2007 HSA PRIMER
For Employers

***Health Savings Accounts (HSA) Basics*:**
HSAs are an economically sound approach to healthcare; rather than pay a lot of money for insurance premiums today which you may not use, pay less for insurance and put the remaining money into a health savings account to spend tax-free for medical expenses when you need it.

* HSAs can only be used in combination with a high-deductible health insurance policy.
* HSA contributions are from pre-tax dollars, and can be made by an employer, individual or employee, and/or third party.
* HSAs are portable benefits, controlled and owned by individuals/employees.
* HSAs can "roll over" from year to year as accumulated tax-free savings.
* HSA payouts for qualified medical expenses are tax-free.
* HSA interest and dividends are tax-free until retirement.
* HSAs are an inheritable asset.
* HSAs will encourage participants to become better healthcare consumers.

The HSA program has two parts: a high-deductible health plan (which usually costs less than other health plans) and a tax-advantaged, portable savings account for payment of current medical expenses which builds like a Medical IRA.

Similar in many respects to IRAs, Keoghs, and 401(k) plans, the tax advantages of Health Savings Accounts (HSAs) make them a "better rainy day fund" because contributions can be taken out as needed for medical expenses before retirement. Remaining dollars can be saved for spending in future years, and/or invested to accumulate tax-free savings for your retirement.

2007 HSA Allowable Amounts (indexed annually)

Minimum deductibles for insurance
$1,100 for individual coverage
$2,200 for family coverage

Maximum contributions: the lesser of the deductible or
$2,850 for individual coverage
$5,650 for family coverage

Plus, there is a catch-up provision of $800 per eligible account for people 55+ years

Maximum out-of-pocket
$5,500 for individual coverage
$11,000 for family coverage

Notes: family is 2+ people
Source: www.irs.gov

This *HSA Primer for Employers* was specially prepared by Information Strategies, Inc., whose website www.HSAfinder.com was cited by *The Wall Street Journal* for its knowledge and completeness. Material contained herein was drawn from *“The Consumer’s Guide to Health Savings Accounts*” and “*The Small Business Guide to HSAs*” by JoAnn M. Laing, President of Information Strategies, Inc.

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What Are HSAs?

Health Savings Accounts (HSAs) help save money on healthcare. For a business owner or an individual, HSAs are an inexpensive way to insure yourself, your family, and your employees – and enjoy tax benefits for almost every dollar you commit to the plan.

HSAs were created to offer individuals a *tax-advantaged way* to accumulate savings for medical expenses. Business owners who offer such a plan to their employees can realize substantial health cost savings on a day-to-day basis, and benefit from tax relief. By making the healthcare consumer a part of the medical services decision process, HSAs help to manage medical expenses and reduce the continuing growth of healthcare costs. HSAs will work well for many consumers – individuals, self-employed, business employers and their employees – and represent a breakthrough strategy that can lower healthcare costs today and increase retirement savings for future healthcare needs.

The major requirement of a Health Savings Account is that you have a high-deductible healthcare insurance policy. There are several other caveats, but as a business owner, Health Savings Accounts may be an answer for those companies who always thought they "couldn't afford health insurance" for their workers. If your business already offers health insurance benefits, you can use the same program to cut what you're paying for benefits – a big part of your overhead expenses – by as much as two-thirds.

What's In It For Your Business?

- **High-deductible health plans cost less.**
  Rather than trying to pay for another year of double–digit health insurance premium increases, your business could be saving money.

- **Spending less on healthcare coverage can help make your business more competitive.**
  An HSA program makes your firm more competitive by enabling it to attract and keep better, healthy employees. Plus, a good HSA strategy cuts your overhead costs, cuts your taxes, streamlines your administrative chores, and helps you stay competitive – even against larger corporations or rivals from overseas.

- **Health insurance is the number one benefit sought by employees.**
  The HSA program will enable your company to continue offering health insurance, or perhaps start offering it; while helping your employees build a retirement nest egg.

- **HSAs can pay for many more medical procedures and products.**
  You can use an HSA to pay tax-free for acupuncture, visits to the chiropractor, fertility treatments, therapy, and laser eye surgery — just to name a few.

- **The cost of the insurance premium and any contribution to employees' HSAs are tax-deductible.**

- **Employer contributions to employee HSAs, when run through a Section 125 Plan, are not subject to FICA, FUTA and other federal, state and local withholding taxes.**

- **HSAs compare favorably to other plans, such as HRAs and FSAs.**

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HSAs utilize lower cost high-deductible health plans, and are eligible for multiple classes (employees, retirees and owners). The employee becomes responsible for their medical expense spending, and the money in the HSA account accumulates and earns interest and dividends. Any contributions are deductible for the business.

