THE ADVANTAGES OF HEALTH SAVINGS ACCOUNTS - THE CODE'S NEWEST HEALTHCARE ARRANGEMENT

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Although the rules seem complex and technical corrections may be needed, HSAs may prove to be quite beneficial for both employers and individuals whose medical insurance involves a "high deductible" plan. Contributions and distributions, subject to the statutory and administrative requirements, are tax advantaged, and unlike flexible spending arrangements the HSA is not an annual but a perennial, and portable to boot.

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (P.L. 108-173, 12/8/03; "the Act") creates a new benefit, the health savings account (HSA), effective 1/1/04, and makes it a permanent feature of the Code.

Contributions are made to the HSA either by an individual on a tax-deductible basis, or by the individual's employer. Employer contributions are not taxable to the individual and are deductible by the employer. Amounts held in the HSA are invested and grow tax free. Amounts may be withdrawn by the individual from the HSA on a tax-free basis and applied to pay the individual's medical expenses that are not covered by insurance or otherwise.

Thus, an HSA could help an individual pay current medical expenses, as well as save for future medical expenses, on a tax-favored basis. The tax-advantaged features of the HSA could make it very useful to an individual facing current and future medical expenses, and to an employer seeking to help its employees pay such expenses. The availability of an HSA is in addition to the Archer medical savings account (MSA), and is accessible to significantly more individuals than the Archer MSA.

The requirements and tax features of the HSA, as clarified by Notice 2004-2, 2004-2 IRB 269, and how it compares with the Archer MSA, flexible spending accounts (FSAs), and health reimbursement arrangements (HRAs), will be explored below.

■ Establishing the HSA

An HSA is a trust or custodial account, which is created or organized in the U.S. as an HSA exclusively for the purpose of paying the qualified medical expenses of the individual for whom the account is established (the "account holder") and his or her spouse and dependents. The terms of the HSA must be set forth in writing, and the written instrument governing the HSA must provide the following:

< Except in the case of a valid "rollover contribution," no contribution will be accepted (1) unless it is in cash, and (2) to the extent such contribution, when added to previous contributions made to the HSA for the year, exceeds the maximum deduction limit on regular contributions for the year ($4,500 for 2004), plus the limit on catch-up contributions for the year ($500 for 2004).

< The trustee or custodian will be a bank (as defined in Section 408(n)), an insurance company (as defined in Section 816), or another person who demonstrates to the satisfaction of the IRS that such person will administer the trust or custodial account in a manner that will be consistent with the Code's requirements for HSAs.

< No portion of the HSA's assets will be invested in life insurance contracts.

< The HSA's assets will not be commingled with other property except in a common trust fund or common investment fund.

< The interest of the account holder in the account balance of his or her HSA account is non forfeitable.

Any violation of the foregoing provisions would cause the account to lose its status as an HSA. Subject to such provisions, amounts contributed to an HSA may be invested in the manner directed by the account holder (e.g., in interest-bearing savings accounts, money market funds, certificates of deposit, mutual funds, stocks and bonds). The HSA's trust or custodial account is exempt from federal income taxation (i.e., the inside build-up of funds is not taxable), except that the account is subject to tax on unrelated business income under Section 511. Thus, an HSA generally provides tax-favored treatment for the accumulation of funds to pay current qualified medical expenses, as well as the ability to save on a tax-favored basis for the payment of future qualified medical expenses. Community property laws do not apply to HSAs.

According to Notice 2004-2, any individual may establish an HSA with a qualified HSA trustee or custodian, in much the same way as an individual would establish an IRA or an Archer MSA. An individual does not need permission or authorization from the Service to establish an HSA. The individual may establish an HSA with or without the involvement of an employer.

As indicated above, any insurance company or bank can be an HSA trustee or custodian. In addition, any other person already approved by the IRS to be a trustee or custodian of an IRA or Archer MSA is automatically approved by the IRS to be an HSA trustee or custodian. Any other person not already approved may request approval to be an HSA trustee or custodian in accordance with the procedures set forth in Reg. 1.408-2(e) (relating to IRA nonbank trustees).

