Health Savings Account Spouses on Medicare

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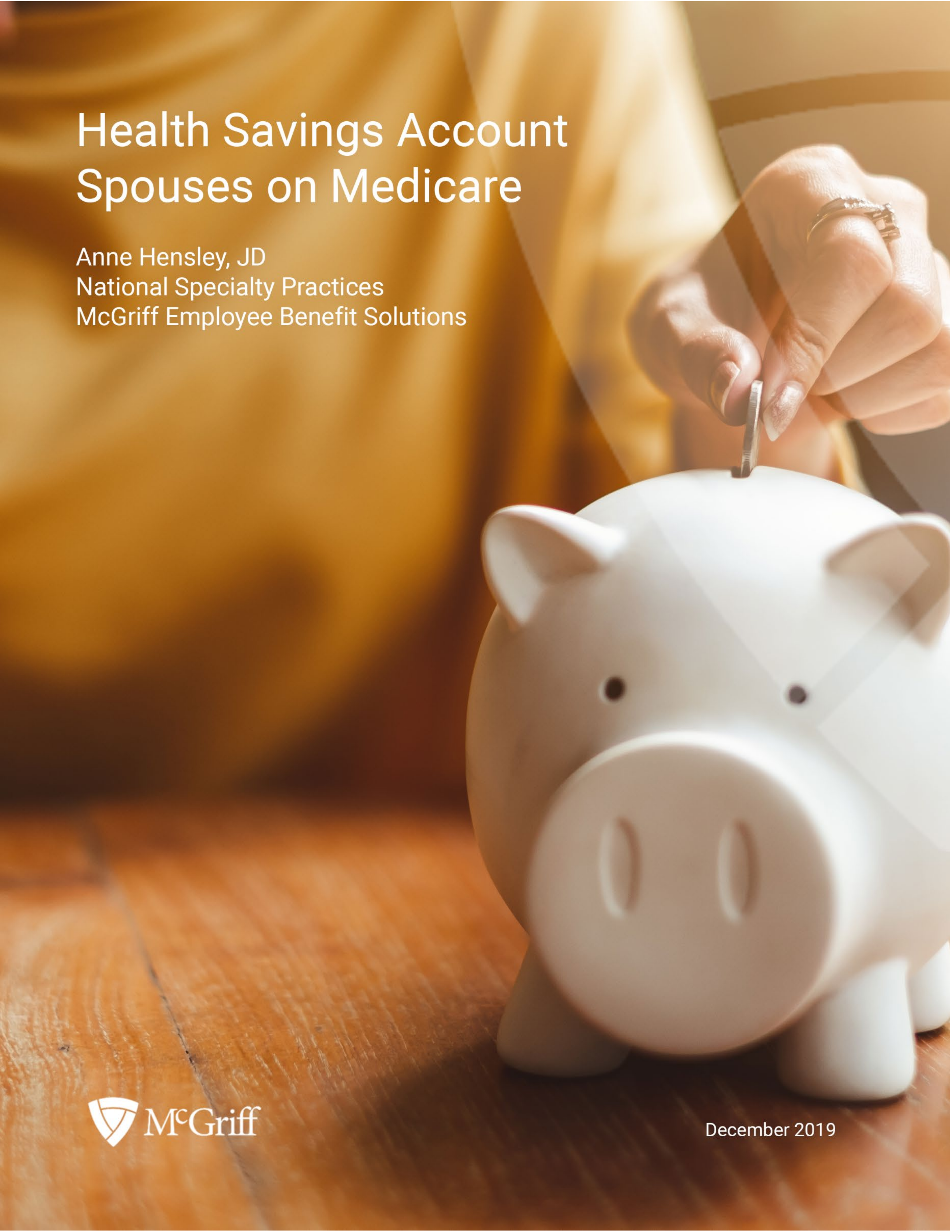

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Question: We have an employee that presently covers his family under a High Deductible Health Plan (HDHP) and is making the maximum family level contribution into an HSA. The employee's spouse will turn 65 next July and will then be covered under Medicare Part A. How does the spouse's Medicare enrollment affect our employee's HSA eligibility and maximum contribution levels?

Summary: We know that in order to be eligible to make or have tax-favored contributions made on his or her behalf to a health savings account (HSA) an individual must be enrolled in a qualified High Deductible Health Plan (HDHP) and no other disqualifying or impermissible coverage.[1] An individual who is entitled to Medicare benefits is not eligible for HSA contributions. In order to be entitled to Medicare, an individual must generally be both eligible and enrolled - eligibility for Medicare alone will not render an individual ineligible for HSA contributions.

While it seems counterintuitive in light of the information above, there is generally no impact on an *employee's* ability to make or have HSA contributions made on his or her behalf if his or her spouse is enrolled in Medicare.