Comparison of Consumer Directed Health Care Plans: HSA, HRA, FSA

	Health Savings Account (HSA)	Health Reimbursement Account (HRA)	Flexible Spending Account (FSA)
ESTABLISHMENT OF ACCOUNT	• Eligible Individual • Employer • Integrate With Employer-Sponsored Cafeteria Plan	Employer-Sponsored Benefit Program	Employer-Sponsored Benefit Program Via Cafeteria Plan
ACCOUNT TYPE	Trust Or Custodial Account	• General Assets Of Employer • Trust	• General Assets Of Employer • Trust
CONTROL AND OWNERSHIP OF ACCOUNT	Employee	Employer (Employees may be permitted to rollover into HSAs beginning in 2007)	Employer (Employees may be permitted to rollover into HSAs beginning in 2007)
ACCOUNT PORTABILITY	Yes	No	No
HIGH-DEDUCTIBLE HEALTH PLAN (HDHP) REQUIRED	Yes	No	No
ELIGIBILITY	• Eligible Individual Covered By HDHP • Eligible Employee Covered By HDHP	Employee Who Meets Employer's Eligibility Criteria	Employee Who Meets Employer's Eligibility Criteria
FUNDING	• Individual • Employee Salary Reduction Dollars • Employer • Third Party	Strictly By Employer	• Employee Salary Reduction Dollars • Employer
ACCOUNT LIMITS	**Individual** — $2,850 if have an eligible health insurance plan with deductible above $1,100 (For 2007)	No Statutory Required Limit	No Statutory Required Limit

	Family —		
	$5,650		
	if have an eligible health insurance plan with deductible above $2,200 (For 2007)		
ANNUAL OUT OF POCKET LIMITS	• $5,500 Individual	N/A	N/A
	(For 2007)		
	• $11,000 Family		
	(For 2007)		
REQUIRED PRE-FUNDING	Yes	No	Yes
DISBURSEMENT OF MONEY	Checks, Debit Card, Withdrawal Slips	Reimburse Through Employer	Checks, Debits, Withdrawal Slips
QUALIFIED MEDICAL EXPENSES	• Qualified Medical Expenses As Defined In IRC §213(d), Including Over-The-Counter Drugs	• Qualified Medical Expenses As Defined In IRC §213(d), Including Over-The-Counter Drugs	• Qualified Medical Expenses As Defined In IRC §213(d), Including Over-The-Counter Drugs
	• Retiree Health Insurance Premium Other Than Medicare Supplement Policies	• Health Insurance Premium, Including LTC Premium	
			Not Permitted:
	• COBRA Premium		• Health Insurance Premium, Including LTC Insurance Premium
	• Long Term Care (LTC) Insurance Premium		
	• Health Insurance Premium If Receiving Unemployment		
	Not Permitted:		
	• Any Other Type Of Health Insurance Premium		
TAX TREATMENT OF CONTRIBUTIONS	• Individual's Contributions To Own HSA Tax-Deductible	• Only Employer Contributions Permitted:	• Only Employer Contributions Permitted:
		- Deductible	- Deductible
	• Employee-Contributions To Employee's Own HSA Are Tax-Deductible	By Employer	By Employer
		- Excludable From Employee's Gross Income	- Excludable From Employee's Gross Income
	• Employer-Contributions To Employee's HSA (With Or Without Cafeteria Plan) With Salary Reduction Dollars:	(Amount remaining may be rolled-over tax-free into an HSA beginning in 2007)	(Amount remaining may be rolled-over tax-free into an HSA beginning in 2007)
	- Deductible By Employer		
	- Excludable From		
	Employee's Gross Income		

TAXATION OF INTEREST OR DIVIDEND ACCUMULATION	Tax-Free	N/A	N/A
CONSEQUENCES OF CASHING-OUT ACCOUNT FOR NON-QUALIFIED MEDICAL EXPENSES	Distributions Are Taxed As Income And Subject To 10% Penalty Tax, Except Following: • Death • Disability • Attainment Of Medicare Eligibility Age	No Cash-Out Option Available	Some (Section 125 Rules Apply)
CARRY-OVER OF FUNDS PERMITTED	Yes	Yes (Employer Decides) (Employees may be permitted to rollover into HSAs beginning in 2007)	No (Employees may be permitted to rollover into HSAs beginning in 2007)
DEATH OF ACCOUNT HOLDER	Surviving Spouse Only (If Designated Beneficiary) Entitled To Use Remaining Account Monies For Qualified Medical Expenses	Eligible Dependents Entitled To Use Remaining Account Monies For Qualified Medical Expenses, In Accordance With The Plan Document	Eligible Dependents Entitled To Use Remaining Account Monies For Qualified Medical Expenses, In Accordance With The Plan Document
APPLICABILITY OF ERISA	No	Yes	Yes
SUBJECT TO COBRA	• No, If Not Employer-Based • Unclear, If Employer-Based	Yes	Yes
EFFECTIVE DATE	1/1/2004	6/26/2002	3/7/1989

Notes: Amounts listed are indexed annually. Plus, there is an additional catch-up provision for individuals 55+ years, $800 in 2007 increasing $100 per year to $1,000 in 2009 and thereafter.
Note: Labor Department permits Employers to designate where an HAS account is set up for employees, but employee may opt to change. Legislation has bee approved that permits one-time rollover of HRA, FSA funds into HSAs, Employers may vary contribution by salary range. Requires only a qualified high deductible plan at or above minimum amounts.