The HSA may be established through a qualified trustee or custodian who is not the sponsor or provider of the high deductible health plan (as described below). Such trustee or custodian may require proof or certification that the individual wishing to establish the HSA is an eligible individual (also described below), including that the individual is covered by a high deductible health plan.

Key Terms

As described below, to be entitled to take a tax deduction for contributions to an HSA, the account holder must be an "eligible individual" for a month. The account holder is an eligible individual, with respect to any month, if he or she is covered by a "high deductible health plan" as of the first day of such month, and is not, while covered by a high deductible health plan, covered (as an individual, spouse, or dependent) by any other health plan that is not a high deductible health plan, and which provides coverage for any benefit that also is covered under the high deductible health plan.

As an exception, an account holder with other coverage in addition to a high deductible health plan is not precluded from being treated as an eligible individual if such other coverage is provided by "permitted insurance" or constitutes "permitted coverage."

Permitted insurance is any of the following:

1. Insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such other similar liabilities as the IRS may prescribe by Regulations.

2. Insurance for a specified disease or illness.

3. Insurance that pays a fixed amount per day (or other period) for hospitalization.

Permitted coverage is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term healthcare.

High deductible plans

A high deductible health plan is a health plan which in the case of self-only coverage has an annual deductible of at least $1,000 and in the case of family coverage has an annual deductible of at least $2,000. Also, under the plan, the sum of the annual out-of-pocket expenses cannot exceed $5,000 in the case of self-only coverage and cannot exceed $10,000 in the case of family coverage. Out-of-pocket expenses consist of deductibles, co-payments, and other amounts (other than premiums) that the individual must pay for covered benefits under the plan.

For these purposes, family coverage is any coverage other than self-only coverage. In the case of family coverage, a plan is a high deductible health plan only if, under the terms of the plan and without regard to which family member or members incur expenses, no amounts are payable from the plan until the family has incurred annual covered medical expenses in excess of the minimum annual deductible. An employer's self-insured medical plan can qualify as a high deductible health plan.

Notice 2004-2 provides some examples in Q&A-3, as adapted below.

Example 1: A and his family are covered by a plan that provides for the payment of covered medical expenses of any member of A's family if the member has incurred covered medical expenses during the year in excess of $1,000, even if the family has not incurred covered medical expenses in excess of $2,000. If A incurred covered medical expenses of $1,500 during a year, the plan would pay $500. Thus, benefits are potentially available under the plan even if the family's covered medical expenses do not exceed $2,000. Because the plan provides family coverage with an annual deductible of less than $2,000, the plan is not a high deductible health plan.

Example 2: The facts are the same as in Example 1, except that the plan has a $5,000 family deductible and provides payment for covered medical expenses if any member of A's family has incurred covered medical expenses during the year in excess of $2,000. The plan satisfies the requirements for a high deductible health plan with respect to the deductibles.

A plan is not treated as a high deductible health plan if substantially all of the coverage it provides is for permitted coverage or coverage that may be provided by permitted insurance, as described above. A plan does not fail to be treated as a high deductible health plan solely because it does not have a deductible (or has a small deductible) for "preventive care" (within the meaning of section 1871 of the Social Security Act, as modified for this purpose by the IRS to make such meaning consistent with the Code's rules pertaining to the HSAs). Thus, preventive care services may be covered on a first-dollar basis, and deductibles need not apply to such services. Except for preventive care, however, a plan may not provide benefits for any year until the deductible for that year is met.

If a plan uses a network of providers, the plan will not fail to be treated as a high deductible health plan solely because it has an out-of-pocket limitation for services provided outside of the network that exceeds the $5,000 and $10,000 out-of-pocket-expense annual maximums. Also, such plan's annual deductible for services provided outside of such network is not taken into account for the purpose of computing the "monthly limitation" on deductions described below (i.e., the deductible for services within the network is used for such purpose).

