

# **HSA**

**Health Savings Account**

**Custodial Agreement  
&  
Disclosure Statement**



## **Congratulations**

By establishing a Health Savings Account (HSA), you have taken an important step toward saving taxes and providing for the health-care needs of you and your family. Contributions to an HSA are tax deductible, and are not taxable when distributed, if used for qualified medical expenses. Therefore, contributions to, and the earnings on, an HSA are generally tax-free.

You do not have to contribute every year. However, we urge you to make additional contributions. Remember, your HSA means real tax savings to you — the more you deposit, the more money you'll have for your health-care needs.

This booklet, containing your HSA Custodial Agreement and Disclosure Statement, is yours to keep. Please read it over carefully to understand the rules relating to your HSA.

Thank you for allowing us to maintain your HSA. We're here to help you in any way we can. If you have any questions, or if we can assist you on any other matter, please let us know.

## **Application**

The Application is used to record all of the participant information necessary to establish the HSA. It is important that all of the information be completed.

## **HSA Custodial Agreement**

This is the legal document that defines the Internal Revenue Service's rules and regulations for HSAs. The Custodial Agreement, together with a fully completed Application to Participate, establishes your HSA with our organization.

## **Disclosure Statement**

The Disclosure Statement is a nontechnical description of the rules governing this HSA. It is easy to understand, because it's written in layman's language. Explanations are separated by headings that help you locate specific rules and regulations.

## Health Savings Custodial Account (Under section 223 of the Internal Revenue Code)

**Introduction**

The Account Owner whose name appears on the Application is establishing this Health Savings Account (HSA) exclusively for the purpose of paying or reimbursing qualified medical expenses of the Account Owner, his or her spouse, and dependents. The Account Owner represents that, unless this account is used solely to make rollover contributions, he or she is eligible to contribute to this HSA; specifically, that he or she: (1) is covered under a high deductible health plan (HDHP); (2) is not also covered by any other health plan that is not an HDHP (with certain exceptions for plans providing preventive care and limited types of permitted insurance and permitted coverage); (3) is not enrolled in Medicare; and (4) cannot be claimed as a dependent on another person's tax return.

This Custodial Account is assigned the dollar amount indicated on the Application in cash.

The Account Owner and the Custodian make the following agreement:

**ARTICLE I**

1. The Custodian will accept additional cash contributions for the tax year made by the Account Owner or on behalf of the Account Owner (by an employer, family member or any other person). No contributions will be accepted by the Custodian for any Account Owner that exceeds the maximum amount for family coverage plus the catch-up contribution.

2. Contributions for any tax year may be made at any time before the deadline for filing the Account Owner's federal income tax return for that year (without extensions).

3. Rollover contributions from an HSA or an Archer Medical Savings Account (Archer MSA) (unless prohibited under this agreement) need not be in cash and are not subject to the maximum annual contribution limit set forth in Article II.

4. Qualified HSA distributions from a health flexible spending arrangement or health reimbursement arrangement must be completed in a trustee-to-trustee transfer and are not subject to the maximum annual contribution limit set forth in Article II.

5. Qualified HSA funding distributions from an individual retirement account must be completed in a trustee-to-trustee transfer and are subject to the maximum annual contribution limit set forth in Article II.

**ARTICLE II**

1. For calendar year 2011, the maximum annual contribution limit for an Account Owner with single coverage is \$3,050. This amount increases to \$3,100 in 2012. For calendar year 2011, the maximum annual contribution limit for an Account Owner with family coverage is \$6,150. This amount increases to \$6,250 in 2012. These limits are subject to cost-of-living increases after 2012.

2. Contributions to Archer MSAs or other HSAs count toward the maximum annual contribution limit to this HSA.

3. For calendar year 2009 and later years, an additional \$1,000 catch-up contribution may be made for an Account Owner who is at least age 55 or older and not enrolled in Medicare.

4. Contributions in excess of the maximum annual contribution limit are subject to an excise tax. However, the catch-up contributions are not subject to an excise tax.

**ARTICLE III**

It is the responsibility of the Account Owner to determine whether contributions to this HSA have exceeded the maximum annual contribution limit described in Article II. If contributions to this HSA exceed the maximum annual contribution limit, the Account Owner shall notify the Custodian that there exist excess contributions to the HSA. It is the responsibility of the Account Owner to request the withdrawal of the excess contribution and any net income attributable to such excess contribution.

**ARTICLE IV**

The Account Owner's interest in the balance in this Custodial Account is nonforfeitable.

**ARTICLE V**

1. No part of the custodial funds in this account may be invested in life insurance contracts or in collectibles as defined in section 408(m).

2. The assets of this account may not be commingled with other property except in a common trust fund or common investment fund.

3. Neither the Account Owner nor the Custodian will engage in any prohibited transaction with respect to this account (such as borrowing or pledging the account or engaging in any other prohibited transaction as defined in section 4975).

**ARTICLE VI**

1. Distributions of funds from this HSA may be made at any time upon the direction of the Account Owner.

2. Distributions from this HSA that are used exclusively to pay or reimburse qualified medical expenses of the Account Owner, his or her spouse, or dependents are tax-free. However, distributions that are not used for qualified medical expenses are included in the Account Owner's gross income and are subject to an additional 20 percent tax on that amount. The additional 20 percent tax does not apply if the distribution is made after the Account Owner's death, disability, or reaching age 65.

3. The Custodian is not required to determine whether the distribution is for the payment or reimbursement of qualified medical expenses. Only the Account Owner is responsible for substantiating that the distribution is for qualified medical expenses and must maintain records sufficient to show, if required, that the distribution is tax-free.

