

MEMORANDUM

Date: June 10, 2011
To: Employees who have enrolled children between age 19 to 26
From: Rosemary Harless, Employee Benefits Coordinator
Subject: **Health Care Reform – Impact on Health Savings Accounts**

The purpose of this memo is to specify the different guidelines as it relates to newly eligible over age dependents. Prior to January 1, 2011, City of Modesto group health insurance plans covered children up to age 19, and children age 19 to 25 if child met the following criteria: unmarried, enrolled in school full time, and receives one half of finance support from you. As a result of the Health Care Reform legislation, effective January 1, 2011 your group health insurance plans now covers dependent children to age 26 regardless of student status, residence, financial support, or marital status.

The Health Savings Account itself – not a group health plan – has different guidelines as it relates to these newly eligible over age dependents. These dependent children in question who are now eligible for coverage under the health plan may not be considered tax dependents for HSA distributions (see “Who Are Your Tax Dependents” on the following page for additional information). To be tax favored, an HSA distribution must be for a qualifying medical expense of the employee, the employee's spouse, or the employee's tax dependent.

What do you need to do?

First, you need to determine whether your dependents under your plan are considered a “tax” dependent. Please refer to page 2 of this letter or consult your legal or tax advisor to make the determination.

If YES, then you are eligible to use your HSA for qualified medical expenses for that dependent and no further action is necessary.

If NO, then you are not eligible to use your HSA for qualified medical expenses for that dependent.

What if I have already used HSA money for my ineligible dependent?

If an employee mistakenly took a taxable HSA distribution they thought was a qualified distribution, it does not automatically mean that the distribution would be taxable or that the employee has to report it. If you have no other qualified expenses to offset the taxable distribution you took out for the ineligible dependent, you could return the amount of the distribution to the HSA. This can be done where there is clear evidence the distribution was due to a mistake of fact due to reasonable cause. An example in the regulations to illustrate this point involves an employee who reasonably, but mistakenly, took a distribution for an expense he thought was a qualified expense. The amount must be returned to the account no later than April 15th following the year in which the account holder knew or should have known the distribution was a mistake. An employee seeking to replace mistaken distributions would use the deposit form from First Horizons located on their website: www.firsthorizonsaver.com/files/FHMail-InDepositForm.pdf. For further clarification, please call First Horizon customer service at (866) 889-8583.

If an employee takes an HSA distribution that is not for a qualified medical expense (which is permitted), then the consequence is that the amount of that distribution is taxable (i.e., it should be included in gross income) and is subject to an additional 20% excise tax. Both of these steps would be the obligation of the account holder to report the distribution accordingly.

QUALIFIED (TAX-FREE) WITHDRAWALS

HSA withdrawals are tax-free if they are for “qualified medical expenses” of you, your spouse, or your tax dependents that are incurred any time after your HSA is established. Generally, your HSA is “established” the day you first make or receive an HSA contribution to the account.

What is a Qualified Medical Expense?

Medical expenses can include expenses for: medical, prescribed drugs (both prescription and over-the-counter), dental, vision, hearing, qualified long term care expenses [IRC 7702B(c)], and other health care expenses that are tax deductible and not reimbursed under another plan (e.g., a medical plan). To be tax deductible, the expense must be for the diagnosis, cure, mitigation, treatment or prevention of a disease.

Who Are Your Tax Dependents?

For purposes of an HSA, the term “tax dependent” means—

1. your qualifying child

The term “qualifying child” means an individual who meets all the following criteria:

- A. is your child or a descendant of your child, brother, sister, stepbrother, or stepsister, or a descendant of any such relative,
- B. has the same principal place of abode as you for more than one-half of the year,
- C. is a citizen or national of the United States or is a resident of the United States, Mexico or Canada,
- D. (is under 19 as of the end calendar year or is a student who is under 24 as of end of the year, and
- E. has not provided over one-half of their own support for the calendar year.

[Note: special rules apply for adopted children, children that are permanently and totally disabled, and children of divorced parents – see your tax advisor for more information]

NONQUALIFIED (TAXABLE) WITHDRAWALS

Any withdrawal of funds from an HSA that is not used for a qualified medical expense is a nonqualified withdrawal. A few examples of nonqualified withdrawals include:

- A. payment for health care expenses that are not deductible (e.g., cosmetic treatments),
- B. payment of health care expenses for a non-tax dependent (e.g. a domestic partner who is not a tax dependent),

Nonqualified withdrawals must be included in your taxable income. In addition, a 20% tax penalty applies to most nonqualified withdrawals. There are three exceptions to the 20% penalty rule:

1. The withdrawal is made after you have reached age 65.
2. You become disabled as defined in Internal Revenue Code Section 72(m) (7).
3. You die (the HSA ceases to be an HSA and becomes taxable as income to the beneficiary - separate rules apply to a surviving spouse).

The intent of this information is to provide you with general information regarding your coverage. It is not intended to provide, nor should it be construed as, legal or tax advice. Questions regarding specific tax issues should be directed to your tax advisor or an attorney who specializes in this practice area.