Supplemental VEHI FAQ on HRAs & HSAs

Updated January 2017

In the wake of producing, disseminating and posting a wide array of resources on health care spending accounts, VEHI has been asked follow-up questions by school districts, local unions and school employees concerning eligibility for HRAs and HSAs, and about other matters related to the implementation of health care spending accounts.

This document was written to supplement, clarify and expand on VEHI's earlier guidance, with a particular focus, but not exclusive, on eligibility criteria for contributions to and/or reimbursements from these accounts. As you will see, there are **similarities** and **differences** in respect to these criteria for HSAs and HRAs. Please take the time to familiarize yourself with this communication and other resources on the VEHI website.

Health Savings Accounts are addressed on pages 2 – 7 and Health Reimbursement Arrangements on pages 8 – 9.

VEHI is grateful for assistance it has received in this endeavor from HealthEquity, BCBSVT and Future Planning Associates. This FAQ provides **general guidance only** – you can find more detailed, federal regulatory guidance at: https://www.irs.gov/pub/irs-pdf/p969.pdf.

Health Savings Accounts
Eligibility for Contributions and Reimbursements

1. **Are there any circumstances that make a school employee enrolled in the VEHI Gold CDHP or Silver CDHP ineligible for a contribution of funds to an HSA (both the employee's and/or employer's funds if bargained) in any calendar year?**

   Answer: *Yes. An employee (or his/her employer) is* ***not*** *eligible to contribute to an HSA in any calendar year if the employee is enrolled in* ***other qualifying health coverage****, including the following:*

   a. *Medicare (Parts A, B, D or all three)*
   b. *Tricare (military health benefits)*
   c. *Coverage, primary or secondary, under a spouse's health plan that is not an HSA-qualified plan*
   d. *Medical flexible spending account (FSA) – even if the FSA is under a spouse's employer. Note: Enrollment in a limited purpose FSA does not limit an employee's HSA contributions.*

   Please Note:

   a. *A spouse's enrollment in the above coverages does not impact the ability of an employee to contribute to an HSA.*

   b. **For information about Medicare enrollment and coverage, please consult the official government handbook "Medicare & You 2017" at https://www.medicare.gov/pubs/pdf/10050-Medicare-and-You.pdf or go to www.medicare.gov.**

IMPORTANT:

A Section 125 plan can be set up to allow employees a choice between the HSA and a Medical Flexible Spending Account (Medical FSA), so employees who are not eligible for contributions to an HSA may direct employer contributions into a Medical FSA.

Employer contributions to the Medical FSA are **limited to $500** unless the **employee** contributes to the Medical FSA as well.

In 2017, an employee may contribute up to $2,600 to a Medical FSA. Additionally, an employer may contribute up to double that amount per employee. By way of example, if an employee contributed $1,500 for the 2017 Plan Year, her employer could contribute $3,000, for a total of $4,500: $1,500 [employee contribution] x $3,000 [employer contribution] = $4,500 for the Plan Year.

Remember: The "use-it-or-lose-it" provisions of Medical FSAs still apply in this context.

2. **What qualifying medical expenses can be reimbursed with HSA funds?**

   Answer*: An HSA may reimburse for all qualifying medical expenses as defined by the IRS. Collective bargaining agreements may not restrict the list of HSA reimbursable expenses.*

3. **Are there any limitations on whose qualifying medical expenses the HSA funds can be used for?**

   Answer: *Yes. HSA funds can be used to reimburse qualifying medical expenses only for employees, their spouses, and their* ***tax dependents****.*

   Note: *There may be cases where an adult child (up to age 26) is enrolled on an employee's health plan but is* ***not*** *a tax dependent. These adult children* ***cannot*** *have their qualifying medical expenses reimbursed from their parent's HSA, but they can establish their own HSA.*

January 2017 Clarifications:

Under IRS regulations defining tax dependency, **adult children between the ages of 24-26 are generally not eligible to have their medical expenses reimbursed from a parent's HSA,** even though they are permitted under federal law to be enrolled on a parent's health care plan until age 26. The only exception is if an adult child between ages 24-26 is **permanently or totally disabled**.

Remember, too, when we speak of "tax dependents" in an HSA context, adult children between the **ages of 19 - 23 must meet all the criteria of tax dependency – age, relationship to the taxpayer, financial support derived from the taxpayer, and full-time student status.**

Health Equity's "HSA Guidebook: 10th Edition" (http://healthequity.com/doclib/hsa/guidebook.pdf) provides on page 66 a detailed explanation of the criteria for tax dependency and their relevance to HSA reimbursement of qualifying medical expenses.

