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An Overview of Health Savings Accounts

Introduction

Introduction

This overview is provided as a high-level orientation on Health Savings Accounts (HSAs) in general. It will help you understand the concept of an HSA, as well as its advantages and administration.

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Background

Background

On January 1, 2004, the IRS began allowing eligible individuals, employers or employees to contribute to Health Savings Accounts (HSAs) to cover qualified medical and retiree health expenses on a tax-advantaged basis. The HSA is an individually-owned account that must be paired with an HSA-compatible high-deductible health plan (HDHP).

HSA Advantages

The HSA is designed to empower consumers by giving them more control over how they save for and manage their health care expenses. The advantages of an HSA can be broken down into two areas - savings benefits and tax benefits:

Savings Benefits

- HSA funds can be used to pay for qualified medical expenses not covered by the HDHP
- Savings can cover your pre-deductible health care costs and other qualified medical expenses
- Money not spent rolls over to following year
- Potential exists to build significant, nest-egg balances after years of tax-advantaged contributions and interest growth

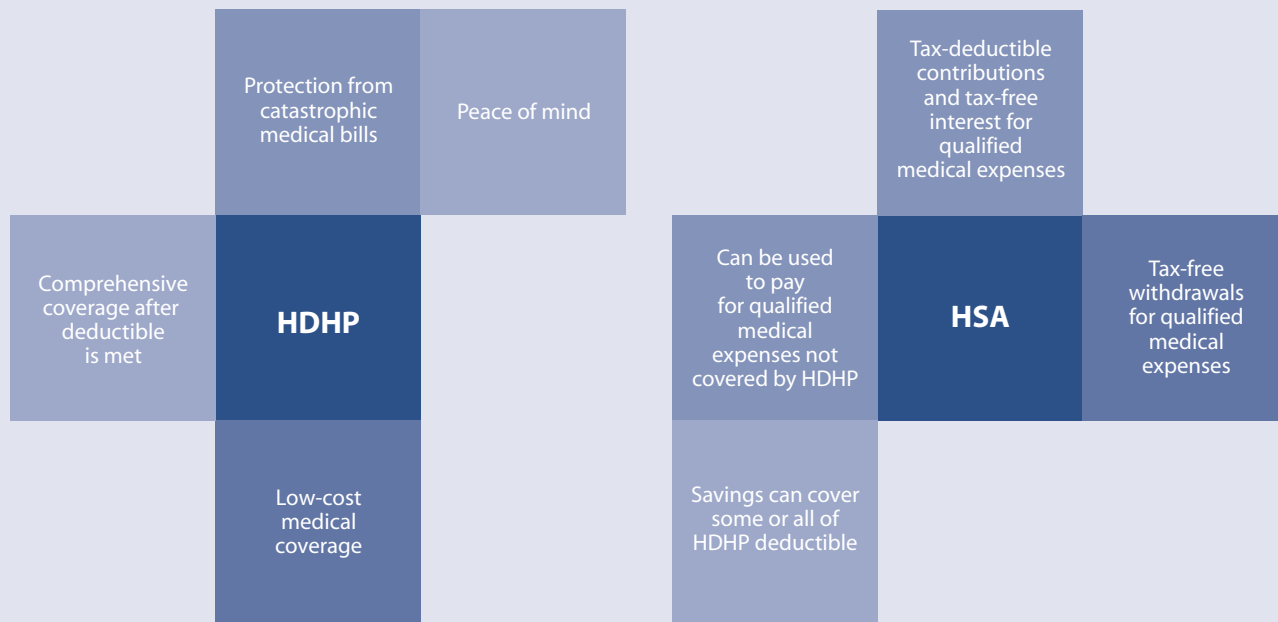
Tax Benefits (subject to IRS Rules)

- Individual/employee HSA contributions are tax-deductible up to the IRS maximum
- Employer contributions are exempt from federal employment taxes
- Interest earned on HSA funds is tax-advantaged
- HSA withdrawals are tax-advantaged for qualified medical expenses

HDHPs and HSAs

How HDHPs and HSAs Work Together

HDHPs and HSAs work hand-in-hand to provide your clients with the medical coverage they need and an account to help them pay for what's not covered. Enrollment in a qualified HDHP is required to establish an HSA.