What's In It For You and Your Employees?

An HSA is:

- **A way to save money on healthcare.**
  Sooner or later you will have to spend money on healthcare. But an HSA might help you spend less.

- **A tax saver.**
  Not only does an HSA let you cover your medical costs tax-free, but also your contributions to the account may nudge you into a lower tax bracket — so you could save on your whole tax bill, not just your healthcare costs.

- **A way to pay for healthcare your traditional insurance might not cover.**
  You can use an HSA to pay tax-free for acupuncture, visits to the chiropractor, fertility treatments, therapy, and laser eye surgery — just to name a few.

- **Portable.**
  HSAs can travel with you from job to job. You always have a right to 100% of the money in your account.

- **A source of investment income.**
  HSAs are designed so that you can always withdraw money when you need it. But the money you don't withdraw has the potential to grow and accumulate interest and dividends tax-free.

- **An improved retirement account.**
  HSAs function much like 401(k)s or IRAs, but with an important difference. When you put money in a typical retirement account, it's there to stay — you could forfeit as much as a third of it in tax penalties if you withdraw it before reaching retirement age. With an HSA, when you use the money for medical expenses, your withdrawals are tax-free. HSAs don't replace your current retirement accounts, but they can be a major supplement to your retirement savings.

- **Money in your pocket.**
  To participate in an HSA, you must be enrolled in a high-deductible health plan (HDHP). HDHPs typically have the lowest premiums of all health plans. If you're currently enrolled in a Health Maintenance Organization (HMO) or a Preferred Provider Organization plan (PPO), and you switch to an HDHP, you could save one-third to one-half of your cost for coverage right off the bat. (Some HMOs and PPOs are offering HSA eligible plans.)

Will HSAs Work For Your Business?

This simple test can help you decide no matter how many employees you have, or if you are self-employed.

For each full-time employee (include yourself), score 1 point.	
For each employee between ages 21-30, score 10 points.	
For each employee already participating in an IRA, Keogh or 401(k) plan, score 10 points.	
For each employee with gross income over $50,000, score 10 points.	
For each employee already covered by another's health plan (spouse or parent), deduct 5 points.	
For each full-time worker with a gross income under $23,000, deduct 1 point.	
Total	

RESULTS: **If the total is over 20 points**, your business can benefit from participating in the HSA program. If your score is higher than 100 points, your business may reduce operating costs by a significant margin with an HSA strategy in place in the current tax year.

If the total is lower than 20 points, *you may not have the necessary cash flow or capital to get the best benefit from the HSA program*. If this is the case, meeting with a tax advisor this tax year may help achieve this goal in future years.

What Are Some Of The Parameters Of HSAs?

The HSA program has two parts:

- A high-deductible health plan (which usually costs less than other health plans), and
- A tax-advantaged, portable savings account for payment of current medical expenses, which builds like a Medical IRA.

Compared to full-coverage health insurance, the premium payments for HD plans can be substantially less, up to half the price. So it's no surprise that young, single, and relatively healthy workers prefer high-deductible plans when the money for premiums comes out of their pockets (for the self-employed) or is taken out of a paycheck (through a high-deductible plan offered as a job benefit by an employer).

High-deductible health plans are sometimes called "hit-by-a-truck-insurance." Good plans pay for both catastrophic and routine medical care once the insured person has paid out-of-pocket for the first $1,100 or $2,200 worth of medical fees as a deductible. And in the unlikely event that the insured person does get hit by a truck, or needs that trip to the emergency room, a few days hospitalization (hundreds of dollars per day), or surgery (thousands of dollars), the high-deductible health plan will cover most of the costs.

Under the HSA program,

- Individuals must have an annual deductible of at least $1,100.
- Families must have an annual deductible of at least $2,200.

Not every high-deductible health plan qualifies:

- The plan must have what is considered a reasonable cap on out-of-pocket expenses ($5,500* for an individual and $11,000* for a family).

Yearly contributions to HSAs are limited:

- For individuals, the maximum amount of money that can be deposited into an HSA account is $2,850*.
- If the account has been set up for a family group, the maximum that can be deposited is $5,650*.

Two possible drawbacks for business owners:

- Because the employee owns the HSA account, when he/she leaves the company the account goes with them.
- The yearly contribution an HSA is limited to $2,850* for an individual and $5,650* for a family.

* Amounts listed in this primer are for 2007; they are indexed annually.

Who Qualifies For An HSA?