Detail: Generally, to be HSA-eligible, an individual must be covered under an HDHP on the first day of a month, have no other disqualifying coverage (including Medicare) and cannot be claimed as a dependent on another individual's tax return. An individual who is entitled to Medicare benefits is not eligible for HSA contributions. In the Medicare context, entitlement means an individual must be both eligible for and actually enrolled in Medicare coverage. IRS Notices 2004-50 and 2008-59 confirm an individual who is simply eligible for and not actually enrolled in Medicare Part A, Part B, Part D, or any other Medicare benefit may contribute to an HSA until the month he or she actually enrolls in Medicare. An individual becomes entitled to Medicare benefits under Title XVIII of the Social Security Act due to age, disability, or end-stage renal disease (ESRD). Once an individual reaches age 65, he is eligible to enroll in Medicare Part A, and if he enrolls at that time, the enrollment then renders the individual HSA-ineligible. Being HSA-ineligible means that an employee is both unable to make contributions to an HSA and also ineligible to receive employer funds in the HSA. If at age 65 the individual has not yet applied for Social Security retirement benefits, the individual will have to affirmatively file an application for Medicare Part A and/or Part B to enroll in these benefits.[2]

Some individuals wish to delay Medicare enrollment by delaying the receipt of Social Security benefits so as to maintain their HSA eligibility. While this is certainly allowed, penalties may apply with delayed enrollment. Penalties will not apply if the individual qualifies for a special circumstances (special enrollment) period. For example, penalties will not apply if an individual has delayed enrollment because he has health coverage as an active employee through his current employer as long as the individual enrolls during the special enrollment period that would begin after coverage as an active employee ends.

It is important that contributions are made by or on behalf of HSA-eligible individuals but not ineligible individuals. Any contributions made by or on behalf of an individual who ceases to be HSA-eligible are labeled an "excess contribution" and

[1] Internal Revenue Code (Code) §223(c)(1).

[2] Once an individual is enrolled in Social Security, he or she is automatically enrolled in Medicare Part A. The age at which one is eligible for Social Security can vary and is not necessarily age 65 as it is for Medicare eligibility (eligibility unrelated to SS benefits or other illness).

could be subject to a 6% excise tax if not withdrawn in a timely fashion. The manner in which an excess contribution is handled depends on if the HSA contributions were made on a pre or post-tax basis and how the employer and employee handle the excess contribution. Typically, we see three types of contributions to an HSA: Employee pre- tax contributions through a Section 125 (cafeteria) plan, employer pre-tax contributions on behalf of the employee and employee post-tax contributions.

Post-tax: In the post-tax context the employer will usually not be involved in the HSA contribution. The employee makes the contribution and takes an "above the line" deduction for any allowable contribution. If, before filing the employee's tax return for the year, the employee discovers the excess contribution and receives a corrective distribution of the excess contribution and any earnings on the excess then no 6% excise tax will be imposed on the excess contribution (or earnings on the excess). The employee must not claim a deduction for the amount of the withdrawn excess contribution and the earnings on the withdrawn excess contribution must be included as the "Other Income" on the employee's tax return for the year in which he or she withdraws the excess contribution and earnings. [3]

Pre-tax: Pre-tax contributions will be those made by the employee through a Section 125 plan and employer contributions. Assuming the excess contribution is caught before year end, the excess can be included in the employee's income and appropriate withholding for income tax and employment tax purposes can be taken out of the employee's other wages. The excess will then appear on the employee's W-2 as regular wages. To avoid the 6% excise tax the employee should then:

1. Withdraw the excess contribution by the due date for the employee's tax return for the year in which the excess contribution was made.

2. Not claim an exclusion from income for the amount of the withdrawn excess contribution; and

3. Withdraw any earnings on the excess contribution and include the earnings in "Other income" on the employee's tax return for the year the contributions and earnings are withdrawn.

If the excess contribution is not included in the employees W-2 then the excess must be reported as "Other Income" on the employee's tax return for *the year in which the excess contribution was made*. Then, to avoid the 6% excise tax the employee should follow the three steps above with respect to withdrawing the excess contribution and reporting any earnings on the excess contribution. [4]

Effect on HSA Contribution Limits:

As stated above, a spouse or dependent on Medicare or Medicaid will not render an employee ineligible for an HSA, though the Medicare-entitled spouse will of course be HSA-ineligible. As long as the employee is an eligible individual he or she can use the HSA for qualified and medical

[3] Alternatively, an employee can re- characterize the excess contribution as a contribution for the current year, but the total of the prior year's excess contribution plus the current year's contributions must be under the maximum allowable HSA contribution for the current year. The employee can then take the excess contribution he or she was not able to deduct in the prior year and deduct it in the current tax year.