Tax Savings

What Kind of Tax Savings are Possible with an HSA?

The following scenario illustrates potential federal tax savings for an individual who makes the maximum amount of contributions to a qualified HSA plan in 2004, when income tax is paid at various rates.

Total Yearly HSA Contributions		Tax Rate		Potential Federal Income Tax Savings
\$2,600	X	35%	=	\$910
		33%		\$858
		28%		\$728
		25%		\$650
		15%		\$390

Important: This is just an illustration; Blue Cross does not provide tax advice and urges all individuals to seek guidance from a qualified tax advisor to determine their specific savings potential.

How HSAs Work

Step by Step: How HSAs Work

- 1. Application/Enrollment:** An individual applies for an HSA-compatible HDHP. Or, an employer offers their employees the option of enrolling in an HSA-compatible HDHP. The individual or employee is enrolled in the HDHP.
- 2. Open HSA:** The individual or employee opens an HSA at a qualified bank or financial institution. Blue Cross does not administer the HSA.
- 3. Contributions:** The individual, employer and/or the employee make contributions up to an annual maximum. See question 10 in the Q&A for details. Employee contributions are tax-deductible on their annual return and employer contributions are exempt from federal employment taxes (e.g., income, FICA, FUTA).
- 4. Pay for expenses:** The individual or employee withdraws money from the account to pay for qualified medical expenses, such as plan deductibles and necessary medical services not covered by the plan.
- 5. Unused balances:** At the end of the year, unused HSA funds roll over to the following year. In the event that an employee or individual terminates HDHP coverage, the HSA is theirs to own and take with them. Contributions to the HSA are not permitted when there is no qualified HDHP coverage, but funds can still be withdrawn from the HSA tax-free for qualified expenses.



Questions and Answers

Q1. What is a Health Savings Account (HSA)?

HSAs were created by the Medicare bill signed on December 8, 2003 and are designed to help eligible individuals save for qualified medical and retiree health expenses on a tax-advantaged basis. To establish an HSA, an individual must first enroll in an HSA-compatible high-deductible health plan (HDHP). HSA contributions are tax-deductible and withdrawals are tax-free, provided they are used to pay for current and future "qualified medical expenses."

Q2. What is the new HSA regulation?

Section 1201 of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 added Section 223 to the Internal Revenue Code to permit eligible individuals to establish HSAs for taxable years beginning after December 31, 2003.

Q3. What is an HSA-compatible high-deductible health plan (HDHP)?

Individuals/employees must first be enrolled in an HSA-compatible HDHP before they can set up an HSA. To qualify as an HSA-compatible HDHP, the plan must:

- Have a minimum deductible of \$1,000 and annual out-of-pocket maximum (including deductibles, coinsurance, copayments, but not premiums) not exceeding \$5,000 for individuals
- Have a minimum deductible of \$2,000 and annual out-of-pocket maximum not exceeding \$10,000 for family coverage
- Apply costs for doctor visit and prescription drugs to the annual medical deductible
- Not provide benefits (except for certain preventive care benefits) until the deductible for that year has been met

Q4. Who owns the HSA?

The individual or employee. It is a personal, portable account that remains theirs if they are no longer enrolled in an HDHP. If an employee changes jobs, their HSA can follow them.

Q5. Who administers an HSA?

HSAs are opened and maintained at an HSA-qualified bank or financial institution.

Q6. How does an eligible individual establish an HSA?

1. First, the individual or employee must be enrolled in an HDHP.
2. Then, the individual or employee is responsible for setting up the HSA at a qualified bank or financial institution.
3. Each year, money can be contributed to the HSA, subject to a maximum annual contribution (see question 10). The money in the HSA can be used to pay their deductible and qualified medical expenses. Once the deductible is met, the health plan pays for covered medical expenses.
4. Any money remaining in the HSA at the end of the year rolls over to the next year. Any eligible individual can establish an HSA with a qualified HSA trustee or custodian, in much the same way that individuals establish IRAs with qualified IRA trustees or custodians. No permission or authorization from the IRS is necessary to establish an HSA. Please advise your clients to consult with a tax advisor before opening such an account. Blue Cross does not give tax advice.

