



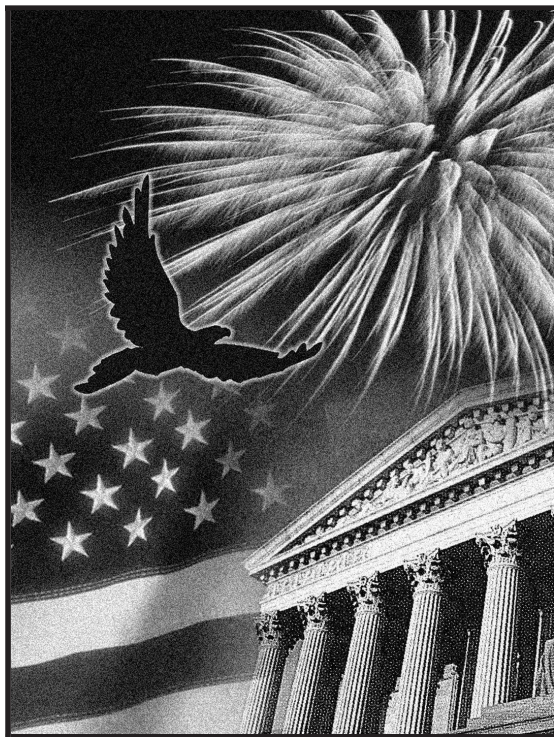
Department of the Treasury  
Internal Revenue Service

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# Health Savings Accounts and Other Tax-Favored Health Plans

For use in preparing  
**2007** Returns



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## What's New

The following new rules apply for 2007.

- Your contributions to your HSA are no longer limited to your annual health plan deductible.
- If you are an eligible individual on the first day of the last month of your tax year, you are treated as being an eligible individual for the entire tax year for purposes of figuring the amount you can contribute to your HSA.
- If you are not a highly compensated employee, your employer does not have to take into account a highly compensated employee in determining who is a comparable participating employee for making contributions to HSAs.
- You may be able to exclude from your gross income a one-time qualified HSA funding distribution from your individual retirement account.
- You may be able to request your employer make a one-time transfer of the balance in your health FSA or HRA to your HSA.
- Medicare Advantage MSAs have been approved by the Medicare Program.
- **Form 8889, Part III.** In Part III of Form 8889, Health Savings Accounts (HSAs), you figure the 10% additional tax that is due to your failure to remain an eligible individual during the testing periods discussed under *Health Savings Accounts (HSAs)*. Form 8889 instructs you to report this tax on Form 1040, line 44, or on Form 1040NR, line 41, using checkbox "c." However, due to late tax law changes, the tax must instead be included on Form 1040, line 63, or on Form 1040NR, line 58, as an additional write-in tax. On the dotted line next to Form 1040, line 63, or Form 1040NR, line 58, enter "HDHP" and the amount of this tax.

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## Reminder

**Photographs of missing children.** The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-5678) if you recognize a child.

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## Introduction

Various programs are designed to give individuals tax advantages to offset health care costs. This publication explains the following programs.

- Health savings accounts (HSAs).
- Medical savings accounts (Archer MSAs and Medicare Advantage MSAs).
- Health flexible spending arrangements (FSAs).
- Health reimbursement arrangements (HRAs).

An HSA may receive contributions from an eligible individual or any other person, including an employer or a family member, on behalf of an eligible individual. Contributions, other than employer contributions, are deductible on the eligible individual's return whether or not the individual itemizes deductions. Employer contributions are not included in income. Distributions from an HSA that are used to pay qualified medical expenses are not taxed.

An Archer MSA may receive contributions from an eligible individual and his or her employer, but not both in the same year. Contributions by the individual are deductible whether or not the individual itemizes deductions. Employer contributions are not included in income. Distributions from an Archer MSA that are used to pay qualified medical expenses are not taxed.

A Medicare Advantage MSA is an Archer MSA designated by Medicare to be used solely to pay the qualified medical expenses of the account holder who is enrolled in Medicare. Contributions can only be made by Medicare. The contributions are not included in your income. Distributions from a Medicare Advantage MSA that are used to pay qualified medical expenses are not taxed.

A health FSA may receive contributions from an eligible individual. Employers may also contribute. Contributions are not includible in income. Reimbursements from an FSA that are used to pay qualified medical expenses are not taxed.

An HRA must receive contributions from the employer only. Employees may not contribute. Contributions are not includible in income. Reimbursements from an HRA that are used to pay qualified medical expenses are not taxed.

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## Health Savings Accounts (HSAs)

A health savings account (HSA) is a tax-exempt trust or custodial account that you set up with a qualified HSA trustee to pay or reimburse certain medical expenses you incur. You must be an eligible individual to qualify for an HSA.

No permission or authorization from the IRS is necessary to establish an HSA. When you set up an HSA, you will need to work with a trustee. A qualified HSA trustee can be a bank, an insurance company, or anyone already approved by the IRS to be a trustee of individual retirement arrangements (IRAs) or Archer MSAs. The HSA can be established through a trustee that is different from your health plan provider.