- **Qualified medical expenses**

As stated above, an HSA must be established exclusively for the purpose of paying "qualified medical expenses." Qualified medical expenses are amounts paid by the account holder for "medical care" (as defined as under Section 213(d)) for the account holder, or his or her spouse or "dependent" (as defined in Section 152), but only to the extent that such amounts are not compensated by insurance or otherwise.

Medical care (as so defined) generally includes expenses for the costs of diagnosis, cure, mitigation, treatment, or prevention of disease, including the costs of transportation primarily for and essential to such care, and qualified long-term care expenses. The cost of prescription drugs and over-the-counter medicines normally would be treated as medical care expenses.

Qualified medical expenses, however, do *not* include premiums or other payments for insurance other than for (1) qualified long-term care insurance (as defined in Section 7702B), (2) health coverage during any period of continuation coverage required by federal law such as COBRA, or (3) health coverage while an individual is receiving unemployment compensation under federal or state law.

Qualified medical expenses also include health insurance premiums for individuals eligible for Medicare, other than premiums for Medigap policies. Such health insurance premiums include, for example, Medicare Part A and Part B premiums, Medicare HMO premiums, and the employee share of premiums for employer sponsored health insurance including employer-sponsored retiree health insurance.

Whether an expense is a qualified medical expense is determined at the time the expense is incurred. An expense cannot be a qualified medical expense if it is incurred before the HSA has been established.

■ **Deductions For The Account Holder**

Contributions may be made to the HSA of an account holder by any of the following:

< The account holder.

< Any other individual (including but not limited to a family member of the account holder)

< The employer of the account holder.

Under Section 125(d)(2)(D), an employer may offer HSAs to its employees as part of a Section 125 cafeteria plan.

If the account holder is an eligible individual for any month during a year, the account holder may deduct, for federal income tax purposes, the contributions made for that year to the HSA by or on behalf of the account holder. Deductions for HSA contributions are "above-the-line" items used to determine adjusted gross income (i.e., the account holder can use the deductions without regard to whether the account holder itemizes deductions). Nevertheless, the amount of the account holder's deduction is limited, as described below.

The amount of an account holder's deduction for a year cannot exceed the sum of the "monthly limitations" for the months during such year for which the account holder is an eligible individual. If the account holder has self-only coverage under a high deductible health plan on the month's first day, the monthly limitation, for that month, is 1/12 of the lesser of (1) the annual deductible under such coverage or (2) $2,250. If the account holder has family coverage under a high deductible health plan on the month's first day, the monthly limitation, for that month, is 1/12 of the lesser of (1) the annual deductible under such coverage or (2) $4,500.

If the account holder is *not* an eligible individual for a particular month, there is no monthly limitation taken into account for that month when computing the deduction

limit, or put another way, the monthly limitation taken into account for that month is zero.

■ **Catch-up amounts**

If the account holder attains age 55 before the close of the year in question, in computing the monthly limitation for each month in that year the lesser amount under each of the variations above is increased by the catch-up amount shown below:

Year	Catch-up amount
2004	$500
2005	600
2006	700
2007	800
2008	900
2009 and thereafter	1,000

Further, the deduction limit for a year, computed after taking into account the catch-up amount (if applicable for that year), is reduced by the sum of (1) the total amount contributed for such year to the account holder's Archer MSAs, and (2) the total amount of nontaxable contributions made for such year to HSAs of the account holder by his or her employer(s). Thus, the account holder cannot deduct any amounts contributed by the employer to an HSA, to the extent that such amounts are not taxable to the account holder.

■ **Special Rules for Deductions**

Contributions are treated as being made for a year if they are made on account of that year, and are actually paid to the HSA's trust or custodial account by the due date (without extension) of the account holder's federal income tax return for that year.

< If two account holders are married to each other, and either spouse has family coverage, then:

< Both spouses are treated as having *only* family coverage (and if each spouse has family coverage under a different plan, as having the family coverage with the lowest annual deductible).

< The deduction limit of the spouses for the year is determined by (1) summing the monthly limitations for both spouses, disregarding any catch-up contribution, (2) then subtracting from that amount the total amount contributed to the Archer MSAs of both spouses for the year, (3) dividing that result between the spouses equally or as they otherwise agree, and finally (4) adding back for each spouse any catch-up contribution available to him or her.

