General Guidance on Eligibility, Contribution & Reimbursement Rules for Health Savings Accounts & Health Reimbursement Arrangements

June, 2020

This resource will focus exclusively on eligibility, contribution and reimbursement rules for Health Savings Accounts (HSAs) and Health Reimbursement Arrangements (HRAs), and comment on two provisions of IRS regulations (i.e., the last-month rule and testing period) that HSA holders should be familiar with. It was updated from a 2017 VEHI document to ensure it is consistent with current IRS regulations and, where appropriate, the terms and conditions of the resolution of statewide negotiations conducted by the Commission of Public School Employee Health Benefits (hereafter, "statewide negotiations"), which will be in effect until December 31, 2022.

Please bear in mind that VEHI is not a source of expert guidance on these matters. This is **general guidance only** – you can find IRS regulatory guidance at: https://www.irs.gov/pub/irs-pdf/p969.pdf.

VEHI strongly urges employees with questions or unique circumstances to consult their school district's Third Party Administrator (TPA); or to call or set up appointments at local Social Security offices and the Veterans Administration; or to visit the websites of the IRS and the Centers for Medicare and Medicaid Services for more comprehensive legal and regulatory guidance. A school district's central office human resources personnel (hereafter "human resources personnel") can provide contact information for a TPA.

Health Savings Accounts are addressed on pages 2-10 and **Health Reimbursement Arrangements** on pages 11-12.

Part I: Health Saving Accounts (HSAs)

Under IRS rules, not everyone is eligible to make or receive a financial contribution to an HSA. Please bear in mind:

1. Accepting or making contributions to an HSA when you are not eligible has tax and penalty consequences.

2. If you have an HSA currently, it would be wise to review the guidance here in the event your life circumstances have changed since you first opened an HSA – for example, an adult child is no longer on your benefit plan or remains on your plan but is no longer a tax dependent; you have since enrolled in Medicare Parts A or B; you are now receiving benefits at the Veterans Administration or through TRICARE; you have recently applied for or are receiving Social Security payments, you are living with a domestic partner, etc.

3. If you are uncertain about your eligibility for an HSA, if your life circumstances have changed since you first opened an HSA, or you simply wish to clarify your understanding of HSA eligibility rules, please speak with your school district's **Third Party Administrator**. Your school district's human resources personnel can provide contact information for the TPA if you need it.

An employee is NOT eligible to make or receive a contribution to an HSA from any source if the employee is enrolled in other qualifying health coverage. This includes:

- Medicare (Parts A, B, C or D)
- TRICARE (military health benefits)
- Coverage, primary or secondary, under a spouse's health plan that is not an HSA-qualified plan
- A medical flexible spending account (FSA) – even if the FSA is under a spouse's employer. **Note:** An employee with a Limited Purpose FSA can make or receive HSA contributions.

More detailed information on HSAs can be found on pages 3-10:

Adult Children & Tax Dependent Status

1) HSA Reimbursement for Qualifying Expenses of Adult Children between the Ages of 19-23:

If adult children are enrolled in your VEHI benefit plan and are between the ages of 19-23, you can be reimbursed for their qualifying medical expenses if your adult children meet all the criteria of tax dependency – *age, relationship to the taxpayer, financial support derived from the taxpayer, and full-time student status* – and if they are claimed on your taxes as dependents.

2) HSA Reimbursement for Qualifying Expenses of Adult Children between the Ages of 24-26:

If adult children are enrolled in your VEHI benefit plan and are between the ages of 24-26, they are generally **NOT** eligible to have their medical expenses reimbursed from your HSA, even though they are permitted to be enrolled on a parent's health benefit plan until age 26.

The **only exception** is if an adult child between the ages 24-26 is **permanently or totally disabled**.

NOTE: Adult children who are **not** dependents for tax purposes, but are covered under a parent's benefit plan, are eligible to **open their own HSA**. While on a parent's benefit plan, IRS regulations allow these adult children to contribute up to the annual **family** limits, pre-tax.

Medicare & Social Security

1) How does signing up for Medicare Part A affect an HSA?

Under the tax code, individuals who are enrolled in Medicare **cannot** receive or make contributions to an HSA. Medicare-enrolled individuals can draw on funds already in an HSA to reimburse qualified medical expenses and, after age 65, have greater flexibility in how the funds can be used.

2) Can a Medicare-eligible employee make or receive contributions to an HSA if the employee has applied for either Social Security or Medicare?

No.

3) Can a Medicare-eligible employee who has not yet applied for Medicare or Social Security receive or make contributions to an HSA if still working and enrolled in an employer's CDHP?

Yes. If an employee is eligible for Medicare but **has not filed an application** for either Social Security retirement benefits or Medicare, the employee can contribute to an HSA after age 65 and postpone applying for Social Security and Medicare until no longer working. There is usually no penalty for this delay.

