Medicare and Health Savings Accounts

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National Specialty Practices

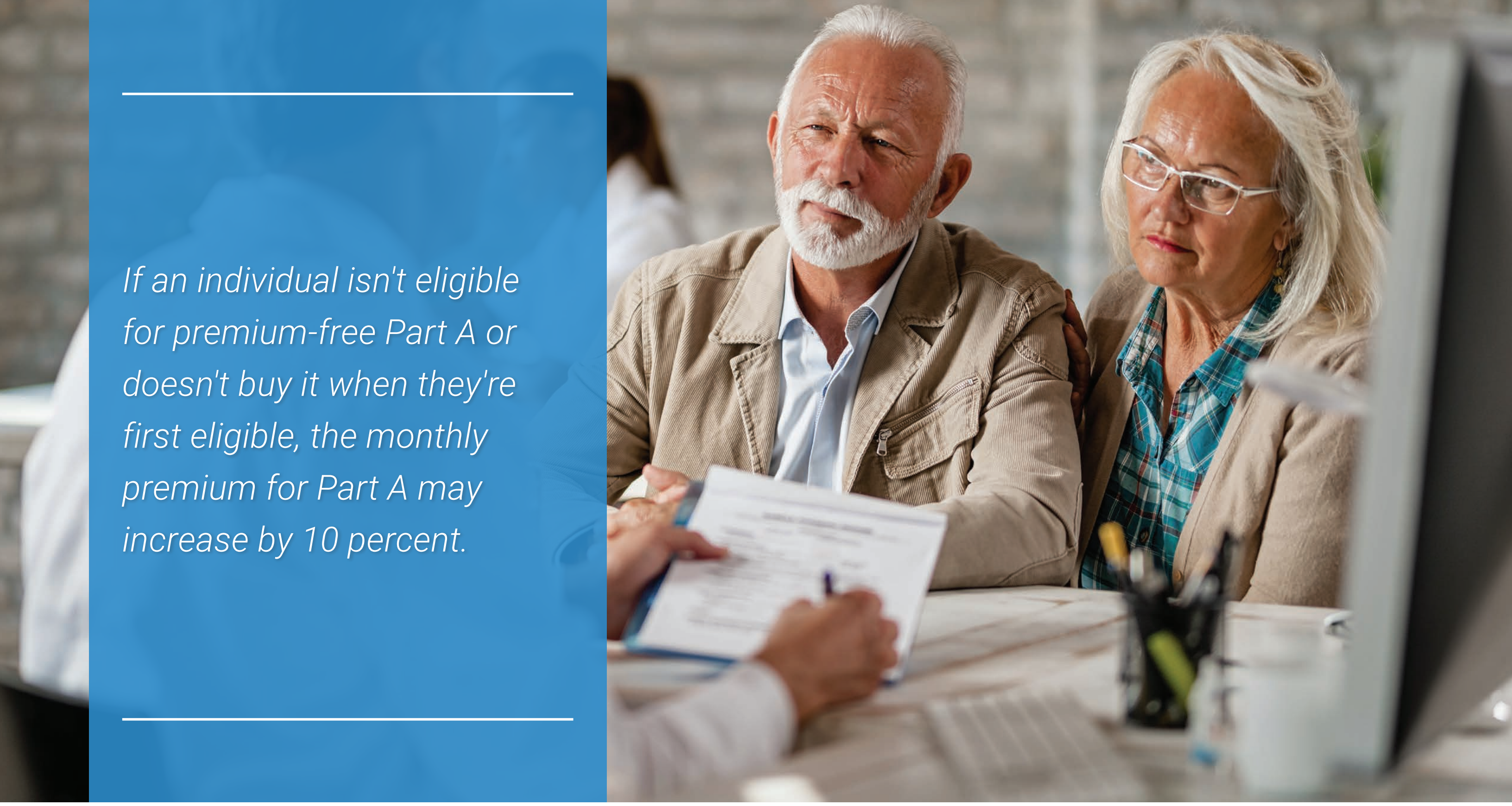
Question: We have an employee who covers his family under a High Deductible Health Plan (HDHP) and is making the maximum family-level contribution into a Health Savings Account (HSA). The employee will turn 65 on September 15, when he will be covered under Medicare Part A. How does his Medicare enrollment affect his HSA eligibility? Can the employee delay his Medicare enrollment? And how does a spouse's Medicare enrollment affect the employee's HSA eligibility and maximum contribution level?