An account holder cannot take any deduction for contributions to his or her HSA for any year for which he or she may be claimed as a deduction under Section 151 by another

individual. The monthly limitation is zero for the first month the account holder is entitled to Medicare benefits (i.e., the month of his or her 65th birthday) and for each month thereafter. The following illustration is adapted from Notice 2004-2, Q&A-14.

Example 3: An individual attains age 65 and becomes eligible for Medicare benefits in July 2004. She had been participating in self-only coverage under a high deductible health plan with an annual deductible of $1,000. She is no longer eligible to make deductible HSA contributions (including catch-up contributions) after June 2004. The monthly contribution limit is $125 ($1,000/12 + $500/12 for the catch-up contribution). The individual may make deductible contributions for January through June 2004 totaling $750 (6 ×× $125), but may not make any deductible contributions for July through December 2004.

▪ EXCISE TAX

A 6% excise tax applies to any "excess contributions" made to the HSAs of an account holder for any year, and is imposed on the account holder. The excess contributions, for any year, are the aggregate amounts contributed by or on behalf of the account holder to all of his or her HSAs for the year (excluding rollovers), which exceed the amount that is either excludable from gross income (i.e., nontaxable contributions made by the account holder's employer) or deductible by the account holder (i.e., not in excess of the deduction limit applicable to the account holder.)

In addition, the excess contributions for a year are increased by the extent to which any excess contributions in the account holder's HSAs at the end of the previous year exceed the sum of (1) any amounts distributed from such HSAs during the year in question that are includable in gross income (i.e., because they are, or are treated as being, used to pay nonqualified medical expenses), and (2) the excess of the maximum deduction limit for the account holder for the year in question, as increased by nontaxable employer contributions made to such HSAs for that year, over all amounts contributed to such HSAs for that year.

An account holder may remove contributions made to an HSA that exceed the deduction limit, and thus avoid or reduce the 6% excise tax, under the following rule: If any "excess contribution" is made to an HSA for a year, contributions distributed from the HSA to the account holder (to the extent the amount distributed does not exceed the aggregate excess contributions to all HSAs of the account holder for such year) are not taxable to the account holder, or counted as contributions when applying the 6% excise tax, if both of the following conditions are met:

1. The distributed contributions are received by the account holder on or before the due date (including extensions) for filing the federal income tax return for such year.

2. The distributed contributions are accompanied by the amount of net income attributable to them.

Any net income received is included in the gross income of the account holder for the

year in which it is received. For purposes of this rule, "excess contribution" means any contribution to an HSA (other than a rollover contribution) that is not excludable from the account holder's gross income (i.e., not a nontaxable contribution made by the account holder's employer), and is not deductible by the account holder.

▪ CONTRIBUTIONS BY EMPLOYERS AND OTHERS

Employer contributions to an HSA (including salary reduction contributions made through a Section 125 cafeteria plan) are excludable from the account holder's gross income, to the extent that the contributions would be deductible if they had been made by the account holder. Otherwise, employer contributions to the HSA are includable in gross income. All contributions made to HSAs by or on behalf of the account holder for a year are aggregated for the purpose of determining whether employer contributions would be deductible if made by the account holder.

In Notice 2004-2, the IRS indicates that employer contributions to an HSA are not subject to income tax withholding (under Section 3401) to the extent the contributions are excludable from the account holder's gross income, and are subject to such withholding otherwise. Similarly, employer contributions to an HSA (including those made under a Section 125 cafeteria plan) are not treated as wages for purposes of employment taxes (i.e., FICA and FUTA taxes) to the extent it is reasonable to believe that such contributions are excludable from the account holder's gross income, and are treated as wages for such purposes otherwise.

The employer itself may deduct any contribution it makes to an HSA as an ordinary and necessary business expense under Section 162. Contributions made to an HSA on behalf of the account holder by any person other than the account holder's employer are generally tax-free gifts to the account holder, subject to the current gift tax rules.