Health Savings Accounts
Interest Payments, COBRA & Designated Beneficiaries

1) If a school district fails to make contractually-obligated contributions to school employees' HSAs, is the district obligated **to pay interest** on the missed contributions to make the employee(s) whole.

   Answer: *Yes.*

2) If a school district is making contributions to an employee's HSA, is it required under law to continue making those contributions to the employee's HSA during any period the employee is eligible for and exercising **COBRA** rights?

   Answer: *No.*

3) To avoid tax consequences, is it necessary for an HSA account holder to declare his/her **spouse** the **designated beneficiary** of any unused HSA funds should the account owner die?

   Answer: *Yes. If a spouse is designated as an HSA beneficiary, the unused funds in the HSA will* ***not*** *be subject to taxes in the year in which the account owner dies. If there is no spouse to designate as a beneficiary, or the account owner fails to designate the spouse as a beneficiary, any unused funds in the HSA will be subject to taxes after the account holder's death.*

HSAs, the Last-month Rule & Testing Period

Under federal law, if an employee is **not** enrolled in a Consumer-Directed Health Plan (CDHP) on January 1 of any given tax year, but enrolls in a CDHP **after** Jan. 1 and sets up an HSA, the employee is subject to a **last-month rule** and **testing period** that may have contribution, tax and penalty implications for the employee if the employee does not satisfy the testing period.

Last-month Rule: If you are enrolled in a CDHP no later than Dec. 1 of any given tax year, you may be eligible to contribute the annual maximum amount to your HSA for that entire year. So, if you were enrolled in a CDHP no later than **Dec. 1, 2018**, for example, you could make the annual maximum contribution to your HSA for all of 2018, even though you only enrolled in a CDHP on November 1, as long as you meet the testing period.

Testing Period: This runs from **Dec. 1** of any given tax year to **Dec. 31** of the following tax year (e.g., Dec. 1, 2018 to Dec. 31, 2019, or Dec. 1, 2019 to Dec. 31, 2020). It is applied to any person who enrolls in a CDHP with an HSA **after** Jan. 1 of any given tax year. To avoid taxes and penalties arising from a violation of a testing period (see below), a person making or receiving contributions to an HSA must be enrolled in a CDHP for the full duration of the testing period.

IMPORTANT: Tax and penalty consequences associated with a **testing period can be avoided if** employee or joint employee/employer contributions to an HSA **do not exceed,** in total, more than one-twelfth (1/12) of the annual maximum contribution for each month the employee is enrolled in the HSA for the calendar year in question.

You can find detailed information about the last-month rule and testing period at:
https://www.irs.gov/pub/irs-pdf/p969.pdf.

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We will now illustrate the contribution, tax and penalty implications that may be triggered by a violation of the IRS's testing period provisions through a hypothetical scenario.

a. An employee is hired in the Fall of 2018, and enrolls in one of her district's CDHP options and opens an HSA. For this example, the day of enrollment in the CDHP is November 1, 2018.

b. The employee in this case would be considered an eligible individual for the purposes of **contributing** the full annual maximum contribution amount to her HSA for all of 2018, because she was enrolled in the CDHP no later than the first day of the **last month** of the tax year (Dec. 1).

c. The employee and her employer contribute to her HSA each month, consistent with the terms of a collective bargaining agreement. **IMPORTANT:** For this particular scenario, let's say joint HSA contributions **exceed** each month one-twelfth (1/12) of the annual maximum contribution.

d. This employee is subject to a **testing period**, which begins on the first day of the last month of her tax year and ends on the last day of the 12th month following that month – **Dec. 1, 2018 through Dec. 31, 2019.** This is because she was NOT enrolled in a CDHP on January 1, 2018.

e. The employee retires, resigns or is laid off effective June 30, 2019. This clearly comes **before** the expiration of the testing period (Dec. 31, 2019).

f. The employee **drops** CDHP health insurance on July 1 and, for this illustration, does not take one of the measures listed in the following section.

g. Consequently, because the employee did **not** satisfy the testing period and was no longer enrolled in a CDHP as of July 1, 2019, she would be subject to <u>taxes</u> and a <u>10% penalty</u> on any HSA **over-contributions** made in the last two months of 2018 (Nov. and Dec.) when she files her tax returns in 2019. She could also be subject to taxes and penalties in her **2020** tax filing for over-contributions made from January to June of **2019**, unless she took one of the measures below to prevent this.

NOTE: There are ways to avoid the taxes and penalties on HSA over-contributions if an employee dropped or lost health coverage before the expiration of the testing period (**see below**).