Summary:

In order to be eligible to make or have tax-favored contributions made on their behalf to a Health Savings Account (HSA), an individual must be enrolled in a qualified High Deductible Health Plan (HDHP) and have no other disqualifying or impermissible coverage.[1]

An individual entitled to Medicare benefits is not eligible for HSA contributions. In order to be entitled to Medicare, an individual usually must be both eligible and enrolled. Eligibility for Medicare alone does not render an individual ineligible for HSA contributions. If Medicare enrollment isn't delayed and the employee applies for Medicare coverage when they turn 65, then the Medicare coverage will begin the first day of the month the employee turns 65. HSA contributions must cease before the first day of the month the employee turns 65. If the employee's birthday is on the first of the month, then his HSA contributions will need to cease one month earlier.

Individuals who delay Social Security retirement benefits and Medicare coverage in order to maintain HSA eligibility are covered retroactively to the month they turned 65 or for six months, whichever is less. Thus, the subsequent application for Social Security benefits and the retroactive enrollment in Part A will retroactively make the employee ineligible for HSA contributions.



If an individual isn't eligible for premium-free Part A or doesn't buy it when they're first eligible, the monthly premium for Part A may increase by 10 percent.

Detail:

Generally, to be HSA-eligible, an individual must be covered under an HDHP on the first day of the 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 they enroll in Medicare. In our example, the employee who turns 65 on September 15 can continue to contribute and have contributions made by his employer to his HSA through the month of August. If his birthday had been on September 1, contributions would have to stop by July 31.

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 turns 65, they are automatically eligible to enroll in Medicare Part A, which, as stated above, then renders the individual HSA-ineligible. HSA ineligibility means the employee is unable to make contributions to an HSA and also ineligible to receive employer funds in the HSA. If at age 65 an individual has not yet applied for Social Security retirement benefits, they must 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 his or her 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.

Medicare Part A Penalties

If an individual isn't eligible for premium-free Part A or doesn't buy it when they're first eligible, the monthly premium for Part A may increase by 10 percent. The individual in our example will have to pay the higher premium for twice the number of years he could have had Part A but did not enroll, unless he meets certain conditions allowing him to sign up for Part A during a special enrollment period.

Medicare Part B Penalties

If an individual doesn't enroll in Part B when they're first eligible, they will have to pay a late enrollment penalty for as long as they have Part B. The monthly premium for Part B may increase by 10 percent for each full 12-month period the individual could have had Part B but didn't enroll in this coverage. The man in our example may have to wait until the general enrollment period, January 1 to March 31, to enroll in Part B, and coverage will start July 1 of that year. If he meets certain conditions for a special enrollment period, he won't have to pay a late-enrollment penalty.

Retroactive Enrollment in Part A

While the delayed enrollment penalties are relatively well known, there is a lesser known issue of the retroactive effective date for Medicare Part A, which will invalidate HSA eligibility. Medicare Part A coverage normally begins the month an individual turns 65, as long as they file an application for Medicare Part A or for Social Security or Railroad Retirement Board Benefits within six months of turning 65. If this process is delayed, once an individual does apply for Social Security retirement benefits, they will be retroactively enrolled in Medicare Part A for the preceding six months, which will also render them ineligible for contributing to or receiving employer contributions to the HSA during those preceding six months.

Individuals who delay Medicare Part A benefits should pay extra attention when determining the amount of their contributions. The limit on annual HSA contributions is reduced by 1/12 for each month during the year the HSA account holder is not HSA-eligible (for example, due to Medicare entitlement), and those reductions apply on an equal basis to months in which the individual is HSA-ineligible due to retroactive Medicare coverage.