**ARTICLE VII**

If the Account Owner dies before the entire interest in the account is distributed, the entire account will be disposed of as follows:

1. If the beneficiary is the Account Owner's spouse, the HSA will become the spouse's HSA as of the date of death.

2. If the beneficiary is not the Account Owner's spouse, the HSA will cease to be an HSA as of the date of death. If the beneficiary is the Account Owner's estate, the fair market value of the account as of the date of death is taxable on the Account Owner's final return. For other beneficiaries, the fair market value of the account is taxable to that person in the tax year that includes such date.

**ARTICLE VIII**

1. The Account Owner agrees to provide the Custodian with information necessary for the Custodian to prepare any report or return required by the IRS.

2. The Custodian agrees to prepare and submit any report or return as prescribed by the IRS.

**ARTICLE IX**

Notwithstanding any other article that may be added or incorporated in this agreement, the provisions of Articles I through VIII and this sentence are controlling. Any additional article in this agreement that is inconsistent with section 223 or IRS published guidance will be void.

**ARTICLE X**

This agreement will be amended from time to time to comply with the provisions of the Code or IRS published guidance. Other amendments may be made with the consent of the persons whose signatures appear on the Application.

**ARTICLE XI**

This article may incorporate additional provisions that are agreed to by the Depositor and Custodian to complete the agreement. They may include, for example, definitions, investment powers, voting rights, exculpatory provisions, amendment and termination, removal of the Custodian, Custodian's fees, state law requirements, accepting only cash, treatment of excess contributions, prohibited transactions with the Depositor, etc.

1. **Custodian.** The Custodian must be a bank or savings and loan association, as defined in section 408(n), an insurance company, defined in section 816, or any person who has the approval of the IRS to act as custodian.

2. **Depositor.** The Depositor is the person who establishes the Custodial Account.

3. **Amendments.**—The Custodian has the right to amend this Custodial Agreement at any time to comply with necessary laws and regulations, without the consent of the Depositor. Such amendments may be made retroactively to comply with statutory or regulatory changes. The Custodian also has the right to amend this Custodial Agreement for any other reason. The Depositor is deemed to have automatically consented to any amendment unless the Depositor notifies the Custodian, in writing, that the Depositor does not consent to the amendment within 30 days after the Custodian mails a copy of the amendment to the Depositor.

4. **Responsibilities.**—The Custodian shall receive all contributions, shall make distributions and pay benefits from the Custodial Account, shall file such statements or reports as may be required, and do other things as may be required of an HSA custodian. If applicable, and unless otherwise specified by the Depositor, his spouse, or his beneficiaries, the Custodian, at its sole discretion, from time to time, shall cast any votes that may be attributable to the Depositor's interest under this agreement. The Custodian shall use reasonable care, skill, prudence, and diligence in the administration and investment of the Custodial Account and in executing any written instructions by the Depositor, and shall be entitled to rely on information submitted by the Depositor. The Custodian shall have no duties under this Agreement and no responsibility for the administration of the Custodial Account, except for such duties imposed by law or this agreement. The Custodian is authorized to invest all or part of the plan's assets in deposits of the financial organization acting as Custodian of this HSA. The Custodian has no responsibility or duty to determine whether contributions to, or distributions from, this HSA comply with the laws or regulations, or this Custodial Agreement. If the Custodian fails to enforce any of the provisions of this Agreement, such failure shall not be construed as a waiver of such provisions, or of the Custodian's right thereafter to enforce each and every such provision.

5. **Resignation, Removal, and Appointment of Custodian.**—The Custodian may resign at any time by giving 30 days prior written notice of such resignation to the Depositor. The Depositor shall fill any vacancy in the office of Custodian. If, after 30 days from notice of resignation, the Depositor does not notify the Custodian, in writing, of the appointment of a successor Custodian of the HSA, the resigning Custodian has the right to appoint a successor Custodian of the HSA or, at its sole discretion, the resigning Custodian may transfer the HSA to a successor custodian or distribute the HSA assets to the Depositor. The Custodian is authorized to reserve such funds it deems necessary to cover any fees or charges against the HSA.

6. **Applicable Law.**—This Agreement is subject to all applicable federal and state laws and regulations. If it is necessary to apply any state law to interpret and administer this Agreement, the law of the Custodian's domicile shall govern.

7. **Severability.**—If any part of this Agreement is held to be unenforceable or invalid, the remaining parts shall not be affected. The remaining parts shall be enforceable and valid as if any unenforceable or invalid parts were not contained herein.

8. **Do not file this Agreement with the IRS.** Instead, keep it with your records.

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## What's New

**Additional Tax Increased.** For tax years beginning after December 31, 2010, the additional tax on distributions not used for qualified medical expenses increases from 10% to 20%.

### General Instructions

*Section references are to the Internal Revenue Code.*

### Purpose of Form

Form 5305-C is a model custodial account agreement that has been approved by the IRS. An HSA is established after the form is fully executed by both the account owner and the custodian. The form can be completed at any time during the tax year. This account must be created in the United States for the exclusive benefit of the account owner.

Do not file Form 5305-C with the IRS. Instead, keep it with your records. For more information on HSAs, see Notice 2004-2, 2004-2 I.R.B. 269, Notice 2004-50, 2004-33 I.R.B. 196, Pub. 969, Health Savings Accounts and Other Tax-Favored Health Plans, and other IRS published guidance.

### Definitions

**Identifying Number.** The account owner's social security number will serve as the identification number of this HSA. For married persons, each spouse who is

eligible to open an HSA and wants to contribute to an HSA must establish his or her own account. An employer identification number (EIN) is required for an HSA for which a return is filed to report unrelated business taxable income. An EIN is also required for a common fund created for HSAs.