Questions and Answers

Q7. Who is eligible for an HSA?

An eligible individual is anyone who:

- Is covered under a high-deductible health plan on the first day of the qualifying month
- Does not have coverage through an additional plan that is not a qualified HDHP
- Is not enrolled in Medicare (generally, has not reached age 65)
- May not be claimed as a dependent on another person's tax return

Individuals are still eligible for an HSA if they have coverage for accidents, disability, dental care, vision care or long-term care, in addition to a qualified HDHP.

Q8. Who may contribute to the HSA?

Any eligible individual, employee or employer may contribute to an HSA. Individual contributions are tax deductible from gross income. Employer contributions are exempt from federal employment taxes (e.g., income, FICA and FUTA).

Q9. How is the HSA funded?

Money is deposited directly into the account. Contributions must be made directly by an employer, employee or individual.

Q10. How much may be contributed to an HSA?

Contribution guidelines vary for singles and families:

- **Singles:** In 2004, the annual contribution maximum for members enrolled in an eligible HDHP for the full 12 months is \$2,600 or the full amount of the HDHP deductible, whichever is less. For members enrolled for less than 12 months, their annual maximum contribution is a prorated portion of their deductible, depending on the number of full months they have been enrolled in the eligible HDHP that year.
- **Families:** In 2004, the annual contribution maximum for members enrolled in an eligible HDHP for the full 12 months is \$5,150 or the full amount of the HDHP deductible, whichever is less. For members enrolled for less than 12 months, their annual maximum contribution is a prorated portion of their deductible, depending on the number of full months they have been enrolled in the eligible HDHP that year.
- Those ages 55-65 can make additional catch-up contributions of \$500 in 2004, increasing \$100 per year until 2009 when it becomes \$1,000.

Q11. Is there a deadline for contributions?

Yes. The deadline for all contributions is April 15 of the year following the year for which the contribution is made. For example, all contributions for the 2004 tax year must be made by April 15, 2005.

Questions and Answers

Q12. Is there any time when HSA contributions are not allowed?

Yes. Contributions to an HSA are prohibited when the individual or employee is not enrolled in a qualified HDHP.

Q13. When is an individual permitted to withdraw funds from an HSA?

Individuals are permitted to withdraw money from an HSA any time after the HSA is established, even if they are not currently enrolled in a qualified HDHP.

Q14. What are "qualified medical expenses" that are eligible for tax-free distribution?

A qualified medical expense is any health care cost as defined in the Internal Revenue Code (IRC Section 213 [d]), but only to the extent the expenses are not covered by insurance. For examples of qualified medical expenses, see Appendix A - Examples of Qualified Medical Expenses. The qualified medical expenses must be incurred only after the HSA has been established. The individual account holder is responsible for determining whether expenditures are for qualified medical expenses.

Q15. Are health insurance premiums qualified expenses?

Generally, no, except in the following instances:

- Qualified long-term care insurance
- COBRA health care continuation coverage
- Health care coverage while an individual is receiving unemployment compensation

Q16. Can HSA funds be used for non-medical expenses?

Non-medical distributions from an HSA are included in gross income and are therefore taxed, as well as subject to a 10 percent tax. Individuals should consult their tax advisors for regulations regarding distributions from HSAs.

Q17. Who will determine whether something is a qualified medical expense?

It is the member's responsibility to ensure that the funds from the account are being used for qualified medical expenses. On annual tax returns or in the event of an audit, it will be the member's responsibility to document and demonstrate the appropriate use of these funds for the IRS. The bank or financial institution administering the HSA will not determine if the funds are being used for qualified medical expenses.

Q18. Are HSAs subject to other statutory rules and provisions?