If an employer makes contributions to an employee's HSA with respect to coverage under a high deductible health plan of that employer during the year, the employer must make "comparable contributions" to HSAs on behalf of all of its "comparable participating employees" for that year. Contributions are considered comparable if they are either of the same amount or the same percentage of the annual deductible limit under the high deductible health plan covering the employees.

The comparability rule is applied separately to part-time employees (i.e., employees who are customarily employed for fewer than 30 hours per week). If an employee is employed by the employer for only a portion of the year, a contribution to the HSA of such employee is treated as comparable if it equals an amount that bears the same ratio to the comparable amount (for an employee employed for the whole year) as such portion of the year bears to the entire year.

The comparable participating employees are those employees who are eligible individuals covered under any high deductible health plan of the employer, and who have the same category of coverage (i.e., one of two categories-self-only coverage or family coverage). In identifying the employer for this purpose, all employers that are treated as a single employer under the aggregation rules of Sections 414(b), (c), (m), and

(o) will be treated as a single employer. The comparability rule does not apply to amounts rolled over from an employee's other HSA, or from an Archer MSA (see below), or to contributions made through a Section 125 cafeteria plan.

If employer contributions do not satisfy the comparability rule during any year, the employer is subject to an excise tax of 35% of the aggregate amount contributed by the employer to HSAs for that year. The excise tax is designed as a proxy for the denial of the deduction for employer contributions. If failure to comply with the comparability rule is due to reasonable cause and not to willful neglect, the IRS may waive part or all of the excise tax to the extent that the payment of the tax would be excessive relative to the failure involved.

There are questions as to whether the rules that apply to FSAs, such as the requirement of 12-month coverage periods, and as to whether the nondiscrimination requirements of Section 125 itself, apply to an HSA that is offered by an employer under a Section 125 cafeteria plan. Since funds may accumulate in an HSA, it would be very difficult to apply some of the FSA rules, such as the uniform coverage rule (i.e., that the maximum reimbursement per year be available at all times) or the use-it-or-lose-it rule, to the HSA. Admittedly, it is harder to argue that the nondiscrimination requirements of Section 125 should not apply. In the absence of guidance, it will be assumed for purposes of this article that such rules and requirements will *not* apply to an HSA.

- **TIMING OF CONTRIBUTIONS**

Contributions to the HSA for any year may be made in one or more payments, at the convenience of the account holder or the employer, at any time prior to the due date (without extensions) of the account holder's federal income tax return for that year, but not before the beginning of that year. For calendar year taxpayers, the deadline for contributions to an HSA is generally April 15 following the year for which the contributions are made. Although the annual contribution is determined on a monthly basis (see above), the maximum contribution may be made on the first day of the year.

- **TREATMENT OF DISTRIBUTIONS**

Distributions from an HSA used to pay qualified medical expenses of the account holder, or his or her spouse or dependent, are excludable from the account holder's gross income. In general, amounts in an HSA can be used to pay qualified medical expenses, at any time and even if the account holder is not then an eligible individual for that HSA.

Distributions from an HSA that are not used to pay qualified medical expenses are includable in the account holder's gross income. Distributions so includable are also subject to an additional 10% excise tax, imposed on the account holder, unless made after the account holder's death or disability, or after the account holder attains the age of Medicare eligibility (i.e., age 65).

Notice 2004-2 indicates that neither the HSA trustee or custodian nor the employer is required to determine whether an HSA distribution is used to pay qualified medical

expenses. The account holder makes that determination, and should maintain records of his or her medical expenses sufficient to show the extent to which an HSA distribution has been used to pay for qualified medical expenses and is therefore excludable from gross income. The account holder does not have to substantiate any medical expenses to the employer.

For purposes of determining the amount of the account holder's deduction under Section 213, Section 223(f)(6) provides that any payment or distribution out of an HSA for qualified medical expenses is not treated as an expense paid by the account holder for medical care. Thus, the account holder cannot deduct amounts distributed from the HSA under Section 213.