**High Deductible Health Plan (HDHP).** For calendar year 2011, an HDHP for self-only coverage has a minimum annual deductible of \$1,200 and an annual out-of-pocket maximum (deductibles, co-payments and other amounts, but not premiums) of \$5,950. In 2012, the \$1,200 minimum annual deductible remains the same and the annual out-of-pocket maximum increases to \$6,050. For calendar year 2011, an HDHP for family coverage has a minimum annual deductible of \$2,400 and an annual out-of-pocket maximum of \$11,900. In 2012, the \$2,400 minimum annual deductible remains the same and the annual out-of-pocket maximum increases to \$12,100. These limits are subject to cost-of-living adjustments after 2012.

**Self-only coverage and family coverage under an HDHP.** Family coverage means coverage that is not self-only coverage.

**Qualified medical expenses.** Qualified medical expenses are amounts paid for medical care as defined in section 213(d) for the account owner, his or her spouse, or dependents (as defined in section 152) but only to the extent that such amounts are not

compensated for by insurance or otherwise. With certain exceptions, health insurance premiums are not qualified medical expenses.

**Custodian.** A custodian of an HSA must be a bank, an insurance company, a person previously approved by the IRS to be a custodian of an individual retirement account (IRA) or Archer MSA, or any other person approved by the IRS.

### Specific Instructions

**Article XI.** Article XI and any that follow it may incorporate additional provisions that are agreed to by the account owner and custodian. The additional provisions may include, for example, definitions, restrictions on rollover contributions from HSAs or Archer MSAs (requiring a rollover not later than 60 days after receipt of a distribution and limited to one rollover during a one-year period), investment powers, voting rights, exculpatory provisions, amendment and termination, removal of custodian, custodian's fees, state law requirements, treatment of excess contributions, distribution procedures (including frequency or minimum dollar amount), use of debit, credit, or stored-value cards, return of mistaken distributions, and descriptions of prohibited transactions. Attach additional pages if necessary.

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# Health Savings Account Custodial Disclosure Statement

IRS Notice 2004-2 as modified by IRS Notice 2004-50  
(Text in *italics* is excerpts from IRS Notice 2004-50)

## PURPOSE

This notice provides guidance on Health Savings Accounts.

## BACKGROUND

Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. No. 108-173, added section 223 to the Internal Revenue Code to permit eligible individuals to establish Health Savings Accounts (HSAs) for taxable years beginning after December 31, 2003. HSAs are established to receive tax-favored contributions by or on behalf of eligible individuals and amounts in an HSA may be accumulated over the years or distributed on a tax-free basis to pay or reimburse qualified medical expenses. A number of the rules that apply to HSAs are similar to rules that apply to Individual Retirement Accounts (IRAs) under sections 219, 408 and 408A, and to Archer Medical Savings Accounts (Archer MSAs) under section 220. For example, like an Archer MSA, an HSA is established for the benefit of an individual, is owned by that individual, and is portable. Thus, if the individual is an employee who later changes employers or leaves the work force, the HSA does not stay behind with the former employer, but stays with the individual. This notice provides certain basic information about HSAs in question and answer format, without attempting to enumerate all of the specific rules that apply under section 223.

The notice is divided into five parts. Part I of the notice explains what HSAs are and who can have them. Part II describes how HSAs can be established. Parts III and IV cover contributions to HSAs and distributions from HSAs. Part V discusses other matters relating to HSAs.

## QUESTIONS AND ANSWERS

Set forth below are questions and answers concerning HSAs.

### I. What Are HSAs and Who Can Have Them?

Q-1. What is an HSA?

A-1. An HSA is a tax-exempt trust or custodial account established exclusively for the purpose of paying qualified medical expenses of the account beneficiary who, for the months for which contributions are made to an HSA, is covered under a high-deductible health plan.

Q-2. Who is eligible to establish an HSA?

A-2. An "eligible individual" can establish an HSA. An "eligible individual" means, with respect to any month, any individual who: (1) is covered under a high-deductible health plan (HDHP) on the first day of such month; (2) is not also covered by any other health plan that is not an HDHP (with certain exceptions for plans providing certain limited types of coverage); (3) is not enrolled in Medicare (generally, has not yet reached age 65); and (4) may not be claimed as a dependent on another person's tax return.

Q-3. What is a "high-deductible health plan" (HDHP)?

A-3. Generally, an HDHP is a health plan that satisfies certain requirements with respect to deductibles and out-of-pocket expenses. Specifically, for self-only coverage, an HDHP has an annual deductible of at least \$1,000 and annual out-of-pocket expenses required to be paid (deductibles, co-payments and other amounts, but not premiums) not exceeding \$5,000. For family coverage, an HDHP has an annual deductible of at least \$2,000 and annual out-of-pocket expenses required to be paid not exceeding \$10,000. In the case of family coverage, a plan is an HDHP 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 HDHP until the family has incurred annual covered medical expenses in excess of the minimum annual deductible. Amounts are indexed for inflation. A plan does not fail to qualify as an HDHP merely because it does not have a deductible (or has a small deductible) for preventive care (e.g., first dollar coverage for preventive care). However, except for preventive care, a plan may not provide benefits for any year until the deductible for that year is met. See A-4 and A-6 for special rules regarding network plans and plans providing certain types of coverage.

Example (1): A Plan provides coverage for A and his family. The Plan 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 in 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 an HDHP.

Example (2): Same facts 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 an HDHP with respect to the deductibles. See A-12 for HSA contribution limits.

Q-4. What are the special rules for determining whether a health plan that is a network plan meets the requirements of an HDHP?