Yes. HSAs are subject to statutory rules and provisions not addressed in this Q&A. No conclusions should be drawn about issues not expressly addressed here in this overview. Always advise your clients to consult a tax advisor before opening an HSA.

Q19. Can IRA, HRA or FSA funds be rolled into an HSA?

Rollovers from an IRA, a health reimbursement account (HRA) or flexible spending account (FSA) to an HSA are not permitted.

Q.20 Are there any California state tax advantages for HSAs?

No, not at this time.

Questions and Answers

Note: The following Q&As apply to small groups only:

Q21. Does the HSA replace the Archer Medical Savings Account (MSA)?

Yes. For tax years after 12/31/03, the Archer MSA program ends and the HSA program is in effect. MSAs that were set up prior to 12/31/03 can continue.

Q22. Can MSA funds be rolled into an HSA?

Yes. MSAs established on or before 12/31/03 can be either "grandfathered" or rolled into HSAs on a tax-free basis. Contributions made to the MSA during and prior to the 2003 tax year will not count toward the 2004 HSA contribution limits. Rollover contributions need not be in cash. Your clients should consult with their tax advisor for details.

Note: Please see Appendix B for a comparison chart of HSAs, MSAs, FSAs and HRAs.

For more information
regarding HSAs, go to
www.hsainsider.com

Appendices

Appendix A

Examples of Qualified Medical Expenses

- Prescription drugs, including birth control pills
- Doctor visits, lab, X-ray and other diagnostic and treatment services
- Car controls for the physically challenged
- Christian Science practitioner services
- Coinsurance costs for health care, prescription drug and dental plans
- Dental X-ray, fillings, extraction and dentures
- Orthodontia (such as braces)
- Specially installed equipment if primary purpose is health care
- Eyeglasses, contact lenses, and solution
- Guide dog or other animal, including its maintenance
- Hearing aids and batteries
- In-vitro fertilization
- Remedial reading lessons for a child with a severe learning disability
- Laser eye surgery
- Routine physical exams
- Stop-smoking programs
- Special school costs, including tutoring fees and tuition, for physically challenged or mentally impaired
- Transportation to and from health care providers
- Vitamin and mineral supplements that can be obtained only by prescription
- Qualified long-term care services and long-term care insurance
- Medicare Part A and B premiums, Medicare HMO or Medicare Advantage premiums
- Retiree health expenses for those 65 and older
- COBRA premiums and health insurance for those on unemployment compensation

Please note these are examples only and may be subject to change. Please refer to the Qualified Medical Expenses as defined in the Internal Revenue Code (IRC Section 213 [d]).

Appendix B

AAHP-HIAA

Comparison of Tax-Advantaged Health Care Spending Accounts

Feature	Archer Medical Savings Accounts (MSAs) ¹	Health Savings Accounts (HSAs) (as approved in the new Medicare legislation)	Flexible Spending Arrangements (FSAs)	Health Reimbursement Arrangements (HRAs)
Overview	A tax-exempt trust or custodial account with a financial institution in which account holders can save money exclusively for future qualified medical expenses. (Authorized under 26 USC 220.)	A tax-exempt trust or custodial account created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse or dependents.	A type of cafeteria plan authorized under Section 125 of the Internal Revenue Code. ² Separate FSAs can be set up to cover each of the following types of expenses: <ol style="list-style-type: none"> 1. Health insurance premiums (known as a “premium-only plan”); 2. Qualified medical expenses; 3. Dependent care expenses. 	An employer funded account that reimburses employees for qualified medical care expenses, typically combined with a high-deductible health plan.
Who is eligible to set up an account?	An employee (or the spouse of an employee) of a small employer (50 or fewer employees) covered by an individual or family <i>high deductible health plan</i> (HDHP), and a self-employed person (or the spouse of a self-employed person) who maintains an individual or family HDHP.	Individuals and families covered by <i>qualified high-deductible health plan</i> . Individuals and families cannot be covered by any other health plan that covers the same benefits as the high deductible health plan. ³	An employee whose employer offers an FSA option. Employees may also set up a Dependent Care Account for qualifying dependents: A child under 13 claimed as a dependent for income taxes; A spouse incapable of self-care; A child 13 or older, parent, sibling, in-law incapable of self-care and claimed as a dependent for income taxes.	An employee whose employer offers an HRA.

