taken in the notice, as well as on specific issues identified at the end of the notice. These specific issues included a request for comments on the appropriate definition for "preventive care," which the HSA statute left undefined.

II. New IRS Guidance

A. Preventive Care: Notice 2004-23

The HSA statute contains one exception to the general rule that all benefits provided under the high deductible health plan are subject to minimum deductibles of \$1,000 (self-only) or \$2,000 (family). This exception applies to any services that satisfy the definition of "preventive care." The HSA statute itself did not include a definition of preventive care. Accordingly, this guidance was necessary in order to determine which benefits may and may not be covered under the high deductible health plan before the deductible is satisfied.

Notice 2004-23 sets forth a safe harbor list of services that are included within the term "preventive care." This list includes periodic health evaluations with associated tests and diagnostic procedures, routine prenatal and well-child care, child and adult immunizations, tobacco cessation programs, obesity weight-loss programs, and specifically identified screening services. Preventive care does not include any service or benefit intended to treat an existing illness, injury, or condition. In addition, the IRS does not recognize a separate exception for benefits that are required to be provided on a first dollar basis pursuant to state law. Instead, all benefits that are covered prior to satisfaction of the deductible must comply with the federal definition of preventive care.

The notice requests comments on whether any other preventive care services should be added to the list. In addition, the notice requests comments on the extent to which benefits provided by an employee assistance program, mental health program or wellness program may qualify as preventive care, including comments regarding the scope of treatments provided as benefits through counseling and health assessments. Finally, the notice requests comments on whether any drug treatments should be considered preventive care.

B. Prescription Drug Coverage: Rev. Rul. 2004-38, Rev. Proc. 2004-22

Currently, many group health insurers offer prescription drug coverage as a separate rider to a high deductible health plan. The prescription drug benefits offered under these riders are typically not subject to a deductible. Accordingly, the issue of whether this type of prescription drug coverage would violate the HSA statutory prohibition against participation in a non-high deductible health plan has been of great concern to several companies and the subject of written comments to Treasury.

Rev. Rul. 2004-38 takes the position that any individual who has prescription drug coverage that is not subject to a minimum deductible of \$1,000 self-only or \$2,000 family coverage is disqualified from participating in an HSA. However, the accompanying Rev. Proc. provides that, prior to January 1, 2006, non-high deductible prescription drug coverage may be provided through a rider or plan that is separate from a high deductible health plan without disqualifying a covered individual from contributing to an HSA. This exception only extends to prescription drug benefits that are through a separate plan or rider and not to prescription drug benefits that are provided as part of the same high deductible health plan.

C. Establishment of HSA: Notice 2004-25

An individual who is participating in a high deductible health plan in 2004 and wishes to participate in an HSA in 2004 has until April 15, 2005 to establish and

contribute to an HSA. Once the HSA is established and funded, that individual may take tax-free distributions for all qualified medical expenses incurred after the later of:

- January 1, 2004; or
- the date the individual became covered under the high deductible health plan.

This rule applies for 2004 only, and is an exception to the general IRS rule described in Notice 2004-2, Q&A-26, that no tax-free distributions may be taken from an HSA for qualified medical expenses incurred before the date the HSA is established. The IRS's stated rationale for this rule is that it has been difficult for individuals to locate trustees who will sponsor HSAs and it is therefore necessary to provide short-term relief.

III. Conclusions and Upcoming Guidance

The recent guidance is clearly designed to facilitate immediate implementation of HSAs. By eliminating the prescription drug issue as an obstacle until January 1, 2006, the guidance makes it more likely that group insurers will be able to offer products that satisfy the HSA statutory requirements on a timely basis. Similarly, by clarifying the definition of preventive care through the use of a safe harbor rather than with an exclusive list services that constitute preventive care, the guidance increases the likelihood that the definition will be consistent with insurance products currently available in the market. Finally, by granting individuals who establish an HSA as late as April 15, 2005 the same treatment that those individuals would have received if they established HSAs on January 1, 2004, the guidance creates an incentive for individuals to adopt HSAs this year.

The IRS has stated the guidance regarding the use of a health flexible spending arrangement and health reimbursement arrangement with an HSA will be issued shortly. In addition, guidance on employer HSA matching contributions and a model document for use by trustees is also expected in the near future. Additional issues will be addressed in June 2004 guidance. At that time, Treasury will assess the outstanding issues that remain, and will consider opening a formal regulations project.

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Please contact Mike Thrasher or Chris Keller at (202) 857-0620 with any questions.