A-4. A network plan is a plan that generally provides more favorable benefits for services provided by its network of providers than for services provided outside of the network. In the case of a plan using a network of providers, the plan does not fail to be an HDHP (if it would otherwise meet the requirements of an HDHP) solely because the out-of-pocket expense limits for services provided outside of the network exceeds the maximum annual out-of-pocket expense limits allowed for an HDHP. In addition, the plan's annual deductible for out-of-network services is not taken into account in determining the annual contribution limit. Rather, the annual contribution limit is determined by reference to the deductible for services within the network.

Q-5. What kind of other health coverage makes an individual ineligible for an HSA?

A-5. Generally, an individual is ineligible for an HSA if the individual, while covered under an HDHP, is also covered under a health plan (whether as an individual, spouse, or dependent) that is not an HDHP. See also A-6.

Q-6. What other kinds of health coverage may an individual maintain without losing eligibility for an HSA?

A-6. An individual does not fail to be eligible for an HSA merely because, in addition to an HDHP, the individual has coverage for any benefit provided by "permitted insurance." Permitted insurance is insurance under which substantially all of the coverage provided relates to liabilities incurred under workers' compensation laws, tort liabilities, liabilities relating to ownership or use of property (e.g., automobile insurance), insurance for a specified disease or illness, and insurance that pays a fixed amount per day (or other period) of hospitalization. In addition to permitted insurance, an individual does not fail to be eligible for an HSA merely because, in addition to an HDHP, the individual has coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care. If a plan that is intended to be an HDHP is one in which substantially all of the coverage of the plan is through permitted insurance or other coverage as described in this answer, it is not an HDHP.

Q-7. Can a self-insured medical reimbursement plan sponsored by an employer be an HDHP?

A-7. Yes.

### II. How Can An HSA Be Established?

Q-8. How does an eligible individual establish an HSA?

A-8. Beginning January 1, 2004, any eligible individual (as described in A-2) can establish an HSA with a qualified HSA trustee or custodian, in much the same way that individuals establish IRAs or Archer MSAs with qualified IRA or Archer MSA trustees or custodians. No permission or authorization from the Internal Revenue Service (IRS) is necessary to establish an HSA. An eligible individual who is an employee may establish an HSA with or without involvement of the employer.

Q-9. Who is a qualified HSA trustee or custodian?

A-9. Any insurance company (as defined in section 816) or any bank (including a similar financial institution as defined in section 408(n)) can be an HSA trustee or custodian. In addition, any other person already approved by the IRS to be a trustee or custodian of IRAs or Archer MSAs is automatically approved to be an HSA trustee or custodian. Other persons may request approval to be a trustee or custodian in accordance with the procedures set forth in Treas. Reg. § 1.408-2(e) (relating to IRA nonbank trustees). For additional information concerning nonbank trustees and custodians, see Announcement 2003-54, 2003-40 I.R.B. 761.

Q-10. Does the HSA have to be opened at the same institution that provides the HDHP?

A-10. No. The HSA can be established through a qualified trustee or custodian who is different from the HDHP provider. Where a trustee or custodian does not sponsor the HDHP, the trustee or custodian may require proof or certification that the account beneficiary is an eligible individual, including that the individual is covered by a health plan that meets all of the requirements of an HDHP.

### III. Contributions to HSAs.

Q-11. Who may contribute to an HSA?

A-11. Any eligible individual may contribute to an HSA. For an HSA established by an employee, the employee, the employee's employer or both may contribute to the HSA of the employee in a given year. For an HSA established by a self-employed (or unemployed) individual, the individual may

contribute to the HSA. Family members may also make contributions to an HSA on behalf of another family member as long as that other family member is an eligible individual. (Q-28. *Who may make contributions on behalf of an eligible individual?* A-28. *Although Q&A 11 of Notice 2004-2 only refers to contributions by employers or family members, any person (an employer, a family member or any other person) may make contributions to an HSA on behalf of an eligible individual.*)

Q-12. How much may be contributed to an HSA in calendar year 2004?

A-12. The maximum annual contribution to an HSA is the sum of the limits determined separately for each month, based on status, eligibility and health plan coverage as of the first day of the month. For calendar year 2004, the maximum monthly contribution for eligible individuals with self-only coverage under an HDHP is 1/12 of the lesser of 100% of the annual deductible under the HDHP (minimum of \$1,000) but not more than \$2,600. For eligible individuals with family coverage under an HDHP, the maximum monthly contribution is 1/12 of the lesser of 100% of the annual deductible under the HDHP (minimum of \$2,000) but not more than \$5,150. In addition to the maximum contribution amount, catch-up contributions, as described in A-14, may be made by or on behalf of individuals age 55 and older who are not enrolled in Medicare. All HSA contributions made by or on behalf of an eligible individual to an HSA are aggregated for purposes of applying the limit. The annual limit is decreased by the aggregate contributions to an Archer MSA. The same annual contribution limit applies whether the contributions are made by an employee, an employer, a self-employed person, or a family member. Unlike Archer MSAs, contributions may be made by or on behalf of eligible individuals even if the individuals have no compensation or if the contributions exceed their compensation. If an individual has more than one HSA, the aggregate annual contributions to all the HSAs are subject to the limit.

Q-13. How is the contribution limit computed for an individual who begins self-only coverage under an HDHP on June 1, 2004 and continues to be covered under the HDHP for the rest of the year?

A-13. The contribution limit is computed each month. If the annual deductible is \$5,000 for the HDHP, then the lesser of the annual deductible and \$2,600 is \$2,600. The monthly contribution limit is \$216.67 ( $\$2,600 \div 12$ ). The annual contribution limit is \$1,516.69 ( $7 \times \$216.67$ ).

Q-14. What are the "catch-up contributions" for individuals age 55 or older?