¹ MSAs were authorized as a demonstration program under the Health Insurance Portability and Accountability Act of 1996 (HIPAA). The program – which has been reauthorized in the past – expired at the end of 2003. The House has passed a bill (H.R. 3521) extending the sunset date for Archer MSAs from 2003 to 2004. A companion Senate bill (S. 1896) has not yet been passed.

² Cafeteria plans are plans under which participants may choose among 2 or more benefits consisting of cash and qualified benefits.

³ An outstanding question is whether HRAs or FSAs would be considered another health plan, or acceptable complementary arrangements.

Feature	Archer Medical Savings Accounts (MSAs) ¹	Health Savings Accounts (HSAs) (as approved in the new Medicare legislation)	Flexible Spending Arrangements (FSAs)	Health Reimbursement Arrangements (HRAs)
What are the requirements for the corresponding health plan?	<p><i>High deductible health plan:</i></p> <p>For 2003, self-only deductible must be between \$1,700 and \$2,500, with an out-of-pocket maximum of not more than \$3,350; family deductible must be between \$3,350 and \$5,050, with an out-of-pocket maximum of \$6,150.</p> <p>Plan can provide first-dollar coverage of preventive care and still be qualified.</p>	<p><i>Qualified high-deductible health insurance:</i></p> <p>For 2004, self-only deductible must be at least \$1,000 for self-only coverage; \$2,000 for family coverage.⁴ The maximum of the deductible and annual out-of-pocket expenses required to be paid under the plan (i.e., copayments and coinsurance, not premiums) is \$5,000 for self-only; \$10,000 for family. These limits are indexed to the CPI.</p> <p>Plan can provide first-dollar coverage of preventive care and still be qualified.</p> <p>For PPOs, deductible and out-of-pocket amounts apply only to in-network services.</p>	No health plan requirements.	No health plan requirements.
Who may contribute to the account?	Either the employee or the employer, but an employee and an employer may not both make contributions to the MSA in the same year.	Either the account holder or the employer or both.	The employee, employer, or both. Usually funded by employees, who choose to set aside a certain amount of their pay in an FSA account.	Solely the employer.
What are the limits on contributions?	75% of the amount of the annual health plan deductible for family coverage; 65% of deductible for self-only coverage, subject to an income limit. Contributions cannot exceed the amount earned for the year from one's employer or, if self-employed, net self-employment income.	Up to 100% of the deductible amount of the accompanying high-deductible health insurance policy, up to a maximum in 2004 of \$2,600 for a self-only account, \$5,150 for a family account. Future year limits indexed to the CPI.	No limits under federal income tax law for FSAs set up to pay for qualified medical expenses or health insurance premiums; employers typically set limits. ⁵	No federal income tax law limits. Employers typically set limits, usually equal to or less than the amount of the deductible of employees' health plan.

⁴ The family deductible applies to the entire family as a unit, not to individuals as is more commonly the case in most health insurance policies.

⁵ Limit for Dependent Care Accounts is \$5,000 per family per calendar year for single taxpayers with dependents, or for married taxpayers who file a joint income tax return.