4) What happens if a person has an HSA PRIOR to Medicare-eligibility and then enrolls in Medicare?

The person must **STOP** all future contributions to the HSA and a **pro-rated contribution** must be determined for the year in which Medicare becomes effective.

REMINDER: The IRS determines eligibility for an HSA on a monthly basis. If contributions to an HSA in a given month are greater than 1/12th of the applicable annual limit, a change in eligibility for any reason will likely result in the individual over contributing and needing to remove excess contributions in a timely manner to avoid federal penalties. See IRS rules at https://www.irs.gov/publications/p969/ar02.html#en_US_2017_publink1000204045.

The amount that can be contributed to an HSA depends on the tier of CDHP (Consumer Directed Health Plan) coverage, age, the date an employee becomes an eligible individual, and the date the employee ceases to be an eligible individual. For 2021, an individual with **self-only** coverage can make or receive contributions up to $3,600; an individual with **other than self-coverage** can make or receive contributions up to $7,200. Individuals age 55 and older are eligible for an additional $1,000 catch-up contribution.

For more on Medicare, read "Medicare & You": https://www.medicare.gov/pubs/pdf/10050-Medicare-and-You.pdf or go to www.medicare.gov**.**

5) If an employee signs up for Social Security benefits, must the employee enroll in Medicare Part A?

Yes. In fact, such employees will be automatically enrolled in Medicare Part A.

6) What happens if an employee has applied for, or is already receiving, Social Security benefits and opts out of Medicare Part A?

The only way an employee can opt out of Part A after applying for or receiving Social Security benefits is to **PAY BACK** to the government all the money received in Social Security payments, plus everything Medicare A spent on medical claims if applicable. These amounts must be repaid **BEFORE** an application to withdraw a Medicare Part A application can be processed.

7) If an employee disenrolls in Medicare Part A while drawing Social Security benefits, will the employee stop receiving Social Security checks in the future until re-enrolling in Medicare Part A?

Yes. An employee drawing Social Security benefits who disenrolls from Medicare Part A will not receive any further Social Security checks until the point the person re-enrolls in Medicare Part A.

8) Are there potential tax or penalty consequences for an employee with an HSA who signs-up for Social Security at least six months beyond full retirement age?

There may be. When an employee signs up for Social Security benefits, and is at least six months beyond full retirement age, Social Security will give this person six months of "back pay" in retirement benefits. This means the person's enrollment in **Part A** will also be backdated by six months.

If this “backdating” happens, HSA contributions will have to be PRO-RATED by the employee for the year in which the employee was enrolled in Medicare Part A. For example, if you are greater than 6 months beyond full retirement age and signed up for Social Security benefits on 1/1/21, you will be **retroactively enrolled** in Medicare Part A as of **7/1/20**. Therefore, you are limited to a pro-rated HSA contribution for **2020**.

If HSA contributions are NOT pro-rated, the employee **must remove** any excess contribution amount where applicable. The monies that are withdrawn are **TAXABLE** without penalty. Any excess HSA contributions left in the HSA account would be subject to a **6% PENALTY.** To learn how the HSA **pro-rating formula** is calculated, contact your school district’s Third Party Administrator.

Veterans & HSA Contributions: TRICARE & Other V.A. Medical Benefits

TRICARE is a federal program for military veterans who qualify. A veteran may not qualify for TRICARE but still be eligible for medical services through the **Veterans Administration.** There are implications for contributions to an HSA in both cases.

1) **May an employee on TRICARE make or receive contributions to an HSA?**

   No.

2) **May an employee who is NOT a veteran but has coverage under TRICARE through a spouse make or receive contributions to an HSA?**

   No.

3) **Does receiving V.A. medical benefits if one is NOT on TRICARE affect an employee's ability to make or receive HSA contributions?**

   There is **one instance** where eligibility to contribute to an HSA is impacted.

   An employee not on TRICARE who is eligible for V.A. medical benefits can receive or make contributions to an HSA, provided the employee does **not** receive V.A. services during the preceding three months.

The exceptions to this three-month rule are as follows:

- Using V.A. benefits **only** for dental, vision, or preventive care does **not** restrict an employee's ability to make or receive HSA contributions.

- Receiving medical services at the V.A. for a service-connected disability does **not** restrict a person from making or receiving HSA contributions. The IRS has defined a "service-connected disability" to apply to any person who has a disability rating from the V.A.

However, to be clear, an employee is **prohibited** from making or receiving contributions to an HSA for **three months** if the employee receives any other medical services at the V.A. For more information on veterans and HSAs, contact your school district's Third Party Administrator, consult IRS guidance, or speak with the Veterans Administration.