A-14. For individuals (and their spouses covered under the HDHP) who have attained age 55 and are not enrolled in Medicare the HSA contribution limit is increased by \$500 in calendar year 2004. This catch-up amount will increase in \$100 increments annually, until it reaches \$1,000 in calendar year 2009. As with the annual contribution limit, the catch-up contribution is also computed on a monthly basis. After an individual has attained age 65 and becomes enrolled in Medicare benefits, contributions, including catchup contributions, cannot be made to an individual's HSA.

Example: An individual attains age 65 and becomes enrolled in Medicare in July, 2004 and had been participating in self-only coverage under an HDHP with an annual deductible of \$1,000. The individual is no longer eligible to make 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 contributions for January through June totaling \$750 ( $6 \times \$125$ ), but may not make any contributions for July through December, 2004.

Q-15. If one or both spouses have family coverage, how is the contribution limit computed?

A-15. In the case of individuals who are married to each other, if either spouse has family coverage, both are treated as having family coverage. If each spouse has family coverage under a separate health plan, both spouses are treated as covered under the plan with the lowest deductible. The contribution limit for the spouses is the lowest deductible amount, divided equally between the spouses unless they agree on a different division. The family coverage limit is reduced further by any contribution to an Archer MSA. However, both spouses may make the catch-up contributions for individuals age 55 or over without exceeding the family coverage limit.

Example (1): H and W are married. H is 58 and W is 53. H and W both have family coverage under separate HDHPs. H has a \$3,000 deductible under his HDHP and W has a \$2,000 deductible under her HDHP. H and W are treated as covered under the plan with the \$2,000 deductible. H can contribute \$1,500 to an HSA (1/2 the deductible of \$2,000 + \$500 catch up contribution) and W can contribute \$1,000 to an HSA (unless they agree to a different division).

Example (2): H and W are married. H is 35 and W is 33. H and W each have a self-only HDHP. H has a \$1,000 deductible under his HDHP and W has a \$1,500 deductible under her HDHP. H can contribute \$1,000 to an HSA and W can contribute \$1,500 to an HSA.

Q-16. In what form must contributions be made to an HSA?

A-16. Contributions to an HSA must be made in cash. For example, contributions may not be made in the form of stock or other property. Payments

for the HDHP and contributions to the HSA can be made through a cafeteria plan. See A-33.

Q-17. What is the tax treatment of an eligible individual's HSA contributions?

A-17. Contributions made by an eligible individual to an HSA (which are subject to the limits described in A-12) are deductible by the eligible individual in determining adjusted gross income (i.e., "above-the-line"). The contributions are deductible whether or not the eligible individual itemizes deductions. However, the individual cannot also deduct the contributions as medical expense deductions under section 213.

Q-18. What is the tax treatment of contributions made by a family member on behalf of an eligible individual?

A-18. Contributions made by a family member on behalf of an eligible individual to an HSA (which are subject to the limits described in A-12) are deductible by the eligible individual in computing adjusted gross income. The contributions are deductible whether or not the eligible individual itemizes deductions. An individual who may be claimed as a dependent on another person's tax return is not an eligible individual and may not deduct contributions to an HSA.

Q-19. What is the tax treatment of employer contributions to an employee's HSA?

A-19. In the case of an employee who is an eligible individual, employer contributions (provided they are within the limits described in A-12) to the employee's HSA are treated as employer-provided coverage for medical expenses under an accident or health plan and are excludable from the employee's gross income. The employer contributions are not subject to withholding from wages for income tax or subject to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), or the Railroad Retirement Tax Act. Contributions to an employee's HSA through a cafeteria plan are treated as employer contributions. The employee cannot deduct employer contributions on his or her federal income tax return as HSA contributions or as medical expense deductions under section 213.

Q-20. What is the tax treatment of an HSA?

A-20. An HSA is generally exempt from tax (like an IRA or Archer MSA), unless it has ceased to be an HSA. Earnings on amounts in an HSA are not includable in gross income while held in the HSA (i.e., inside buildup is not taxable). See A-25 regarding the taxation of distributions to the account beneficiary.

Q-21. When may HSA contributions be made? Is there a deadline for contributions to an HSA for a taxable year?

A-21. Contributions for the taxable year can be made in one or more payments, at the convenience of the individual or the employer, at any time prior to the time prescribed by law (without extensions) for filing the eligible individual'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 monthly, the maximum contribution may be made on the first day of the year. See A-22 regarding correcting excess contributions.

Example: B has self-only coverage under an HDHP with a deductible of \$1,500 and also has an HSA. B's employer contributes \$200 to B's HSA at the end of every quarter in 2004 and at the end of the first quarter in 2005 (March 31, 2005). B can exclude from income in 2004 all of the employer contributions (i.e., \$1,000) because B's exclusion for all contributions does not exceed the maximum annual HSA contributions. See A-12. (Q-74. *Is the HSA trustee or custodian responsible for determining whether contributions to an HSA exceed the maximum annual contribution for a particular account beneficiary?* A-74. *No. This is the responsibility of the account beneficiary, who is also responsible for notifying the trustee or custodian of any excess contribution and requesting a withdrawal of the excess contribution together with any net income attributable to the excess contribution. The HSA trustee or custodian is, however, responsible for accepting cash contributions within the limits in Q&A 73 and for filing required information returns with the IRS (Form 5498-SA and Form 1099-SA).)*

Q-22. What happens when HSA contributions exceed the maximum amount that may be deducted or excluded from gross income in a taxable year?

