

Part III. Administrative, Procedural, and Miscellaneous

Medical Savings Accounts

Notice 96-53

The Health Insurance Portability and Accountability Act of 1996 added section 220 to the Internal Revenue Code to permit eligible individuals to establish medical savings accounts (MSAs) under a pilot project beginning on January 1, 1997.

This notice provides certain basic information about MSAs. It does not attempt to summarize all of the specific rules that apply.

The notice is divided into seven parts. Part I of the notice explains what MSAs are and who can have them. Part II describes how MSAs can be established. Parts III and IV cover contributions to MSAs and distributions from MSAs. Part V deals with the statutory limit on the number of taxpayers who can use MSAs. Part VI relates to information reporting by MSA trustees and custodians, and Part VII addresses other matters relating to MSAs.

I. What Are MSAs and Who Can Have Them?

Q-1. What is an MSA?

A-1. An MSA is a tax-exempt trust or custodial account established for the purpose of paying medical expenses in conjunction with a high-deductible health plan. A number of the rules that apply to MSA are similar to rules that apply to individual retirement arrangements (IRAs). For example, like an IRA, an MSA is established for the benefit of an individual, and is "portable". Thus, if the individual is an employee who later changes employers or leaves the work force, the MSA does not stay behind with the former employer, but stays with the individual. However, because MSAs differ from IRAs in some important respects, taxpayers cannot use an IRA as an MSA, and cannot combine an IRA and an MSA in a single account.

Q-2. Who is eligible to have an MSA?

A-2. Two types of individuals are eligible to establish an MSA:

(1) an employee (or spouse of an employee) of a "small employer" that maintains an individual or family "high-deductible health plan" covering that individual (employee or spouse); or

(2) a self-employed person (or the spouse of a self-employed person) main-

taining an individual or family "high-deductible health plan" covering that individual (self-employed person or spouse).

See A-6 and A-7 for additional limitations on who may establish MSAs.

Q-3. What is a "small employer" for MSA purposes?

A-3. An employer is a "small employer" for a calendar year if the employer employed an average of 50 or fewer employees on business days during either of the two preceding calendar years. Special rules apply to new employers, consolidated groups, and certain employers that have added employees. See Internal Revenue Code section 220(c)(4).

Q-4. What is a "high-deductible health plan" that makes someone eligible for an MSA?

A-4. A "high-deductible health plan" is a health plan that: (1) has an annual deductible of at least \$1,500, and not more than \$2,250, for individual (self-only) coverage; or (2) has an annual deductible of at least \$3,000, and not more than \$4,500, for family coverage (coverage of more than one individual). In addition, the annual out-of-pocket expenses under the plan cannot exceed \$3,000 for individual coverage and \$5,500 for family coverage. Out-of-pocket expenses include deductibles, copayments and other amounts the participant must pay for covered benefits, but do not include premiums.

Q-5. Can a health maintenance organization (HMO) offer a high-deductible health plan?

A-5. Yes. A high-deductible health plan may be offered by a variety of entities, including insurance companies and health maintenance organizations (HMOs).

Q-6. What kind of other health coverage makes an individual ineligible for an MSA?

A-6. Except as described in A-7, an individual is ineligible for an MSA if the individual is covered under a health plan (whether as an individual, spouse, or dependent) that is not a high-deductible health plan (including being covered as a beneficiary under Medicare) as well as under a high-deductible health plan.

Q-7. What other kinds of health coverage may an individual maintain without losing eligibility for an MSA?

A-7. An individual remains eligible for an MSA if, in addition to a high-

deductible health plan, the individual has coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, long-term care, insurance for a specified disease or illness, insurance that pays a fixed amount per day (or other period) of hospitalization; or insurance under which substantially all of the coverage provided relates to liabilities from workers' compensation laws, torts, or ownership or use of property (such as automobile insurance).

Q-8. Are MSAs allowed under a cafeteria plan?