Anyone can qualify if you are:

- Under the age of 65,
- Not listed as someone else's dependent for income tax purposes,
- Not receiving Medicare or Social Security benefits,
- Covered by a high-deductible health plan, and
- ***NOT*** covered by any other type of health insurance plan, ***except for***
    - Separate dental and/or vision care insurance, or flexible spending accounts (FSAs) covering only dental and/or vision care,
    - Discount cards for healthcare services or products (for example, prescription drugs),
    - Disease management and wellness programs, as long as they do not "provide significant benefits in the nature of medical care",
    - Employee assistance plans, again if they do not "provide significant benefits" (short-term counseling is okay),
    - FSAs or HRAs that pay or reimburse for medical expenses after a high deductible has been met*,
    - Separate long-term care insurance,
    - Worker's compensation insurance (through employers),
    - Disability insurance (individual or through unions or employment),
    - Automobile insurance (including coverage for medical care in accidents and emergencies),
    - Business liability insurance,
    - Insurance that pays for fixed amount of hospitalization,
    - Freestanding health insurance for travel (such as flight insurance or automatic travel coverage when transport is booked on a credit card).

* Employers may offer HSAs or FSAs that pay or reimburse additional fees for coinsurance or out-of-pocket costs, provided that you have already satisfied your in-network deductible. Retirement HRAs funded by employers, i.e. accounts that will only pay for or reimburse medical expenses incurred after retirement, are permitted.

Certain FSA coverage treated as disregarded coverage. Under previous law, if an FSA had a grace period following the end of the plan year allowing participants to incur additional reimbursable expenses, participants were treated as having disqualifying coverage, reducing their HSA contribution for that year, even though they had switched to HSA-eligible coverage at the first of the year. The new rules, effective starting January 1, 2007 treat certain FSA coverage during a grace period as disregarded coverage, eliminating any resulting reduction in the HSA contribution for the year. First, the coverage is disregarded if the balance in the health FSA at the end of the plan year is zero. Second, the coverage is disregarded if the year-end balance is transferred directly to an HSA from the FSA, as noted above.

Self-employed or those employed by others can participate. Spouses or dependents covered by other insurance may not be able to participate; but you may still be able to use your HSA to pay for their qualifying medical expenses tax-free.

Who Will Not Qualify?

- HSAs are not available to persons who are both eligible for and enrolled in Medicare. Most Americans qualify for Medicare at age 65. However, if an individual continues to work past that age, remains enrolled in a high-deductible health plan, and does not apply for Medicare benefits, he or she may qualify to contribute to an HSA.

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- If you're claimed as a dependent on someone else's tax forms — regardless of whether that someone is a spouse, a domestic partner, or a parent — you cannot open your own HSA. Children under working age cannot open their own HSAs with money given by their parents. Children who work but are claimed as dependents on their parents' tax return cannot open their own HSAs. Similarly, a non-working spouse or any other relative who is claimed as a dependent on another person's tax return cannot open his or her own HSA either.

- Individuals and families covered under traditional, full-coverage insurance plans (including HMO, PPO, POS plans, Medicare and Medicaid) that do not meet the deductible minimum are not eligible for HSAs.

Who Is Best Suited For An HSA Account?

Clearly, those who would prefer, or already have, a high deductible on their health insurance policy are poised to get the most benefit from this new program.

For the self-employed, and those who don't have any insurance policy at all, a low-cost, high-deductible plan that qualifies for an HSA is a good starting point.

For small business owners thinking about adding healthcare insurance coverage as a new benefit for your workers, offering them only a high-deductible plan is 1) a good first step; 2) the least expensive health benefit available; and 3) probably a better deal than is offered by competitors.

If a company already offers a different type of health insurance plan, such as a Preferred Provider Organization (PPO), Point of Service Plan (POS), or Health Maintenance Organization (HMO) with a low deductible ($500 or less), it's safe to assume that at least some employees will be unhappy if they're forced to switch to plans that require them to pay more out of pocket for a higher deductible of at least $1,100. However, medical expenses are low for most of us.

Seventy-three percent of the population spends $500 or less on medical expenses per year, according to American Health Value; and most people will not spend all of their HSA funds in any given year. What is not spent is theirs to keep and earn interest.

The worksheet below will show how much you could save by using an HSA. Often, current medical plan costs are much greater than you might think when all co-pay commitments are added. Most HSA-eligible plans do not require co-insurance once the deductible has been met.

Total up what you paid last year (A) and the maximum of what you might expect to pay this year (B). Subtract (B) from (A). If the result (C) is less than (A), congratulations! You've just demonstrated how to save money on healthcare using the HSA program.

For a few, your (C) result may be more than (A). But remember, this is a worst-case scenario. It assumes you are going to have a serious medical need this year, but odds are that you won't. And even if you do reach your deductible, you will be covered by the lower cost, high-deductible policy; and after you reach your out-of-pocket maximum, you won't spend another dime on covered services for the rest of the year.