A-22. Contributions by individuals to an HSA, or if made on behalf of an individual to an HSA, are not deductible to the extent they exceed the limits described in A-2. Contributions by an employer to an HSA for an employee are included in the gross income of the employee to the extent that they exceed the limits described in A-12 or if they are made on behalf of an employee who is not an eligible individual. In addition, an excise tax of 6% for each taxable year is imposed on the account beneficiary for excess individual and employer contributions. However, if the excess contributions for a taxable year and the net income attributable to such excess contributions are paid to the account beneficiary before the last day prescribed by law (including extensions) for filing the account beneficiary's federal income tax return for the taxable year, then the net income attributable to the excess contributions is included in the

account beneficiary's gross income for the taxable year in which the distribution is received but the excise tax is not imposed on the excess contribution and the distribution of the excess contributions is not taxed. (Q-34. *An account beneficiary wants to withdraw an excess contribution from an HSA before the due date of his or her federal income tax return (including extensions), to avoid the 6 percent excise tax under section 4973(a)(5). How is the net income attributable to the excess contribution computed?* A-34. *Section 223(f)(3)(A)(ii) provides that any distribution of excess contribution to an HSA must be "accompanied by the amount of net income attributable to such excess contribution." Any net income is included in the individual's gross income. The rules for computing attributable net income for excess IRA contributions apply to HSAs. See Treas. Reg. § 1.408-11 and Notice 2004-2, Q&A 22.*)

Q-23. Are rollover contributions to HSAs permitted?

A-23. Rollover contributions from Archer MSAs and other HSAs into an HSA are permitted. Rollover contributions need not be in cash. Rollovers are not subject to the annual contribution limits. Rollovers from an IRA, from a health reimbursement arrangement (HRA), or from a health flexible spending arrangement (FSA) to an HSA are not permitted. (Q-56. *Are transfers of HSA amounts from one HSA trustee directly to another HSA trustee (trustee-to-trustee transfers), subject to the rollover restrictions?* A-56. *No. The rules under section 223(f)(5) limiting the number of rollover contributions to one a year do not apply to trustee-to-trustee transfers. Thus, there is no limit on the number of trustee-to-trustee transfers allowed during a year.*)

#### IV. Distributions from HSAs.

Q-24. When is an individual permitted to receive distributions from an HSA?

A-24. An individual is permitted to receive distributions from an HSA at any time.

Q-25. How are distributions from an HSA taxed?

A-25. Distributions from an HSA used exclusively to pay for qualified medical expenses of the account beneficiary, his or her spouse, or dependents are excludable from gross income. In general, amounts in an HSA can be used for qualified medical expenses and will be excludable from gross income even if the individual is not currently eligible for contributions to the HSA. However, any amount of the distribution not used exclusively to pay for qualified medical expenses of the account beneficiary, spouse or dependents is includable in gross income of the account beneficiary and is subject to an additional 10% tax on the amount includable, except in the case of distributions made after the account beneficiary's death, disability, or attaining age 65.

Q-26. What are the "qualified medical expenses" that are eligible for tax-free distributions?

A-26. The term "qualified medical expenses" are expenses paid by the account beneficiary, his or her spouse or dependents for medical care as defined in section 213(d) (including nonprescription drugs as described in Rev. Rul. 2003-102, 2003-38 I.R.B. 559), but only to the extent the expenses are not covered by insurance or otherwise. The qualified medical expenses must be incurred only after the HSA has been established. For purposes of determining the itemized deduction for medical expenses, medical expenses paid or reimbursed by distributions from an HSA are not treated as expenses paid for medical care under section 213.

Q-27. Are health insurance premiums qualified medical expenses?

A-27. Generally, health insurance premiums are not qualified medical expenses except for the following: qualified long-term care insurance, COBRA health care continuation coverage, and health care coverage while an individual is receiving unemployment compensation. In addition, (Q&A-45 adds, "for individuals enrolled in Medicare," ) premiums for Medicare Part A or B, Medicare HMO, and the employee share of premiums for employer-sponsored health insurance, including premiums for employer-sponsored retiree health insurance can be paid from an HSA. Premiums for Medigap policies are not qualified medical expenses.

Q-28. How are distributions from an HSA taxed after the account beneficiary is no longer an eligible individual?

A-28. If the account beneficiary is no longer an eligible individual (e.g., the individual is over age 65 and entitled to Medicare benefits, or no longer has an HDHP), distributions used exclusively to pay for qualified medical expenses continue to be excludable from the account beneficiary's gross income.

Q-29. Must HSA trustees or custodians determine whether HSA distributions are used exclusively for qualified medical expenses?

A-29. No. HSA trustees or custodians are not required to determine whether HSA distributions are used for qualified medical expenses. Individuals who establish HSAs make that determination and should maintain records of their medical expenses sufficient to show that the distributions have been made exclusively for qualified medical expenses and are therefore excludable from gross income.

Q-30. Must employers who make contributions to an employee's HSA determine whether HSA distributions are used exclusively for qualified medical expenses?

A-30. No. The same rule that applies to trustees or custodians applies to employers. See A-29.

Q-31. What are the income tax consequences after the HSA account beneficiary's death?

A-31. Upon death, any balance remaining in the account beneficiary's HSA becomes the property of the individual named in the HSA instrument as the beneficiary of the account. If the account beneficiary's surviving spouse is the named beneficiary of the HSA, the HSA becomes the HSA of the surviving spouse. The surviving spouse is subject to income tax only to the extent distributions from the HSA are not used for qualified medical expenses. If, by reason of the death of the account beneficiary, the HSA passes to a person other than the account beneficiary's surviving spouse, the HSA ceases to be an HSA as of the date of the account beneficiary's death, and the person is required to include in gross income the fair market value of the HSA assets as of the date of death. For such a person (except the decedent's estate), the includable amount is reduced by any payments from the HSA made for the decedent's qualified medical expenses, if paid within one year after death.