Feature	Archer Medical Savings Accounts (MSAs) ¹	Health Savings Accounts (HSAs) (as approved in the new Medicare legislation)	Flexible Spending Arrangements (FSAs)	Health Reimbursement Arrangements (HRAs)
<i>What are qualified medical expenses?</i>	<p>Unreimbursed qualified medical expenses as defined in Section 213(d) of the Internal Revenue Code, except (in general) for health insurance premiums: e.g., amounts paid for doctors' fees, prescription medicines, and necessary medical services not paid for by insurance (including many over-the-counter medications).</p> <p>MSA funds generally cannot be used to pay health insurance premiums; however, there are certain exceptions. See below ("When can funds be used to pay health insurance premiums?").</p>	Same as Archer MSAs.	Same as Archer MSAs.	Unreimbursed qualified medical expenses as defined in Section 213(d) of the Internal Revenue Code, including health insurance premiums.
<i>When can funds be used to pay health insurance premiums?</i>	<ol style="list-style-type: none"> 1. While receiving unemployment benefits. 2. While receiving COBRA continuation benefits. 	<ol style="list-style-type: none"> 1. While receiving unemployment benefits. 2. While receiving COBRA continuation benefits. 3. When age 65 or over for any health insurance except Medicare supplemental policies. 	<p>A separate FSA ("premium-only plan") can be set up to pay the employee's contribution toward the monthly cost of health insurance. Under a salary reduction agreement, the employee agrees to contribute a portion of salary on a pre-tax basis to pay for qualified benefits.</p>	<p>In general, funds can be used to pay for premiums under:</p> <ol style="list-style-type: none"> 1. the employee's health plan 2. a spouse's health plan 3. the employer's retiree health plan 4. COBRA continuation coverage. <p>However, premiums that may be paid by salary reduction may not be paid from an HRA.</p>
<i>Can funds be used to pay for long-term care coverage?</i>	Yes, premiums for long-term care insurance are reimbursable.	Same as Archer MSAs.	No, the Internal Revenue Service code specifically excludes long term care insurance as a qualified benefit under a cafeteria plan; so long term care insurance premiums are not reimbursable under an FSA.	Same as Archer MSAs.

Feature	Archer Medical Savings Accounts (MSAs) ¹	Health Savings Accounts (HSAs) (as approved in the new Medicare legislation)	Flexible Spending Arrangements (FSAs)	Health Reimbursement Arrangements (HRAs)
<i>Are withdrawals for non-medical expenses allowed?</i>	Yes, but distributions not used exclusively to pay "qualified medical expenses" are included in income and are subject to a 15% additional tax – except when the individual is age 65 or older, disabled, has died during the year.	Same as Archer MSAs, except the additional tax penalty is 10%.	No	No
<i>What is the tax treatment of contributions?</i>	Employee contributions are tax deductible. Employer contributions are excludable from gross income and not subject to employment taxes (e.g., FICA).	Same as Archer MSAs.	Employees pay no federal, Social Security or (in most states) state taxes on FSA contributions. Employers pay no FICA tax or federal or state unemployment taxes on FSA contributions.	Employer contributions are generally excludable from employee's gross income. However, an arrangement that distributes the unused HRA amount at termination either as a death benefit or as a severance payment will not qualify as an HRA. Employers receive expense deductions for payments.
<i>Can funds be carried over from one year to the next?</i>	Yes. MSA funds may be carried over indefinitely during a participant's lifetime. Upon a participant's death, an MSA may be passed on to a surviving spouse without federal tax liability.	Same as Archer MSAs. In addition, unspent funds from an Archer MSA may be rolled over into an HSA.	No. Unused FSA balances are forfeited at the end of the year.	Yes. Unused amounts in an HRA may be carried over, subject to any limits set by the employer.
<i>Are accounts portable?</i>	Yes. Employees may take funds with them when they leave or change jobs.	Same as Archer MSAs.	No. Unused FSA balances are forfeited if the employee leaves or changes jobs.	Yes, but only at discretion of the employer.
<i>Does interest accrue on funds deposited in the account?</i>	Yes. Interest accrues tax free.	Same as Archer MSAs.	No. Interest is not accrued.	There is no requirement that interest accrue but employers have discretion to credit interest to the HRA accounts.



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IMPORTANT: This overview intended for agent use only - not for client presentation. This booklet provides general information only and is not intended to be a substitute for the advice of a qualified tax professional. If your client is considering an HSA, they should consult a qualified tax advisor who can evaluate their particular needs and circumstances.

A high-deductible plan is not an MSA or HSA. An MSA or HSA, which must be established for tax-advantaged treatment, is a separate arrangement between the individual and a bank or other qualified institution. One must be an eligible individual under IRS regulations to receive the MSA or HSA tax benefits. Consultation with a tax advisor is recommended.

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