Your employer may already have some information on HSA trustees in your area.



*If you have an Archer MSA, you can generally roll it over into an HSA tax free. See Rollovers, later.*

**What are the benefits of an HSA?** You may enjoy several benefits from having an HSA.

- You can claim a tax deduction for contributions you, or someone other than your employer, make to your

HSA even if you do not itemize your deductions on Form 1040.

- Contributions to your HSA made by your employer (including contributions made through a cafeteria plan) may be excluded from your gross income.
- The contributions remain in your account from year to year until you use them.
- The interest or other earnings on the assets in the account are tax free.
- Distributions may be tax free if you pay qualified medical expenses. See *Qualified medical expenses*, later.
- An HSA is “portable” so it stays with you if you change employers or leave the work force.

## Qualifying for an HSA

To be an eligible individual and qualify for an HSA, you must meet the following requirements.

- You have a high deductible health plan (HDHP), described later, on the first day of the month.
- You have no other health coverage except what is permitted under *Other health coverage*, later.
- You are not enrolled in Medicare.
- You cannot be claimed as a dependent on someone else’s 2007 tax return.



*Under the last-month rule, you are considered to be an eligible individual for the entire year if you are an eligible individual on the first day of the last month of your tax year (December 1 for most taxpayers).*

If you meet these requirements, you are an eligible individual even if your spouse has non-HDHP family coverage, provided your spouse’s coverage does not cover you.



*If another taxpayer is entitled to claim an exemption for you, you cannot claim a deduction for an HSA contribution. This is true even if the other person does not actually claim your exemption.*



*Each spouse who is an eligible individual who wants an HSA must open a separate HSA. You cannot have a joint HSA.*

**High deductible health plan (HDHP).** An HDHP has:

- A higher annual deductible than typical health plans, and
- A maximum limit on the sum of the annual deductible and out-of-pocket medical expenses that you must pay for covered expenses. Out-of-pocket expenses include copayments and other amounts, but do not include premiums.

An HDHP may provide preventive care benefits without a deductible or with a deductible below the minimum annual deductible. Preventive care includes, but is not limited to, the following.

1. Periodic health evaluations, including tests and diagnostic procedures ordered in connection with routine examinations, such as annual physicals.
2. Routine prenatal and well-child care.
3. Child and adult immunizations.
4. Tobacco cessation programs.
5. Obesity weight-loss programs.
6. Screening services. This includes screening services for the following:
  - a. Cancer.
  - b. Heart and vascular diseases.
  - c. Infectious diseases.
  - d. Mental health conditions.
  - e. Substance abuse.
  - f. Metabolic, nutritional, and endocrine conditions.
  - g. Musculoskeletal disorders.
  - h. Obstetric and gynecological conditions.
  - i. Pediatric conditions.
  - j. Vision and hearing disorders.

For more information on screening services, see Notice 2004-23, which is on page 725 of Internal Revenue Bulletin 2004-15 at [www.irs.gov/pub/irs-irbs/irb04-15.pdf](http://www.irs.gov/pub/irs-irbs/irb04-15.pdf).

The following table shows the minimum annual deductible and maximum annual deductible and other out-of-pocket expenses for HDHPs for 2007.

Type of Coverage	Minimum Annual Deductible	Maximum Annual Deductible and Other Out-of-Pocket Expenses *
Self-only	\$1,100	\$5,500
Family	\$2,200	\$11,000

\* This limit does not apply to deductibles and expenses for out-of-network services if the plan uses a network of providers. Instead, only deductibles and out-of-pocket expenses for services within the network should be used to figure whether the limit applies.

Self-only HDHP coverage is an HDHP covering only an eligible individual. Family HDHP coverage is an HDHP covering an eligible individual and at least one other individual (whether or not that individual is an eligible individual).

**Example.** An eligible individual and his dependent child are covered under an “employee plus one” HDHP offered by the individual’s employer. This is family HDHP coverage.



**Family plans that do not meet the high deductible rules.** There are some family plans that have deductibles for both the family as a whole and for individual family members. Under these plans, if you meet the individual deductible for one family member, you do not have to meet the higher annual deductible amount for the family. If either the deductible for the family as a whole or the deductible for an individual family member is below the minimum annual deductible for family coverage, the plan does not qualify as an HDHP.

**Example.** You have family health insurance coverage in 2007. The annual deductible for the family plan is \$3,500. This plan also has an individual deductible of \$1,500 for each family member. The plan does not qualify as an HDHP because the deductible for an individual family member is below the minimum annual deductible (\$2,200) for family coverage.

**Other health coverage.** You (and your spouse, if you have family coverage) generally cannot have any other health coverage that is not an HDHP. However, you can still be an eligible individual even if your spouse has non-HDHP coverage provided you are not covered by that plan.

You can have additional insurance that provides benefits only for the following items.