#### V. Other Matters.

Q-32. What discrimination rules apply to HSAs?

A-32. If an employer makes HSA contributions, the employer must make available comparable contributions on behalf of all "comparable participating employees" (i.e., eligible employees with comparable coverage) during the same period. Contributions are considered comparable if they are either the same amount or same percentage of the deductible under the HDHP. The comparability rule is applied separately to part-time employees (i.e., employees who are customarily employed for fewer than 30 hours per week). The comparability rule does not apply to amounts rolled over from an employee's HSA or Archer MSA, or to contributions made through a cafeteria plan. If employer contributions do not satisfy the comparability rule during a period, the employer is subject to an excise tax equal to 35% of the aggregate amount contributed by the employer to HSAs for that period.

Example: Employer X offers its collectively bargained employees three health plans, including an HDHP with self-only coverage and a \$2,000 deductible. For each employee electing the HDHP self-only coverage, X contributes \$1,000 per year on behalf of the employee to an HSA. X makes no HSA contributions for employees who do not elect the HDHP. X's plans and HSA contributions satisfy the comparability rule.

Q-33. Can an HSA be offered under a cafeteria plan?

A-33. Yes. Both an HSA and an HDHP may be offered as options under a cafeteria plan. Thus, an employee may elect to have amounts contributed as employer contributions to an HSA and an HDHP on a salary-reduction basis.

Q-34. What reporting is required for an HSA?

A-34. Employer contributions to an HSA must be reported on the employee's Form W-2. In addition, information 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.

Q-35. Are HSAs subject to COBRA continuation coverage under section 4980B?

A-35. No. Like Archer MSAs, HSAs are not subject to COBRA continuation coverage.

Q-36. How do the rules under section 419 affect contributions by an employer to an HSA?

A-36. Contributions by an employer to an HSA are not subject to the rules under section 419. An HSA is a trust that is exempt from tax under section 223. Thus, an HSA is not a "fund" under section 419(e)(3) and, therefore, is not a "welfare benefit fund" under section 419(e)(1).

Q-37. May eligible individuals use debit, credit or stored-value cards to receive distributions from an HSA for qualified medical expenses?

A-37. Yes. (Q-80. *May a trustee or custodian restrict the frequency or minimum amount of distributions from an HSA?* A-80. *Yes. Trustees or custodians may place reasonable restrictions on both the frequency and the minimum amount of distributions from an HSA. For example, the trustee may prohibit distributions for amounts of less than \$50 or only allow a certain number of distributions per month. Generally, the terms regarding the frequency or minimum amount of distributions from an HSA are matters of contract between the trustee and the account beneficiary.*)

Q-38. Are HSAs subject to other statutory rules and provisions?

A-38. Yes. HSAs are subject to other statutory rules and provisions not addressed in this notice. No inference should be drawn regarding issues not expressly addressed in this notice that may be suggested by a particular question or answer, or by the inclusion or exclusion of certain questions. (Q-67. *Are there any transactions which account beneficiaries are prohibited from entering into with an HSA?* A-67. *Yes. Section 223(e)(2) provides that rules similar to the rules of section 408(e)(2) and (4) shall apply to HSAs. Therefore, account beneficiaries may not enter into "prohibited transactions" with an HSA (e.g.,*

the account beneficiary may not sell, exchange, or lease property, borrow or lend money, furnish goods, services or facilities, transfer to or use by or for the benefit of himself/herself any assets, pledge the HSA, etc.). Any amount treated as distributed as the result of a prohibited transaction will not be treated as used to pay for qualified medical expenses. The account beneficiary must, therefore, include the distribution in gross income and generally will be subject to the additional 10 percent tax on distributions not made for qualified medical expenses. See Notice 2004-2, Q&A 25.)

#### **Addendum — Investment**

**Investment of Contributions.** Contributions under the Plan are held in a custodial account for your exclusive benefit, or that of your surviving spouse or your beneficiaries who may include your estate, your dependents or any other persons or entities you may designate, in writing, to the Custodian. Your interest in the account is fully vested and nonforfeitable. The funds in this plan shall be invested in savings accounts, certificates of deposit, and any other investments that are, or may become, legal for the Custodian to make available for investment. The assets of the Custodial Account may not be commingled with other property except in a common trust fund or common investment fund. At no time may any portion of the funds be invested in life insurance contracts or collectibles. The prohibition against investment in collectibles does not apply to certain gold, silver, and platinum coins minted by the government of the United States or any state thereof, or to certain gold, silver, platinum, and palladium bullion.

#### **Addendum — The Tax Relief and Health Care Act of 2006 has made significant changes to the HSA rules. Please note the following changes to IRS Notices 2004-2 and 2004-50 (as shown earlier):**

1: Beginning with the 2007 tax year, the maximum HSA contribution is not limited to the annual deductible under the HDHP. Therefore, the maximum annual HSA contribution that can be made for 2007 is \$2,850 for self-only coverage and \$5,650 for family coverage regardless of the amount of the deductible of the HDHP.

2: Under the Tax Relief and Health Care Act of 2006, there is an exception to the pro-rata calculation of the annual contribution amount. For tax years beginning in 2007 and thereafter, individuals who become covered under an HDHP in a month other than January may make a full deductible contribution for the entire year, even though they were not covered by the HDHP for the full year. If an individual is still eligible for the HSA during the last month of a tax year, he or she is treated as having been eligible for an HSA during every month of the year for purposes of calculating the annual contribution limit. Thus, contributions could be made for such an individual for months before the individual was enrolled in the plan. For the months that an individual is treated as being eligible for a contribution under this provision, the individual is treated as being covered under the same HDHP as he or she is covered during the last month of the tax year.