If the account holder engages in a transaction prohibited by Section 4975 with respect to the HSA during any year, the HSA ceases to be tax-exempt as of the first day of such year, and the account holder will be treated as if he or she received a distribution from the account on such first day in an amount equal to the FMV of all assets in the account (on such first day). This treatment is in lieu of an excise tax being imposed on the account holder with respect to the prohibited transaction. If during any year the account holder uses any portion of the HSA as security for a loan, the portion so used is treated as distributed to that account holder.

Any amount treated as distributed to the account holder under the foregoing rules will be considered as *not* used to pay qualified medical expenses, and therefore will be included in the account holder's gross income and will be subject to the 10% excise tax, unless one of the exceptions described above applies.

- **ROLLOVERS AND TRANSFERS**

Amounts can be rolled over tax free from an HSA, or from an Archer MSA, to an HSA. The rollover must be completed within 60 days after the date on which the account holder receives the amounts from the HSA or Archer MSA. A rollover need not be made in cash.

Amounts so rolled over to an HSA of an account holder are not subject to, and are not taken into account in determining, the annual contribution limit for the HSA, or the deduction limit for the account holder. Nevertheless, an amount received from an HSA will be taxable to the account holder (unless used to pay qualified medical expenses), and will not be eligible for rollover treatment, if at any time during the one-year period ending on the date of such receipt, the account holder received any other amount from an HSA or Archer MSA that was not includable in gross income because it was rolled over to an HSA. Rollovers to an HSA are not permitted from an IRA, from an HRA, or from an FSA.

The transfer of an account holder's interest in an HSA to a spouse or former spouse under a divorce or separation instrument (described in Section 71(b)(2)(A)) is not taxable to the recipient spouse or former spouse. After such transfer, the recipient spouse or former spouse is treated as the account holder of the HSA.

- **TAX TREATMENT OF HSAs AFTER DEATH**

On the account holder's death, any balance remaining in the account holder's HSA is includable in his or her gross estate.

If the account holder's surviving spouse is the named beneficiary of the HSA, then after the death of the account holder the HSA becomes the HSA of the surviving spouse and an amount equal to the balance of the HSA may be deducted in computing the account holder's taxable estate, pursuant to the estate tax marital deduction.

The surviving spouse is not required to include any amount in gross income as a result of the death, and the rules applicable to the HSA become applicable to the HSA passing to the surviving spouse (e.g., the surviving spouse is subject to income tax only on distributions from the HSA for nonqualified medical expenses). The surviving spouse can exclude from gross income amounts distributed from the HSA and used to pay expenses incurred by the account holder prior to death, to the extent they otherwise are qualified medical expenses.

If, on the account holder's death, the HSA passes to a named beneficiary other than the account holder's surviving spouse or estate, the HSA ceases to be treated as an HSA as of the date of the account holder's death. The beneficiary is required to include the FMV of the HSA's assets as of the date of death in gross income for the year that includes such date. The amount so includable is reduced by the amount in the HSA used, within one year after the account holder's death, to pay qualified medical expenses incurred by the account holder prior to death.

In computing taxable income, the beneficiary may claim a deduction for that portion of the federal estate tax on the account holder's estate that was attributable to the amount of the HSA balance. The deduction is calculated in accordance with the rules in Section 691(c) relating to income in respect of a decedent.

If there is no named beneficiary of the account holder's HSA, or if the named beneficiary is the account holder's estate, the account ceases to be treated as an HSA as of the date of the account holder's death, and the FMV of the assets in the HSA as of such date is includable in the account holder's gross income for the year of death, *without* any reduction for amounts subsequently used by the HSA to pay any medical expenses the account holder incurred before death. This rule applies in all instances in which there is no named beneficiary or the named beneficiary is the account holder's estate, even if the surviving spouse ultimately obtains the right to the HSA assets (e.g., if the surviving spouse is the sole beneficiary of the account holder's estate).