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Potential Savings With HSAs

A. Cost of premiums and out-of-pocket expenses **last year** (fees up to deductibles, co-pays, uncovered expenses and medication)

TOTAL A

B. Estimated total for high-deductible insurance premiums **this year** *plus* the total deductible under the insurance policy for this year

TOTAL B

C. Subtract "B" from "A" to get estimated cost savings for the new plan this year

TOTAL C

Calculating The Cost Savings Of A High-Deductible Health Care Plan

Total Spent in Health Insurance premiums for all employees, Previous Year

Divide by Total number of employees covered by plan

Equals TOTAL Y (Insurance Cost Per Employee)

Estimate TOTAL X for High-Deductible Insurance Premiums in New Year, for one employee

Subtract "X" from "Y" to get estimated cost savings for each employee converting to high-deductible plan, New Year

Multiple "C" (from above) by number of employees to estimate potential savings if all employees convert to high-deductible plan

Key Financial Considerations for Any High-Deductible Health Plan

1. Cost of premium(s) on monthly basis for the year.
2. Amount of deductible for year.
3. Maximum Lifetime Benefit amount for life of the policyholder.
4. Exclusion of preventative care from deductible amounts.
5. Discounts for use of in-network services or doctors.
6. Additional costs for desirable options (i.e. maternity, prescription drug benefits).
7. Guaranteed Renewability.

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8. Reasonable assurance of insurer's financial stability and ability to pay claims.
9. Insurer's reputation for good customer service and rapid response to questions when they arise.

Selecting An HSA Custodian for Your Employees

You can set-up HSA accounts for you and your employees with an Account Custodian, such as a bank. A good HSA provider will have the following features:

- Easy deposits — in person, by mail, by electronic transfer, or through an automatic payroll deposit mechanism.
- Easy withdrawals with a checkbook or debit card.
- An attractive daily compound interest rate on your deposits (2% APR is the current norm).
- Reasonable charges for administering the account (annual fees of $3 per month are reported as the norm, although some vendors offer "no fee" accounts).
- Ability to check balances and recent account action at any time, by phone, by web and by monthly printed account summaries.
- A yearly printed statement of all deposits and detailed data on all debits or expenses, to satisfy the IRS requirements for reporting.
- FDIC insurance.

New Department of Labor Guidance

On October 27, 2006, the U.S. Department of Labor issued additional guidance concerning Health Savings Accounts. It clarifies that Employers can:

- Pay HSA account fees for their employees.
- Open an HSA for an employee and deposit employer funds in the account even without the employee's consent.
- Limit the HSA providers that it allows to market their HSA products in the workplace or select a single HSA provider to which it will forward contributions.
- Select an HSA provider that offers some or all of the investment options made available to the employees in their 401(k) plan.

The guidance also clarifies that employers may appropriately realize savings from reductions in employment taxes when employees make HSA contributions on a pre-tax basis through a cafeteria plan.

Opening an HSA

Opening up an HSA is not much different from opening a regular checking account. You'll get paperwork to fill out, including:
• Application Form: You fill out this form with your name, address and Social Security number.
• Beneficiary Form: Because an HSA is an inheritable asset, you will be asked to designate an heir or beneficiary in the event that you die.

In all cases, remember that your high-deductible health plan must be in place before you're allowed to open an HSA.

HSA Contributions

Contributions to an HSA can be made by the employer** (but not obligated to do so for employees with a health savings account), the employee, and/or a third party. Contributions can be made through regular payroll deductions, lump sum and/or sporadically. Monies may be put into the HSA until April 15th following the tax year.

Normally, the HSA contribution is pro rated based on the number of months that an individual during the year a person was an eligible individual. The new provisions, effective starting in 2007, provide an exception to this rule; individuals who become covered under an HSA-eligible plan in a month other than January are allowed to make the maximum HSA contribution ($2,850 for an individual, $5,650 for a family; plus $800 for a catch-up contribution) for the year based on their coverage in the last month of the year. This eliminates a common barrier to switching to HSA-eligible coverage. If an individual does not stay in the HSA-eligible plan 12 months following the last month of the year of the first year of eligibility, the amount which could not have been contributed except for this provision will be included in income and subject to a 10 percent additional tax.

**** Beginning in 2007, Employers are allowed greater employer contributions for lower-paid employees.** Previously, employer contributions under the comparability rules had to be the same amount or percentage of the deductible for all employees with the same category of coverage. Consequently, employers could not contribute higher amounts to lower-paid employees. The new rules, effective January 1, 2007, provide an exception to the comparability rules allowing employers to contribute more to the HSAs of non-highly compensated individuals. For this purpose, the definition of "highly compensated employee" is based on same definition used for qualified retirement plans.