*Example:* Sam, age 40, became covered by a self-only HDHP on 8/1/07 and was still covered by that HDHP in December 2007. For purposes of his 2007 contribution limit, Sam is treated as being covered by the HDHP for the entire year. He can contribute up to \$2,850 to his HSA for 2007, even though he was covered by the HDHP for only 5 months of the year.

If contributions are made for an individual under this rule, he or she must remain an eligible individual (except for death or disability) during a testing period that begins on the last day of the tax year and ends on the last day of the month 12 months later. If he or she does not remain eligible for HSA contributions during the testing period, the contribution amount attributable to the months he or she was not actually covered under the HDHP become taxable. The amounts are includible in income for the taxable year in which occurs the first day during the testing period that the individual is no longer eligible. A 10%\* penalty also applies to the amount included in income.

*Example:* In our previous example, Sam, age 40, became covered by a self-only HDHP on 8/1/07. For purposes of his 2007 contribution, Sam was treated as being covered by the HDHP for the entire year and he contributed \$2,850 to his HSA. In August 2008, he no longer was covered by an HDHP. Since he did not remain eligible for the entire testing period, the amount he contributed for the first 7 months of 2007 (January through July), when he was not actually covered by the HDHP, is includible in income for 2008. Thus, \$1,662.50 ( $\$2,850 \div 12 \times 7$ ) is includible in income and subject to a 10%\* penalty. Further, he may only contribute 7/12th of the annual limit for 2008.

3: Beginning with the 2007 tax year, the deductible under the HDHP is not taken into consideration for purposes of determining the contribution amount. The applicable contribution limit, after reduction for any Archer MSA

contributions, is split equally between both spouses unless they agree on a different division.

4: A provision in the Tax Relief and Health Care Act of 2006 allows a one-time movement of funds by the employer from a health FSA or an HRA to an HSA. Beginning with date of enactment on December 20, 2006 and ending on December 31, 2011, a limited amount of funds may be distributed from a health FSA or HRA and contributed through a direct transfer to an HSA. The amount that can be transferred cannot exceed the lesser of (1) the balance in the health FSA or HRA as of September 21, 2006 or (2) the balance in the health FSA or HRA as of the date of the distribution. The balance is determined on a cash basis (i.e. expenses incurred that have not been reimbursed as of the date of determination are not taken into account). These transferred amounts are not taken into account in applying the maximum deduction limitation for other HSA contributions, and are not deductible.

Because this provision is designed to assist individuals in transitioning from another type of health plan to an HDHP, if an individual for whom a contribution is made under this provision does not remain eligible for an HSA during the testing period (except for disability or death), the amount of the contribution is includible in the gross income of the individual. The testing period begins with the month of the contribution and ends on the last day of the month 12 months later. The amount is includible for the tax year of the first day during the testing period that the individual is no longer eligible for an HSA. A 10% additional penalty also applies to the amount includible in income.

If an employer allows any employee the ability to make transfers under this provision, all employees who are covered under an HDHP of the employer must be allowed to make such transfers.

*Example:* Mary has a balance in her FSA as of September 21, 2006 of \$2,000 and a balance on January 1, 2008 of \$3,000. As of January 1, 2008, a one-time amount not to exceed \$2,000 may be transferred from the FSA to the HSA. The \$2,000 distribution would not be includible in income, would not be deductible, nor would it count against the maximum annual contribution to the HSA. If Mary ceases to be eligible for an HSA before January 31, 2009 (the end of the testing period), the amount is includible in income and subject to a 10% tax. If, instead of \$3,000, the balance on January 1, 2008 had been \$1,500, Mary's transfer would have been limited to \$1,500.

5: Beginning for the 2007 tax year, an individual can make a one-time-only tax-free direct transfer from his or her IRA to an HSA (known as a "qualified HSA funding distribution" (QHFD)). In addition, a QHFD is not subject to the IRS 10% early distribution penalty tax. The amount that can be transferred is limited to the maximum annual contribution amount applicable to the type of HDHP (self-only or family) under which the individual is covered. The amount is reduced by the amount that has already been contributed to the HSA for the year, if any. No deduction is allowed for the contribution amount transferred from the IRA.

A QHFD applies only to the taxable portion of a Traditional IRA withdrawal; it does not apply to any nontaxable portion (basis). Special rules apply when the IRA contains basis (after-tax funds such as nondeductible IRA contributions). The QHFD is deemed to come first from the taxable portion (i.e., there is no prorate distribution of basis).

*Example:* Nick, age 40, has \$50,000 of total Traditional IRA assets, including \$10,000 of total basis. In 2007, he decides to make a \$2,500 qualified HSA funding distribution from his Traditional IRA directly to his HSA. The entire \$2,500 is treated as coming from the taxable funds in Nick's Traditional IRAs, leaving him with \$10,000 of basis in his Traditional IRAs.

Even though only one distribution and contribution from an IRA to an HSA is allowed during an individual's lifetime, there is one exception. If an individual starts out the tax year with self-only coverage and later in the year becomes covered by a family HDHP, an additional amount can be transferred (the difference between the self-only limit and the family limit) within the same tax year.

Once the transfer has occurred, the individual must remain eligible for the HSA (except because of death or disability) during a testing period which begins with the month of the contribution and ends on the last day of the month 12 months later. If the individual does not remain eligible, the amount of the IRA distribution that was deposited into the HSA is taxable and subject to a 10%\* penalty tax for the tax year in which he or she first became ineligible.

This provision does not apply to Simplified Employee Pensions (SEPs) or SIMPLE IRAs.

\* For tax years beginning after December 31, 2010, the 10% penalty tax is increased to 20%.