Domestic Partnerships & Eligibility for HSA Contributions

1) Can an employee use HSA funds to pay for the qualified medical expenses of domestic partners?

(a) Typically, domestic partners are not considered tax dependents by the IRS. Individuals may use their Health Savings Accounts to pay qualified medical expenses only for **tax dependents** (which includes their spouse, themselves, and children who qualify).

(b) If, however, a domestic partner meets the definition of a "**qualifying relative,"** HSA funds can be used to pay for the qualified medical expenses of the domestic partner. To be a "qualifying relative," **four tests** must be satisfied. The most relevant for most employees is the "gross income" test.

More details on these four tests can be found at: https://www.irs.gov/publications/p17/ch03.html. We also recommend you consult with your school district's Third Party Administrator for guidance.

(c) If the domestic partner is not a "qualifying relative," the employee **cannot** use HSA funds to pay for the domestic partner's qualified medical expenses. The domestic partner can still be covered by the employee's HSA-qualified health plan and is eligible to open a personal HSA account and fund the account up to the maximum family contribution.

For more information, click on: https://www.irs.gov/uac/answers-to-frequently-asked-questions-for-registered-domestic-partners-and-individuals-in-civil-unions, or consult with your school district's Third Party Administrator.

Annual Contribution Limits for Spouses with More than One HSA

In 2020, the maximum annual contribution to one or more HSAs for a married couple is $7,100 **combined**. In 2021, the maximum annual contribution to one or more HSAs for a married couple is $7,200. *Annual contribution limits may change annually in conformance with IRS rules.*

For purposes of illustration, if each spouse contributed to an HSA during 2020 and their **combined total** exceeded $7,100, one or both spouses would have to withdraw the excess contribution, plus any earnings on the excess HSA contributions, by their tax due date, generally, in this case, April 15, 2021.

The monies that are withdrawn are **TAXABLE without penalty**. Any excess HSA contributions left in the HSA account, however, would be subject to a **6% PENALTY**.

COBRA & the End of Employment

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

No. An employer has no legal obligation to continue making payments to an HSA after employment ends, even if the individual remains enrolled in the employer health plan under COBRA. The employee still "owns" the HSA, however, and can use money already deposited in the account to cover reimbursements for qualified medical expenses. Please note, in 2021 and 2022, employers are required to deposit the full HSA allocation in January, so the entire funding is available to the employee at the start of each calendar year.

2) What happens to the HSA when an individual leaves employment?

The individual can continue to use their HSA funds for qualified medical expenses and the account will remain open until the individual closes it. **Be aware that the HSA will no longer be associated with the former employer.** The individual may also be responsible for any monthly administrative fee; however, the individual is free to move the HSA to another qualified institution.

If the individual remains enrolled in a qualifying health plan, either through a new employer, a spouse, the former employer's plan via COBRA, or an individually purchased insurance plan on Vermont Health Connect, then the individual will remain eligible to contribute to the HSA.

However, if the individual has **no coverage**, or enrolls in a health plan **not compatible** with an HSA, then the individual will no longer be eligible to contribute to the HSA.

If an individual is no longer eligible to contribute, it should be determined if the individual has already contributed more to the HSA **than allowed in the calendar year** and, therefore, must take action **to avoid a penalty**. Speak to your school district's Third Party Administrator for guidance and direction on this matter.

HSAs & Designated Beneficiaries

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

   Yes. If a spouse is designated as an HSA beneficiary, the unused funds in the HSA will **not** be subject to taxes in the year in which the account owner dies.

   If there is no spouse to designate as a beneficiary, or the account owner fails to designate the spouse as a beneficiary, any unused funds in the HSA will be subject to taxes after the account holder's death.

HSAs: The Last-month Rule & Testing Period

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

Last-month Rule: If you are enrolled in a CDHP no later than December 1 of any given tax year, you may be eligible to contribute the annual maximum amount to your HSA for that entire year. So, if you were enrolled in a CDHP no later than **December 1, 2020**, for example, you could make the annual maximum contribution to your HSA **for all of 2020**. But you must also satisfy a "testing period."

Testing Period: This runs from **December 1** of any given tax year to **December 31** of the following tax year (e.g., December 1, 2020 to December 31, 2021). It is applied to any person who enrolls in a CDHP with an HSA **after** Jan. 1 of any tax year. To avoid taxes and penalties arising from a violation of a testing period, a person making or receiving contributions to an HSA must be enrolled in a CDHP **for the full duration of the testing period**.

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

More information about the last-month rule and testing period is at https://www.irs.gov/pub/irs-pdf/p969.pdf. You should also consult your school district's Third Party Administrator if you have questions.