A-8. A high-deductible health plan (described in A-4) can be provided as part of a cafeteria plan. Such a high-deductible health plan can be used in conjunction with an MSA. However, the MSA must be established outside the cafeteria plan, because a cafeteria plan is not permitted to provide for contributions to an MSA. Outside of the cafeteria plan context, an employee will not be subject to taxation merely because the employee has a choice between employer contributions to an MSA and other employer-provided accident or health coverage.

II. How Can An MSA Be Established?

Q-9. How does an eligible individual establish an MSA?

A-9. Beginning January 1, 1997, any eligible individual (as described in A-2) can establish an MSA with a qualified MSA trustee or custodian, in much the same way that individuals establish IRAs with qualified IRA trustees or custodians. No permission or authorization from the Internal Revenue Service (IRS) is necessary to establish an MSA.

Q-10. Who is a qualified MSA trustee or custodian?

A-10. Any insurance company or any bank (including a similar financial institution as defined in Internal Revenue Code section 408(n)) can be a MSA trustee or custodian. In addition, any other persons already approved by the IRS to be trustees or custodians of IRAs are automatically approved to be MSA trustees or custodians. Persons other than banks, insurance companies, or previously approved IRA trustees or custodians may request approval to be a trustee or custodian in accordance with the procedures set forth in Treasury Regulation § 1.408-2(e) (relating to IRA nonbank trustees). An eligible indi-

vidual who is an employee may establish a MSA without any involvement of the employer.

Q-11. How does an individual or small employer sign up for or enroll in the MSA pilot project?

A-11. Neither individuals nor small employers “sign up for”, “apply for”, or otherwise “enroll in” the MSA pilot project. Rather, as described in A-9, eligible individuals or small employers can proceed to arrange for the establishment of MSAs with qualified trustees or custodians without awaiting permission or authorization from the IRS. (Sections V and VI, below, give further information on the limits Congress imposed on the number of taxpayers who can contribute to MSAs, and reporting by trustees and custodians.)

III. Contributions to MSAs.

Q-12. Who may contribute to an MSA?

A-12. In the case of an MSA established by an employee or by the spouse of an employee, the account holder (employee or spouse, respectively) may contribute to the MSA. Alternatively, the employee’s employer may contribute to the employee’s or spouse’s MSA. However, if an employer makes a contribution to an MSA for a given year, the account holder of that MSA may not contribute to any MSA for that year. (Additional restrictions apply if an employee’s spouse receives MSA contributions. See Internal Revenue Code section 220(b)(5)(B).)

In the case of an MSA established by a self-employed individual or spouse, the account holder (the self-employed individual or the spouse, respectively) may contribute to the MSA.

Q-13. How much may be contributed to an MSA?

A-13. The maximum annual amount permitted to be contributed to an MSA for a year is (1) for high-deductible individual coverage, 65 percent of the deductible; and (2) for high-deductible family coverage, 75 percent of the deductible. The same annual contribution limit applies whether the contributions are made by an employee, an employer, or a self-employed person. The annual contribution limit 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. Although the annual limitation is calculated using monthly data, the contribution for the year can be

made in one or more payments, at the convenience of the individual or the employer, at any time within the deadline described in A-15.

For example, assume that an individual has self-only coverage under a high-deductible health plan with an annual deductible of \$1,800. The annual contribution limit is 65 percent of \$1,800 (\$1,170), and the monthly contribution limit is \$97.50 (\$1,170/12). Assume further that the individual is an eligible individual for each of the first eight months of the year, but not thereafter. In that case, the contribution limit for the year is \$780 (8 x \$97.50).

Q-14. In what form may contributions be made to an MSA?

A-14. Contributions to an MSA must be made in cash. For example, contributions may not be made in the form of stock or other property.

Q-15. What is the tax treatment of an eligible individual’s MSA contributions?