Special Rules For Those Over 55

To allow older taxpayers to “catch up,” the current law allows HSA participants to stretch their contribution limit by an additional $800 in 2007. This means that if you are over 55 and have a $1,100 deductible, your legal contribution might be $1,900 for the tax year. Under current law, the “catch-up” amount will increase $100 per year (the catch-up amount will be $900 in 2008) until it reaches an additional $1,000 per tax year by 2009 and thereafter.

Penalties On Excess Contributions

Current law mandates a penalty if you, or your employee, contribute in excess of the limit for the tax year. The employee will be penalized with a 6% excise tax on the entire amount that is over the limit. The IRS will also treat amounts in excess as income. The tax responsibility will be the employee’s, even if the employer made that excess contribution.

The 6% penalty tax will be waived if a distribution of the excess (including its earnings) is made to the account holder in a timely manner. The easiest way to do this is to have the account holder write an HSA check to him or herself in the amount of the excess before December 31 of the relevant tax year. The earnings on the excess will be taxable on distribution. If the account holder can prove the check is a reimbursement for out-of-pocket qualified medical expenses in the second year, he or she may not have to pay any tax on that amount. Naturally, receipts will be needed to back this up.

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Avoid A Tax Penalty
It's up to the account holder to monitor HSA contributions and make sure he or she doesn't exceed the legal limit. The employee must pay attention. A monthly number-check at the time he or she balances their checkbook ought to be enough — it will take only an additional minute or two.

What About Rollovers From Other Accounts?

If you had a Medical Savings Account (the ancestor of the HSA, which was available only to the self-employed, employees of qualified small businesses or qualified small business owners - with a qualified high-deductible health plan), you can roll over accumulated funds from that account into your HSA without paying a tax or penalty. Rollovers do not count towards your contribution limit, but you do not get an additional deduction for them in the current tax year. An HSA may accept only one rollover per year.

Beginning 2007 and through 2011, **rollovers are allowed from health FSAs and HRAs into HSAs.** Employers can transfer funds from Flexible Spending Arrangements (FSAs) or Health Reimbursement Arrangements (HRAs) to an HSA for employees switching to coverage under an HSA-compatible health plan. The amounts rolled over to HSAs from FSAs or HRAs are over and above the amounts allowed as annual contributions. The maximum contribution is the balance in the FSA or HRA as of September 21, 2006, or if less, the balance as of the date of the transfer. The provision is limited to one distribution with respect to each health FSA or HRA of the individual. If an individual does not remain an eligible individual for the 12 months following the month of the contribution, the transferred amount is included in income and subject to a 10 percent additional tax.

Beginning in 2007, an account holder is **one-time transfer from IRAs to HSAs.** The contribution must be made in a direct trustee-to-trustee transfer. The IRA transfer will not be included in income or subject to the early withdrawal additional tax. The transfer is limited to the maximum HSA contribution for the year, and the amount contributed is not allowed as a deduction. Generally, only one transfer may be made during the lifetime of an individual. If an individual electing the one-time transfer does not remain an eligible individual for the 12 months following the month of the contribution, the transferred amount is included in income and subject to a 10 percent additional tax.

Some Tax Rules On HSA Funds

- Small organizations often operate as a Limited Liability Company (LLC). Under the current tax laws, single-owner LLCs are taxed as if they were sole proprietorships. LLCs with multiple owners get the same tax treatment as a partnership unless they elect to be treated as a corporation. Limited Liability Partnership (LLP) get the same tax treatment as a partnership. For the most part, there are no special tax advantages for an LLC or LLP under the HSA program.

  With a "regular" or C Corporation, your business must pay its own income tax on the taxable profits of your corporation. Tax rules for a "special" or S Corporation are similar to those for a partnership, i.e., you pay tax on your salary and your share of after-salary profits. Corporations reporting taxable income (profits) of less than $100,000 qualify for a

significantly lower corporate tax rate. So, many small corporations strive to find as many business deductions as possible, to get under the $100,000 limit.

HSAs are a new way to get there. Because owner salaries and compensation are deductible as a corporate business expense, contributions into an HSA can cut both the corporate tax and income tax at the same time. Because of the non-discrimination rules for HSA contributions, a corporation with many employees should set a practical limit on contributions and make a comparable yearly contribution to all workers who have chosen the high-deductible health insurance plan and an HSA account.

- On a payroll you must calculate withholding in accordance with Federal, State and Local government tables to cover the employee's income tax. Contributions to HSAs on behalf of employees are exempt from these taxes, and join the list of other forms of worker compensation that are not taxed, e.g. generally all employer contributions to employee retirement plans, all worker's compensation premiums or benefits, etc.

  In addition to withholding for income tax, you must withhold a percentage of each employee's pay for Social Security and Medicare under The Federal Insurance Contributions Act (otherwise known as FICA). Currently, the tax rate of a paycheck is 7.65%. An employer must also pay an equal amount of taxes to the government on behalf of each employee.