■ REPORTING REQUIREMENTS

Employer contributions to an HSA are required to be reported on the account holder's Form W-2. According to Notice 2004-2, reporting for HSAs will be similar to information reporting for Archer MSAs. The IRS will release forms and instructions, similar to those required for Archer MSAs, on how to report HSA contributions, deductions, and distributions.

In addition, sponsors and providers of health insurance are required to report information as may be prescribed by the IRS. Under Section 6693, a penalty of $50 per failure may be imposed if these reporting requirements are not met.

■ OTHER RULES AND EFFECTIVE DATE

HSAs are not subject to COBRA continuation coverage. Contributions by an employer to an HSA are not subject to the rules of Section 419. An account holder may use a debit, credit, or stored-value card to receive a distribution (i.e., by a charge to such card) from an HSA for qualified medical expenses.

As noted above, the Act creates HSAs effective for years beginning after 2003.

■ COMPARISON TO OTHER ARRANGEMENTS

Exhibit 1 compares the primary rules, requirements, and tax features of HSAs to those of Archer MSAs, FSAs, and HRAs.

The Code limits the number of taxpayers with an Archer MSA to which contributions are made each year to a threshold level (generally 750,000 taxpayers). The number of Archer MSAs established has not yet exceeded the threshold level. After 2003, no additional contributions may be made to an Archer MSA, except, in general, by or on behalf of an individual who, prior to 2004, had an Archer MSA to which contributions had been made, or who is employed by an employer which made any contributions to an Archer MSA prior to 2004.

In Notice 2004-2, the IRS requests comments on the relationship between HSAs, FSAs, and HRAs. Any rules that the Service develops as an outgrowth of such comments may affect the answers given in Exhibit 1.

■ CONCLUSION

The HSA could be very useful to an employer that maintains an insured health plan. For this employer, both premium payments for employees' health insurance and contributions to HSAs are generally fully deductible and are not subject to employment taxes. Thus, neither the insurance premiums nor HSA contributions offers any tax advantage over the other to the employer.

Consequently, if the employer's plan is a high deductible health plan (or could be after negotiations with the insurer), the employer might consider negotiating with the insurer to increase the deductibles and out-of-pocket expenses (minding the Code's maximums) and thereby reduce the employer's premium for the health plan. The employer could use a portion of the savings from the lowered premiums to make contributions to HSAs, and help its employees accumulate funds to pay the medical expenses that will not be covered because of the increased deductibles and out-of-pocket expenses. Alternatively, the employer could encourage its employees to make their own tax-deductible contributions to HSAs, in lieu of the employer making all or a portion of the contributions to the HSAs, to accumulate such funds.

By contrast, the HSA would not be attractive to an employer that maintains a self-insured medical plan. Since such employer pays all benefits out of the plan, and therefore pays no premiums, the strategy of taking steps to lower the premium is unavailable. Moreover, if the employer has a high deductible health plan, and if the employer would like to help its employees pay for the medical expenses not covered by the plan due to deductibles and out-of-pocket expense requirements, the employer is better off doing so by offering an HRA rather than an HSA. This is so because payments under an HRA need not be made by the employer until claims are filed, while contributions to HSAs must be made in advance and the employer must make comparable contributions for all of its comparable participating employees.

An individual covered by a high deductible health plan could find the HSA to be very useful. The HSA cannot be used to pay most insurance premiums. Within the limits described in this article, however, HSA contributions are fully deductible, and therefore can be applied to pay medical expenses (other than those premiums) which are not covered by insurance or otherwise, on a tax-advantaged basis. This is preferable to paying such medical expenses outside of the HSA and being able to deduct them only to the extent that they (plus those premiums) exceed the 7.5% of AGI threshold of Section 213(a). Thus, if the HSA's deduction limits are observed, the HSA gives the individual the ability to pay all of his or her uncovered medical expenses (again, other than those premiums) on a fully deductible basis.

The HSA is totally portable. It is established for the benefit of, and is owned by, the account holder. Thus, even if the account holder's employer initially establishes the HSA on the account holder's behalf, the account holder will take the HSA along when the account holder changes jobs or stops working. This portability facilitates the use of the HSA by the account holder to accumulate funds for a later day.

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