A-15. Contributions by an eligible individual to an MSA (which are subject to the limits described in A-13) are deductible in computing adjusted gross income. Accordingly, the contributions are deductible whether or not the eligible individual itemizes deductions. The tax deduction for an employee or the employee’s spouse, however, cannot exceed the individual’s compensation attributable to the employer that sponsors the high-deductible plan covering the individual. For a self-employed individual, in addition to the contribution limits described in A-13, the tax deduction cannot exceed the individual’s earned income from the trade or business with respect to which the high-deductible plan is established. In addition, the statute denies a tax deduction to any individual who may be claimed as a dependent on another taxpayer’s return.

Q-16. What is the tax treatment of employer contributions to an eligible individual’s MSA?

A-16. Employer contributions to an eligible individual’s MSA (which are limited as described in A-13) are excludable from gross income, are not subject to withholding for income tax, and are not subject to other employment taxes (i.e., Social Security and Medicare taxes (FICA), federal unemployment tax (FUTA) or railroad retirement tax).

Q-17. What is the tax treatment of earnings on amounts in an MSA?

A-17. Earnings on amounts in an MSA are not taxable prior to distribu-

tion from the MSA. See A-21 regarding the taxation of distributions.

Q-18. When is the deadline for an eligible individual to make contributions to an MSA for any particular year?

A-18. An eligible individual may make MSA contributions for a particular tax year no later than the time prescribed by law (without extensions) for filing the individual’s federal income tax return for that year. As in the case of IRAs, for calendar year taxpayers, generally the deadline for contributions to an MSA is April 15 following the year for which the contributions are made.

Q-19. What happens when MSA contributions exceed the amount that may be deducted or excluded from gross income?

A-19. Contributions by individuals are not deductible to the extent that they exceed the limits in A-13 or A-15 or if they are made by an individual who is not an eligible individual. Contributions by employers are included in gross income to the extent that they exceed the limits in A-13 or if they are made on behalf of an individual who is not an eligible individual. In addition, under the statute an excise tax of six percent for each tax year is imposed on the account holder for these excess individual and employer contributions. If, however, the excess contributions for a tax year and the net income attributable to these excess contributions are paid to the account holder before the last day prescribed by law, including extensions, for filing the account holder’s tax return for the tax year, then (1) the excise tax does not apply; (2) the distribution of the excess contributions is not taxed; and (3) the net income attributable to the excess contributions is included in the account holder’s gross income for the tax year in which the distribution is made.

IV. Distributions From MSAs.

Q-20. When is an individual permitted to receive distributions from an MSA?

A-20. An individual is permitted to receive a distribution from an MSA at any time.

Q-21. How are distributions from an MSA taxed?

A-21. Distributions from an MSA are excludable from gross income if used for medical expenses of the MSA account holder and the account holder’s family, with certain exceptions, and are includable in gross income if used for

any other purpose. Under one such exception, in any year for which an MSA contribution is made, distributions from an MSA of that account holder to pay medical expenses are included in gross income if, for the month in which the expense was incurred, the individual for whom the expense was incurred was not covered under a high-deductible health plan or had coverage that makes a person ineligible for an MSA (see A-4 through A-7). If included in gross income, distributions generally are subject to an additional 15 percent tax. However, if distributions that are included in gross income are made after the account holder turns age 65, becomes disabled or dies, the additional 15 percent tax does not apply.

Q-22. What medical expenses are eligible for tax-free distributions?

A-22. Medical expenses are defined under section 213 of the Code, but do not include expenses for insurance other than long-term care insurance, premiums for "COBRA"-type health care continuation coverage, or premiums for health care coverage while an individual receives unemployment compensation.

Q-23. Must MSA trustees or custodians determine whether MSA distributions are used for medical expenses?

A-23. MSA trustees or custodians are not required to determine whether MSA distributions are used for medical expenses; individuals who have MSAs should make this determination.

V. Cap on Number of Taxpayers Using MSAs.

Q-24. Does the law limit the number of MSAs that can be established?