  Under the HSA program, employer contributions to worker HSAs are not subject to any of these taxes, nor are they considered to be gross wages when calculating a variety of other taxes, such as Withholding Unemployment Tax (FUTA). Unemployment tax benefits are regulated by a combined state and federal program. Just like income tax, the company has to withhold both a federal tax (FUTA) and a state unemployment tax. The current percentage for federal withholding for FUTA is 6.2%. It is a single flat rate, paid up to a ceiling on the first $7,000 of cash wages for anyone to whom you pay $1,000 or more in any quarter of the current or prior year. There is a credit of up to 5.4 percent available if you pay state unemployment taxes, making the net federal rate only 0.8 percent.

  The company's state unemployment tax rate will vary from state to state. The company may also have to pay Disability Insurance Tax. In certain states (notably New York and California) this is a tax that pays for a mandated state disability insurance program must be paid and/or withheld by the employer. Under current federal rules, employer contributions to worker HSAs are exempted from these taxes as well.

- For you and your employees, HSA money must be used for qualified medical expenses to remain tax-free. You can make tax-free withdrawals from your HSA to pay for these expenses as soon as
  - Your account is activated, and
  - You have an opening balance.

  However, you may choose to pay for qualifying medical expenses with funds outside the HSA account for a couple reasons:
  - You do not have enough money in the account to pay for a medical procedure. In that case, you may use other funds and take the deduction later as long as you have supporting documents to show the tax authorities.
  - You may prefer to leave the funds in the HSA and continue to earn dividends and profits that are not taxable until you retire or use later for qualifying expenses.

What Can A HSA Pay For?

HSAs don't replace a normal or typical health insurance plan. They are designed as a supplement to a high-deductible health insurance policy. By themselves, HSAs are savings vehicles — not insurance policies — so they don't restrict your access to coverage or your choice of insurance providers.

Because an HSA is tied to a high-deductible health insurance policy, you will "pay as you go" for medical care, using your tax-free HSA dollars, until you spend up to the deductible. Once you meet the deductible, the health insurance policy pays for most of your medical expenses for the rest of the year.

You can spend your HSA dollars on qualified medical expenses for yourself, or anyone you claim as a spouse or dependent on your personal income tax — even if that person is not covered by your high-deductible insurance plan. In general, HSA withdrawals for qualifying medical expenses are excluded from your gross income — that is, they are not taxed. However, *only distributions provable as qualifying medical expenses will be tax-free. If you pay for procedures that do not qualify, the monies used are considered to be "income" for your tax year and will be subject to both federal and state income taxes, as well as an additional penalty tax of 10% of the amount that was spent.*

The IRS definition of "qualifying medical expenses" is broad, and you can use your HSA to pay for many things your health insurance won't cover, such as contact lenses, chiropractic care, physical therapy, and nursing services. However, regulations do change. You can always find the most up-to-date list of qualifying expenses online, in Publication 502 on the IRS website (www.irs.gov) or on HSAfinder.com under "Qualifying Medical Expenses".

Here's just a sampling:

- Self-pay for COBRA healthcare continuation after leaving a job
- Long-term care insurance (medical expenses and insurance up to allowable limits)
- Medicare Part A or Part B and Medicare HMO insurance premiums
- Medical doctors
- Dental and Optical care, including dentures, eyeglasses, contact lenses, eye surgery
- Nursing services
- Emergency care
- Physical therapy
- Chiropractic care
- Psychoanalysis
- Acupuncture
- Christian Science practitioners
- Treatments not often covered by health insurance:
    - Alcoholism or drug addiction treatment
    - Fertility enhancement
- Birth control prescriptions
- Prescribed weight-loss or stop-smoking programs
- Special schools and homes for the mentally retarded
- Medical equipment, appliances and other personal items:
    - Artificial limbs and prosthetics
    - Braille books and magazines
    - Crutches and wheelchairs

    - Hearing aids
    - Guide dogs and other helper animals
- Costs that may be incurred when seeking treatment
    - Trips and travel exclusively for the purpose of a treatment
    - Meals and lodging associated with such trips
- Qualifying treatment-related expenses:
    - Telephone or television modifications for disability
    - Legal fees related to treatments
    - Medical conferences (must be related to a condition)

What Expenses Do NOT Qualify?

These expenses are just a sampling of expenses you can't pay for with your HSA. (If you do pay for these with a withdrawal from your HSA, you'll either have to reimburse the account by April 14th of the year following the tax year or pay income tax — plus a 10% penalty tax — on the withdrawal amount.)

- Cosmetic surgery (unless the surgery is related to a medical condition, as in the case of a birth defect or a mastectomy)
- Teeth whitening
- Maternity clothes
- Diaper services
- Health club dues
- Electrolysis for hair removal
- Hair transplants
- Household help or babysitting
- Marijuana for glaucoma (or other controlled substances)
- Nonprescription drugs and medicines (over-the-counter drugs can be qualifying expenses, but you must have a doctor's written recommendation)
- Food supplements not prescribed by a doctor (e.g., Ensure ™)
- Over-the-counter vitamins or diet drinks (e.g., SlimFast ™)
- Swimming lessons
- Weight-loss programs *not prescribed*
- Funeral expenses

How Are Medical Bills Paid From An HSA?