Below is a hypothetical illustration of the contribution, tax and penalty implications that may be triggered by a violation of the IRS's testing period provisions:

a. An employee is hired in the Fall of 2020 and enrolls in one of the school district's CDHP options and opens an HSA. For this example, the day of enrollment in the CDHP is **November 1, 2020**.

b. The employee in this case would be considered an eligible individual for the purposes of **contributing** the full annual maximum contribution amount to her HSA for all of 2020, because the employee was enrolled in the CDHP no later than **the first day of the last month** of the tax year (**December 1**).

c. The employee and her employer contribute to the employee's HSA each month.

IMPORTANT: For this scenario, we will say that joint HSA contributions **exceed** each month one-twelfth (1/12) of the annual maximum contribution.

d. This employee is subject to a **testing period**, which begins on the first day of the last month of her tax year and ends on the last day of the 12^{th} month following that month – **December 1, 2020 through December 31, 2021.** (This is because the employee was NOT enrolled in a CDHP on January 1, 2020.)

e. The employee retires, resigns or is laid off effective **June 30, 2021**. This comes **before** the expiration of the testing period (**December 31, 2021**).

f. The employee **drops** CDHP health insurance on **July 1, 2021**, and, for this illustration, does NOT take one of the measures listed in the section that follows.

g. Consequently, because the employee did **not** satisfy the testing period and was no longer enrolled in a CDHP as of July 1, 2021, the employee would be subject to taxes and a 10% penalty on any HSA **over-contributions** made **in the last two months of 2020** (November and December) when the employee files tax returns for 2021.

   The employee could also be subject to taxes and penalties in her **2021** tax filing for over-contributions made from **January to June of 2020**, unless the employee took one of the measures below to prevent this.

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

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

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

Taxes and/or the 10% penalty on over-contributions to an HSA can be avoided or minimized if one of the following measures is taken:

a) An employee exercises COBRA rights and remains enrolled in the employer's CDHP through the testing period.

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

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

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

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

   Important: In order to withdraw excess contributions, an employee must complete an **Excessive Contribution Form (ECF)**, which can be secured from an employer's Third Party Administrator.

Part II: Health Reimbursement Arrangements (HRAs)

1. **What makes an employee eligible to be reimbursed from an employer's HRA?**

   An employee must be enrolled in their employer's group health plan to be eligible for HRA reimbursements.

   Note: Each HRA is governed by an employer's Plan document. The terms and conditions of statewide negotiations as they relate to HRAs must be incorporated into each employer's HRA plan document. Employees should check with their human resources personnel, their local union leaders (if their work position is covered by a collective bargaining agreement), or their school district's Third Party Administrator if they have questions regarding the use of HRA funds.

2. **What qualifying medical expenses can be reimbursed with HRA funds under the terms of statewide negotiations?**

   Under the terms and conditions of statewide negotiations, in 2021 and 2022, HRA reimbursable expenses are those related to health care services, medical prescriptions, and products provided by your VEHI benefit plan.

   Please note

3. **Whose qualifying medical expenses can be covered by HRA funds?**

   HRA funds can be used to reimburse qualified medical expenses for an employee and family members who are enrolled as a spouse or dependent in the employee's health plan as outlined in the HRA Plan document. Dependents include adult children up to age 26.

4. **Can an employee be reimbursed from an HRA for an adult child's (up to age 26) qualified medical expenses even if the adult child is NOT a tax dependent?**

   Yes.

5. **Are employees enrolled in Medicare and Social Security eligible to receive reimbursements from an HRA.**

   Yes.

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

Information on Medicare enrollment and coverage is found in the official government handbook "Medicare & You," which you can access at: **https://www.medicare.gov/pubs/pdf/10050-Medicare-and-You.pdf.**

6. **Are employees enrolled in TRICARE eligible to receive reimbursements from an HRA?**

   Yes.

7. **Are employees eligible to receive reimbursements from an HRA if they are covered by a medical FSA (theirs or their spouse's)?**

   Yes.

8. **Are employees eligible to receive reimbursements from an HRA if they have secondary coverage under a spouse's health plan?**

   Yes.

9. **Are the domestic partners of employees eligible to receive reimbursements from an HRA?**

   Yes.

10. **Are there tax consequences if an employee with an HRA dies and not all HRA funds have been used prior to death, or the employee has a spouse who has not been declared a designated beneficiary?**

    No. This is because an HRA is an employer account; money not spent is retained by the employer. It cannot go to an employee's designated beneficiary.

COBRA, Last-month Rule & Testing Period

1. **Is a school district required under law to continue making HRA reimbursements to an employee for qualified medical expenses during any period when the employee is eligible for and exercising COBRA rights?**

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

2. **Are HRAs Subject to Last-month and Testing Period rules?**

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