Just the same, school districts, school employees and union leaders should be alert to this issue, particularly given that most school employees retire or resign on June 30 each year.

Employees could maximize contributions to an HSA during a testing period, especially if they have a planned medical service(s) scheduled, only to discover that they will be subject to taxes and a penalty on the **over-contributions** because they did not satisfy the requirements of the testing period.

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In the scenario above, taxes and/or the 10% penalty on the over-contributions to an HSA could have been avoided or minimized if one of the following measures had been taken:

a) The employee exercised her COBRA rights and remained enrolled in her employer's CDHP through the testing period.

b) The employee and employer had contributed **each month** to the employee's HSA, cumulatively, **no more than one-twelfth** (1/12) of the annual maximum contribution for each month the employee was enrolled in the CDHP.

c) The employee enrolls in a CDHP on Vermont Health Connect (the state exchange) or a CDHP offered by another employer, with effective coverage on July 1, 2018, and remains covered on that plan through the testing period.

d) If applicable, the employee enrolls as a dependent on a spouse's CDHP and remains on that plan through the testing period.

e) The employee can avoid paying the **penalty** on the over-contributions – but **cannot** avoid paying taxes – if she withdraws the excess contribution by the due date of her tax return for the year the contributions were made.

Important: In order to withdraw the excess contributions, the employee must complete an **Excessive Contribution Form (ECF)**, which can be secured from HealthEquity or the district's third party administrator.

Health Reimbursement Arrangement
Eligibility and Reimbursement

1. **Are there any circumstances that make a school employee ineligible to take advantage of employer funds in an HRA?**

   Answer: *Yes. An employee must be enrolled in their **employer's group health plan** in order to be eligible for HRA reimbursements.*

   Note: *Each HRA is governed by a Plan document that outlines the terms and conditions of the HRA. This Plan document is subject to collective bargaining and will vary from employer to employer. Employees should check with their employer regarding specific rules governing the use of HRA funds.*

2. **What qualifying medical expenses can be reimbursed with HRA funds?**

   Answer: *Federal law allows an HRA to reimburse for any qualified medical expense as defined by the IRS. **However**, collective bargaining agreements may restrict the list of HRA reimbursable expenses, provided those restrictions are consistent with IRS rules*.

   *As noted above, consistent with collective bargaining agreements, the **HRA Plan document** will outline what qualifying medical expenses can be reimbursed with HRA funds. Employees should check with their employer if they have questions about specific rules governing the use of their HRA funds.*

3. **Are there any limitations on whose qualifying medical expenses the HRA funds can be used for?**

   Answer: *Yes. HRA funds can only be used to reimburse qualified medical expenses for the employee and other family members that are enrolled as a spouse or dependent in the employee's health plan* as outlined in the HRA Plan document*.*

   Note: *An adult child (up to age 26) enrolled in the employee's health plan is eligible to be reimbursed for their qualifying medical expenses from his/her parent's HRA, regardless of whether s/he is a tax dependent.*

   Employees with Medicare (Parts A, B, D or all three), Tricare, a Medical FSA (theirs or their spouse's), or coverage under a spouse's health plan are also eligible to receive reimbursements from an HRA.

   Important: *Medicare is generally the **secondary payer** for employees who have Medicare coverage but are also enrolled in an employer's health plan. This means Medicare covers allowable charges incurred that the **employer's** primary insurance did* *not pay and* **after** *the expenditure of HRA funds. An employee may be asked to provide documentation that HRA funds have been exhausted in order to receive Medicare benefits.*

For information about Medicare enrollment and coverage, please consult the official government handbook "Medicare & You 2017" at https://www.medicare.gov/pubs/pdf/10050-Medicare-and-You.pdf or go to www.medicare.gov.

Health Reimbursement Arrangements
COBRA, Last-month Rule & Testing Period

1. **If a school district, under the terms of a collective bargaining agreement or employment contract, is making HRA reimbursements, is it required under law to continue making those reimbursements to the employee's for qualified medical expenses during any period the employee is eligible for and exercising COBRA rights?**

   Answer: *Yes. There may be an additional premium cost for employees who elect to continue receiving HRA reimbursements under COBRA. The actual cost is based upon the HRA plan design and will vary by employer.*

2. **Are HRAs Subject to a Last-month Rule & Testing Period?**

   Answer: *No. Health Reimbursement Arrangements, unlike HSAs, are employer accounts. They are* ***not*** *subject to a last-month rule or testing period, as employees are prohibited from making contributions to an HRA.*