Example: Mary applies for Medicare in July 2022 and becomes entitled to Medicare Part A. The coverage will be retroactive to January 1, 2022. Mary will not be able to make HSA contributions for the year. If contributions were already made, they would need to be distributed in a timely manner (by the due date of her tax return for the year the contributions were made) to avoid the excise tax on excess contributions.

If Mary applied later in the year, in October, for example,, the Medicare Part A coverage would be retroactive to April of the same year, and HSA contributions would need to be limited to 3/12 of the annual limit (assuming Mary was otherwise HSA-eligible January through March).

Age 65/Medicare and HSA Distributions

Once a person reaches age 65, they may take penalty-free distributions from an HSA; however, ordinary income taxes still apply on any funds distributed from the HSA that are not used for qualified medical expenses. Account holders may continue to use their HSAs for qualified medical expenses and for other expenses for as long as funds are available in the HSA. Once an individual has elected Medicare Part B and Part D, they can use the HSA funds to pay for the Medicare premiums, however those funds may not be used for supplemental or Medigap policy premiums.

Contribution Limits:

With that background, let’s return to our employee who along with his family is covered under the HDHP for 2022. The employee turns 65 on September 15, 2022, and is not planning on delaying Medicare enrollment. Because the employee is age 55 or older, he can increase his general HSA annual contribution limit by an additional $1,000. Keep in mind that, as with the general HSA contribution limit, the additional HSA catch-up contribution limit is determined on a monthly basis under the general monthly contribution rule.

The formula used to determine how much the employee can contribute, including a catch-up contribution, is as follows:

> *The 2022 maximum HSA contribution for family coverage x (number of months the employee was HSA-eligible/12)) + ($1,000 catch-up contribution x (number of months the employee was HSA-eligible/12))*

So for 2022, our employee could contribute the following:
($7,300 x 8/12)) + ($1,000 x (8/12)) = $5,533.35.

Contributions must be made by or on behalf of an HSA-eligible individual. Any contributions made by or on behalf of an individual who is not HSA-eligible are labeled “excess contributions," which are subject to excise taxes. If excess contributions for a taxable year and the associated net income are distributed to the account holder before their federal income tax return filing deadline (including extensions) for that taxable year, then the net income attributable to the excess contributions is included in the account holder's gross income for the taxable year in which the distribution is received. The 6% excise tax is not imposed on the excess contributions and the distribution of the excess contributions is not taxed. Although the distribution of the excess contribution is not taxed, the excess contribution must be included in the taxpayer's gross income.

Let’s take an example which illustrates excess contributions resulting from the loss of HSA eligibility:

Example: Under his employer's HSA program, Ken elects self-only HDHP coverage (effective January 1, 2022). His maximum HSA contribution for 2022 is $3,650, or $304.17 per month ($3,650/12). Ken contributes pre-tax $150 per month to his HSA which is matched by his employer. On September 30, 2022, John notifies his employer that he became covered by his wife's non-HDHP coverage on July 1, 2022 (during open enrollment under her employer's plan). Because of his enrollment in non-HDHP coverage, Ken’s employer contributed too much to his HSA. The combined contributions of $2,700 for 9 months (9 × ($150 + $150)) exceeded the $1,825 limit for Ken’s six months of HSA eligibility ($3,650 × 6/12) by $875 ($2,700 – $1,825).

Ken should immediately stop contributing to his HSA for the remainder of the year, but there are actions that both he and his employer should take to minimize adverse tax consequences.

Employer HSA contributions are not subject to withholding from wages for income tax or subject to FICA, FUTA, or Railroad Retirement Tax Act (RRTA) taxes if, at the time the employer makes the contribution, it reasonably believes the employee will be able to exclude the payment from the employee's income under Code §106(d). In other words, if an employer contributes to an employee's HSA in the mistaken but reasonable belief that the employee is an eligible individual, the employer won’t have to take any corrective action later with respect to these payroll taxes if the employer discovers the individual was not eligible for HSA contributions.