[4] https://www.irs.gov/pub/irs-pdf/i8889.pdf.

expenses for dependents.[5]

Let's take a few examples:

Employee and HSA Owner Maintains Family Level HDHP Coverage after Spouse's Medicare Enrollment: Employee Brian is married to Irene, who turns age 65 April 1, 2020, and will enroll in Medicare at that time. Brian and Irene have a daughter, Allison, who is age 24 and who still requires coverage under Brian's plan. Brian wishes to maintain his family level HDHP coverage to continue covering Irene and Allison. He is allowed to enroll Irene and Allison, maintain the family HDHP coverage after Irene's Medicare enrollment and contribute up to the IRS family maximum ($7,100 in 2020) to an HSA in his name because he has no other disqualifying coverage and remains HSA-eligible. Irene does not need to be an HSA-eligible individual in order for her qualified medical expenses to be reimbursed on a tax-free basis by Brian's HSA. Assuming Brian is age 55 years or older, he will also make an additional catch-up contribution of $1,000 to his HSA.[6]

Employee and HSA Owner Drops to Individual Coverage after Spouse's Medicare Enrollment: Let's change the facts a bit. Brian and Irene have no dependents to cover and as a result Brian wishes to drop from family to individual coverage when Irene enrolls in Medicare on April 1, 2020. If Brian has no other disqualifying coverage and remains HSA-eligible, his contributions for the 2020 are as follows:

($7,100 x 3/12 (3 months of family HDHP coverage)) + ($3,550 x 9/12 (9 months of self-only HDHP coverage)) = $4,437.50. Brian would also be eligible for the additional $1,000 catch-up contribution.

Special Rule for Married Individuals: Under the Code Section 223(b)(5) special rule for married individuals, if either spouse has family HDHP coverage, both spouses are treated as having such family coverage. In other words, if both spouses are HSA- eligible and either has family coverage, the spouses' combined HSA contribution limit is the annual maximum limit for those individual's with family HDHP coverage.
This joint limit is divided between the spouses equally unless the spouses agree upon a different division.[7]

Frequently, if one spouse enrolls in Medicare mid-year, the other spouse will drop to self-only HDHP coverage if there are no other dependents to cover. If one of the spouses loses family HDHP coverage midyear and one spouse continues with self- only HDHP coverage for the rest of the year, their contribution limits will be calculated as follows:

- The spouses combined HSA contributions for those months of the year in which they have family HDHP coverage and are subject to the special rule described above will be the prorated portion of the contribution limit for individuals with family HDHP coverage;
- The spouse who continues under self-only HDHP coverage can continue to make HSA contributions up to the prorated portion of the contribution limit for individuals with self-only HDHP coverage; and
- Each spouse who is 55 or older can contribute a prorated portion of

[5] A qualified medical expense generally is an expenditure for medical care, as defined in Code §213(d), for the account holder and his or her spouse or tax dependents that are not reimbursed by insurance or otherwise.
[6] Under Code §223(b)(3), an individual's annual HSA contribution limit is increased by an additional $1,000 for those HSA-eligible individuals who turn age 55 by the end of the taxable year.

the $1,000 catch-up contribution, based on that spouse's months of HSA eligibility.

Here is an example of spouses losing family HDHP coverage mid-year due to Medicare entitlement:

Spouses Losing Coverage Due to Medicare Entitlement: Maureen and Rick are married with no children. At the beginning of 2020, the year in which both attain age 65, they have family HDHP coverage. On May 1, 2020, Rick enrolls in Medicare and Maureen switches to self-only coverage. Maureen continues her self-only coverage until she enrolls in Medicare on October 1, 2020.

If neither spouse has any other disqualifying coverage, Maureen and Rick will be allowed a combined contribution of $2,366.66 ($7,100 × 4/12) under the Special Rule that can be divided between their HSAs as they agree. Rick will also be allowed a catch-up contribution of $333.33 ($1,000 × 4/12) for the four months in which he was HSA-eligible. Maureen will be able to make an additional HSA contribution of $1,479.16 ($3,550 × 5/12) for her five months of self-only coverage, and a catch-up contribution of $750 ($1,000 × 9/12) for her nine months of HSA eligibility.[8]

Conclusion: In order to make or have contributions made on his or her behalf, the employee in the question above must be HSA-eligible. This means he or she must be covered under an HDHP on the first day of a month, have no other disqualifying coverage (including Medicare) and cannot be claimed as a dependent on another individual's tax return. Although the HSA owner must satisfy the eligibility requirements, his or her spouse does not have to be HSA-eligible in order for the employee to elect family level HDHP coverage and use the HSA funds on the spouse's qualifying medical expenses.

[7] IRS Notice 2008-59, 2008-29 I.R.B. 123, Q/A-18 and IRS Notice 2008-59, 2008-29 I.R.B. 123, Q/A-17.