A-24. Yes. The statute authorizes MSAs as a "pilot project". Under the statute, the pilot project is scheduled to end in the year 2000; however, the ability to establish MSAs generally will end earlier if the number of taxpayers contributing (or receiving employer contributions) to an MSA exceeds certain statutory limits for 1997, 1998 or 1999. In general, in determining whether the limits are exceeded, certain previously uninsured individuals will not be counted.

Q-25. What happens after the pilot project ends?

A-25. After the pilot project ends, all eligible individuals (as described in A-2) who previously made or received MSA contributions (or who are employed by certain employers whose employees previously used MSAs) can

make or receive MSA contributions, if they remain eligible individuals. In addition, individuals can continue to receive distributions from MSAs as described in A-20 through A-22.

Q-26. Do any special deadlines apply if the ability to establish MSAs generally ends early?

A-26. If the statutory limits are reached and therefore the ability to establish MSAs ends early (as referred to in A-24), an eligible individual who is not covered by a high-deductible health plan by a "cut-off date" specified in the law will be unable to establish an MSA, unless the individual's employer established a high-deductible health plan for its employees before that date and meets certain other requirements.

For employees of small employers, the law specifies two potential cut-off dates in 1997: September 1 and October 1. (For self-employed individuals, these dates are October 1, and November 1, 1997, respectively.) For each of 1998 and 1999, the potential cut-off date is October 1 of that year. If the employer's health plan has a regularly scheduled enrollment period that occurs during the period between the potential cut-off date and the end of the relevant year, the potential cut-off date is deferred to December 31 of that year.

Q-27. How will a taxpayer know if the ability to establish MSA generally ends early?

A-27. If the statutory limits are reached and therefore the ability to establish MSAs generally ends early (as described in A-24), the IRS will make an announcement not later than October 1 of the relevant year stating the applicable cut-off date. The ability to establish MSAs will not be cut off before the announcement is made.

VI. Information Reporting by Trustees and Custodians.

Q-28. How will the number of MSAs be determined?

A-28. The statute requires MSA trustees and custodians to report by August 1 of each year (1997, 1998, and 1999) the number of MSAs established before July 1 of the year, and also to report by June 1, 1997, the number of MSAs established before May 1, 1997 (together with additional information). See Internal Revenue Code section 220(j). The IRS will release a form to be used in making these reports.

Q-29. What other information reporting is required?

A-29. Information reporting required for MSAs is similar to information reporting for IRAs. The IRS will release forms and instructions to report MSA contributions, distributions and deductions. For further information, contact the Information Reporting Call Site on (304) 263-8700 (not a toll-free number).

VII. Other Matters.

MSAs are subject to a variety of other statutory rules and provisions, many of which are 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.

Among the statutory provisions not addressed in this notice are:

- * The requirement that employers make comparable MSA contributions for all comparable participating employees.

- * The investment restrictions on MSAs.

- * The rollover rules for MSAs.

- * The special rules that apply upon divorce or death of the account holder.

- * The rules for allocating the deduction for MSA contributions between married people.

- * The Congressionally mandated study as to the effects of MSAs in the small group market on selection (including adverse selection), health costs (including the impact on premiums of individuals with comprehensive coverage), use of preventive care, consumer choice, the scope of coverage of high-deductible plans purchased in conjunction with such accounts, and other issues.

The statutory provisions governing MSAs, including new section 220 of the Internal Code are contained in section 301 of the Health Insurance Portability and Accountability Act of 1996, P. L. No. 104-191, 110 Stat. 1936.

VIII. Comments Invited.

Comments are invited on new section 220 of the Internal Revenue Code. Written comments are requested by March 16, 1997. Send submissions to: CC:DOM:CORP:R (Notice 96-53), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (Notice 96-53), Courier's Desk, Internal Revenue Service, 1111 Constitution Av-

enue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

The principal author of this notice is Felix Zech of the Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations). For further information regarding this notice, call (202) 622-4606 (not a toll-free call).