If the employer has become aware of the excess contribution before the end of the taxable year, it would be possible to include the $875 in Ken’s 2022 wages for income and employment tax purposes. While employers are not able to recoup any contributions from an HSA once they have been contributed, the employer can withhold excess employer contributions from future wages. If the employer does not include the $875 in Ken's 2022 wages on Form W-2, he should report this amount as “other income” on his federal income tax return.

Once a person reaches age 65, they may take penalty-free distributions from an HSA; however, ordinary income taxes still apply on any funds distributed from the HSA that are not used for qualified medical expenses.

Ken must notify the HSA trustee/custodian of the $875 excess contribution and request a distribution of the excess amount and any (taxable) earnings. The distribution will be reported on Form 1099-SA, coded as an excess contribution.

Spouse's Medicare Enrollment: Now let's assume the employee is HSA-eligible but the employee's spouse is enrolled in Medicare. Of course, the Medicare-entitled spouse is HSA-ineligible. 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 their behalf if their spouse is enrolled in Medicare. In addition, HSA-account owners can always use the HSA for qualified dependent medical expenses, including Medicare-entitled spouses.[3]

Let's look at a few examples:

Employee and HSA Owner Maintains Family Level HDHP Coverage after Spouse's Medicare Enrollment: Employee Brian is married to Irene. Irene turns 65 on April 1, 2022, and will enroll in Medicare at that time. Brian and Irene have a daughter, Allison, who is 24 and 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 them, maintain the family HDHP coverage after Irene's Medicare enrollment, and contribute up to the IRS family maximum ($7,300 in 2022) to an HSA in his name because he has no other disqualifying coverage and remains HSA-eligible. Irene does not have to be HSA-eligible in order for her qualified medical expenses to be reimbursed on a tax-free basis by Brian's HSA. Assuming Brian is 55 or older, he will also make an additional catch-up contribution of $1,000 to his HSA.[4]

Employee and HSA Owner Drops to Individual Coverage after Spouse's Medicare Enrollment: Let's change the scenario a bit. Let's say 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, 2022. If Brian has no other disqualifying coverage and remains HSA-eligible, his contributions for 2022 are as follows: ($7,300 x 3/12 (3 months of family HDHP coverage)) + ($3,650 x 9/12 (9 months of self-only HDHP coverage)) = $4,562.50. 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 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 individuals with family HDHP coverage. This joint limit is divided between the spouses equally unless the spouses agree upon a different division.[5]

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 mid-year 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 the $1,000 catch-up contributions, 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: Maureen and Rick are married with no children. At the beginning of 2022, the year in which both turn 65, they have family HDHP coverage. On May 1, 2022, 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, 2022.

If neither spouse has any other disqualifying coverage, Maureen and Rick will be allowed a combined contribution of $2,409 ($7,300 x 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 x 4/12) for the four months in which he was HSA- eligible. Maureen will be able to make an additional HSA contribution of $1,520.83 ($3,650 x 5/12) for her five months of self-only coverage, and a catch-up contribution of $750 ($1,000 x 9/12) for her nine months of HSA eligibility.[6]

Conclusion:

In order to make or have contributions made on their behalf, an individual must be HSA-eligible. This means they 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, their spouse does not have to be HSA-eligible in order for the employee to elect family HDHP coverage and use the HSA funds on the spouse's qualifying medical expenses.

When an individual has an HSA and is nearing age 65, careful planning is required to avoid mistakes and penalties that can arise if the HSA rules and interplay with Medicare entitlement are not considered in advance. With proper planning, the individual can maximize their HSA contributions and avoid penalties.

References

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).

3 - 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.

4 - 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.

5 - 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.

6 - IRS Information Letter 2016-0003 (Mar. 25, 2016). This example uses the limit for 2022.

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