Using an HSA is pretty much like using any checking account. Typically, you'll have a checkbook with about 25 checks, plus a debit card. Some account custodians charge you for the checks (anywhere from $10 to $25) and will charge you for additional check orders as well.

Besides debit cards and checks, other ways to pay include certain types of credit cards issued by the account custodian and stored-value cards in specific dollar amounts. Stored-value cards for HSAs are similar to store gift cards or phone cards. The starting balance is debited every time the card is used, until the amount is used up.

As a practical matter, the amount of money you spend depends on the balance in your account. Although your deposits in the first few years may be small, your accumulated savings can provide a cushion of tax-free dollars over time.

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What If Money From The HSA Is Needed For Something Else?

In the event of severe financial difficulties, money saved in an HSA account may be immediately withdrawn to meet a crisis. All you have to do is write yourself a check. You will have to report this distribution as potentially taxable income, as you would if you “cashed out” your IRA or Keogh. But you don’t have to withdraw the entire amount, just what’s really needed for this important, non-medical need.

Remember, though, that the amount you withdraw for non-medical expenses loses value as soon as you withdraw it — you will be taxed at your regular tax rate plus a 10% penalty. Plus, whatever’s left in the account will accumulate less interest/dividends for the future. Unless you’re facing a true financial crisis, such as a foreclosure or eviction, you’re probably better off leaving the money in your account.

Tracking HSA Spending

Your HSA custodian is required to report all distributions from HSA accounts to the IRS. You (as an individual account holder) and your employees get a copy of the report from the custodian vendor at the end of the year. It’s up to you (as an individual account holder) and your employees to tell the IRS how much of the distribution total was for qualifying medical expenses, and what part of the total does not qualify.

Any unqualified amounts must be included in taxable income for the year (when you file your personal income taxes). The qualified amount is noted on a special form. Medical receipts *do not* have to be filed with the IRS, though they should be saved, along with copies of your tax forms, in case of an audit.

What To Do At Tax Time

HSA contributions *do not* have to be itemized to get the tax write-off for medical expenses. It comes right off the top and gets deducted from gross income.

On your personal income tax return, the amount of your HSA contribution should ideally equal the limit of your allowable deduction under your insurance plan. To make up any difference, the law allows the individual account holder to contribute to your HSA as late as April 15 of the year after the current tax year. Amounts over this maximum contribution amount may incur tax penalties.

All eligible contributions into an individual or family HSA are exempt from personal income tax. It doesn’t matter whether or not you spend all the money in the HSA in that tax year.

Rules For Reporting Premium Costs And HSA Contributions

Contributions into an HSA can be made either by an individual or by an employer, even a third party. If an individual makes the contribution, the amount is *deductible* from *total income* in the

section for “Adjustments to Gross Income” of Form 1040. A rundown of contributions and disbursements may be noted on a separate schedule (Form 8889) to be attached to the 1040.

If the employer contributes to the HSA, the amount is *excludable* from *wages*, and noted on W-2 paperwork. Employees should check to be sure that wages minus the employer’s contribution is correct on the W-2.

If the employer paid for all health insurance premiums, only that employer is entitled to deduct this amount as a business expense. An individual can’t deduct the premium costs. However, *if the employee paid part of the premium* out of his or her salary, the costs for the premium will be noted on the W-2, but this sum is not excludable from wages.

Can I Retire On Funds From My HSA?

To retire comfortably, you’ll probably need more income than an HSA alone can provide. For most Americans, that income will probably come from a combination of sources: Social Security, employer-sponsored pension plans, and personal savings in accounts like 401(k)s and IRAs. Your HSA can be a part of that — even a big part. *But HSAs aren’t designed to be your primary retirement savings vehicle.* Use a 401(k), SEP, IRA, or Keogh plan to provide for your retirement income. Use an HSA to give that income a hefty supplement.

After you reach age 65, you can use your accumulated HSA funds (which can include interest or dividends from stock funds, bonds, or other high-yield instruments) for other things besides healthcare. After retirement, money you withdraw and use for non-qualifying expenses is taxed at the normal rate for investment income. However, money you use for qualifying expenses later in life — such as nursing home costs — can still be withdrawn entirely tax-free.

Death Benefits

The money saved in an HSA is considered an “inheritable asset” subject to estate tax. Taxes may be paid by your heirs or assigns in the year the funds are released from your estate at the same rate as other inherited, previously untaxed income. Under the current law, the entire amount may pass to a surviving spouse without estate tax.

To Find Out More About HSAs

The best way to find out more about Health Savings Accounts and if they are for you and your business is to consult with a broker or specialist either within your company or from the list of accredited agents available at www.HSAfinder.com

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