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Briefing

Medicare Modernization Act To Provide New Tax-Exempt Health Savings Accounts

December 2003

The topic in Brief:

- **Medicare Modernization Act signed into law December 8, 2003**
- **Provides a prescription drug benefit to Medicare beneficiaries by 2006**
- **Creates new Health Savings Accounts (HSAs) allowing for tax-exempt savings toward future health care expenses starting in 2004**
- **Act confirms no 1099 reporting required for FSA or HRA debit card reimbursements**
- **Provides for reimportation of prescription drugs from Canada only, but will not be implemented until safety and quality protections can be ensured**
- **Detailed regulations on implementation and administration will have to be issued by Treasury Department**

The Medicare Prescription Drug, Improvement, and Modernization Act (H.R. 1, Public Law 108-173) was signed into law on December 8. This is a long-awaited compromise measure to give Medicare recipients access to a prescription drug benefit beginning in 2006. The extensive new law also created new provisions for a tax-exempt Health Savings Account (HSA) to help individuals save and pay for future qualified medical expenses. The Act also amended Section 125 to allow tax-free contributions to HSAs through a cafeteria plan.

Medicare Prescription Drug Benefit

Under the new Medicare benefits, Medicare beneficiaries would have prescription drug discount cards available to them beginning in April 2004. However, the standard prescription benefit in the Medicare plan would not begin until 2006. The provisions of the Standard Benefit (to be known as Medicare Part D) will include:

- $250 annual deductible
- 75% benefit to a maximum of $2,250
- Catastrophic coverage for out-of-pocket costs over $3,600 annually, with copayments tied to income
- Participant premiums for the optional drug coverage, graded according to income, will average $35 per month

Medicare will guarantee access to at least two qualifying prescription drug alternatives in each region of the country, either a prescription drug plan for fee-for-service enrollees, or an integrated plan through a managed care Medicare plan. In areas where there is no integrated plan available, two standalone prescription drug plans will be available to Medicare beneficiaries.

To encourage current employer plan sponsors that provide retiree prescription drug coverage to continue those plans, the Act provides a tax subsidy equal to 28% of qualifying retirees' prescription drug expenses. The subsidy is paid to plan sponsors on drug costs exceeding $250, up to a maximum of $5,000, with these amounts being adjusted annually based on increases in Medicare per capita prescription drug costs.

Health Savings Accounts (HSAs)

The law adds a new type of tax-exempt savings vehicle under the Internal Revenue Code called a Health Savings Account, or HSA. Beginning January 1, 2004, HSAs will be available to individuals who are covered by a "qualified health plan" of a type also known as a "high deductible health plan". Specific provisions available under HSAs include:

- For self-only policies, a qualified health plan must have a minimum deductible of $1,000 with a $5,000 cap on out-of-pocket expenses (indexed annually).
- For family policies, a qualified health plan must have a minimum deductible of $2,000 with a $10,000 cap on out-of-pocket expenses (indexed annually).
- Preventive care services, as well as coverage for accidents, disability, dental care, vision care, and long-term care are not subject to the deductible.
- For 2004, the maximum annual contribution is $2,600 for self-only policies and $5,150 for family policies (indexed annually).
- Individuals age 55 – 65 may make additional "catch-up" contributions of up to $500 in 2004, increasing to $1,000 annually in 2009 and thereafter. A married couple can make two catch-up contributions as long as both spouses are at least 55.
- Contributions may be made by individuals, family members and employers and are tax deductible, even if the account beneficiary does not itemize. Employer contributions are made on a pre-tax basis and are not taxable to the employee. Employers will be allowed to offer HSAs through a cafeteria plan.
- Investment earnings accrue tax-free.
- HSA distributions are tax-free if they are used to pay for qualified medical expenses. Qualified expenses include prescription drugs, qualified long-term care services and long-term care insurance, COBRA coverage, Medicare expenses (but not Medigap), and retiree health expenses for individuals age 65 and older.
- Distributions made for any other purpose are subject to income tax and a 10% penalty. The 10% penalty is waived in the case of death or disability. The 10% penalty is also waived for distributions made by individuals age 65 and older.
- Upon death, HSA ownership may transfer to the spouse on a tax-free basis.

Employers may make contributions to employee HSAs up to the prescribed limits, but they must make comparable contributions to all comparable participating employees during the calendar year. Discriminatory contributions will incur an excise tax against the employer. Employers must also report HSA contributions on employees' W-2s, but employees won't be subject to income tax, FICA, FUTA or withholding on the contribution amounts. The Treasury Department will need to issue regulations for specific guidance on the new HSA provisions, and has announced that guidance will be released "shortly."

Other Provisions of the Medicare Modernization Act

The new Act includes clarification, for Flexible Spending Accounts (FSA) under IRC Section 125 and Health Reimbursement Accounts (HRA) under IRC Section 106, that reimbursement amounts paid to providers using debit, credit, or stored value cards are ***not*** subject to Form 1099 reporting. This administrative relief applies to any payment for medical care, during 2003 or later, reimbursed through FSAs or HRAs and not covered by other forms of insurance.

Finally, H.R. 1 also permits reimportation of prescription drugs from Canada only. This provision will only become effective if the necessary safeguards to product safety, quality and effectiveness can be ensured by the Secretary of Health & Human Services. Previously passed prescription drug reimportation laws have not been implemented by the office of the Secretary because they could not give those assurances. While the U.S. and Canadian authorities have entered discussions to facilitate and coordinate prescription drug

regulation, it is expected to be months or years before the issue can be resolved and Canadian prescription products can be purchased legally in the U.S.