- Liabilities incurred under workers' compensation laws, tort liabilities, or liabilities related to ownership or use of property.
- A specific disease or illness.
- A fixed amount per day (or other period) of hospitalization.

You can also have coverage (whether provided through insurance or otherwise) for the following items.

- Accidents.
- Disability.
- Dental care.
- Vision care.
- Long-term care.



*Plans in which substantially all of the coverage is through the above listed items are not HDHPs. For example, if your plan provides coverage substantially all of which is for a specific disease or illness, the plan is not an HDHP for purposes of establishing an HSA.*

**Prescription drug plans.** You can have a prescription drug plan, either as part of your HDHP or a separate plan (or rider), and qualify as an eligible individual if the plan does not provide benefits until the minimum annual deductible of the HDHP has been met. If you can receive benefits before that deductible is met, you are not an eligible individual.

**Other employee health plans.** An employee covered by an HDHP and a health FSA or an HRA that pays or reimburses qualified medical expenses generally cannot

make contributions to an HSA. Health FSAs and HRAs are discussed later.

However, an employee can make contributions to an HSA while covered under an HDHP and one or more of the following arrangements.

- Limited-purpose health FSA or HRA. These arrangements can pay or reimburse the items listed earlier under *Other health coverage*, except long-term care. Also, these arrangements can pay or reimburse preventive care expenses because they can be paid without having to satisfy the deductible.
- Suspended HRA. Before the beginning of an HRA coverage period, you can elect to suspend the HRA. The HRA does not pay or reimburse, at any time, the medical expenses incurred during the suspension period except preventive care and items listed under *Other health coverage*. When the suspension period ends, you are no longer eligible to make contributions to an HSA.
- Post-deductible health FSA or HRA. These arrangements do not pay or reimburse any medical expenses incurred before the minimum annual deductible amount is met. The deductible for these arrangements does not have to be the same as the deductible for the HDHP, but benefits may not be provided before the minimum annual deductible amount is met.
- Retirement HRA. This arrangement pays or reimburses only those medical expenses incurred after retirement. After retirement you are no longer eligible to make contributions to an HSA.

**Health FSA – grace period.** Coverage during a grace period by a general purpose health FSA is allowed if the balance in the health FSA at the end of its prior year plan is zero, or a qualified HSA distribution (discussed later) of any balance remaining is made to an HSA. See *Flexible Spending Arrangements (FSAs)*, later.

## Contributions to an HSA

Any eligible individual can contribute to an HSA. For an employee's HSA, the employee, the employee's employer, or both may contribute to the employee's HSA in the same year. For an HSA established by a self-employed (or un-employed) individual, the individual can contribute. Family members or any other person may also make contributions on behalf of an eligible individual.

Contributions to an HSA must be made in cash. Contributions of stock or property are not allowed.

## Limit on Contributions

The amount you or any other person can contribute to your HSA depends on the type of HDHP coverage you have, your age, the date you become an eligible individual, and the date you cease to be an eligible individual. For 2007, if you have self-only HDHP coverage, you can contribute up to \$2,850. If you have family HDHP coverage, you can contribute up to \$5,650.



For 2008, if you have self-only HDHP coverage, you can contribute up to \$2,900. If you have family HDHP coverage you can contribute up to \$5,800.

If you were, or were considered (under the last-month rule, discussed later), an eligible individual for the entire year and did not change your type of coverage, you can contribute the full amount based on your type of coverage. However, if you were not an eligible individual for the entire year or changed your coverage during the year, your contribution limit is the greater of:

1. The limitation shown on the last line of the *Line 3 Limitation Chart and Worksheet* in the Instructions for Form 8889, Health Savings Accounts (HSAs), or
2. The maximum annual HSA contribution based on your HDHP coverage (self-only or family) on the first day of the last month of your tax year.



If you had family HDHP coverage on the first day of the last month of your tax year, your contribution limit for 2007 is \$5,650 even if you changed coverage during the year.

**Last-month rule.** Under the last-month rule, if you are an eligible individual on the first day of the last month of your tax year (December 1 for most taxpayers), you are considered an eligible individual for the entire year. You are treated as having the same HDHP coverage for the entire year as you had on the first day of that last month.

**Testing period.** If contributions were made to your HSA based on you being an eligible individual for the entire year under the last-month rule, you must remain an eligible individual during the testing period. For the last-month rule, the testing period begins with the last month of your tax year and ends on the last day of the 12th month following that month. For example, December 1, 2007, through December 31, 2008.

If you fail to remain an eligible individual during the testing period, other than because of death or becoming disabled, you will have to include in income the total contributions made to your HSA that would not have been made except for the last-month rule. You include this amount in your income in the year in which you fail to be an eligible individual. This amount is also subject to a 10% additional tax. The income and additional tax are shown on Form 8889, Part III.

**Example 1.** Chris, age 53, becomes an eligible individual on December 1, 2007. He has family HDHP coverage on that date. Under the last-month rule, he contributes \$5,650 to his HSA.

Chris fails to be an eligible individual in June 2008. Because Chris did not remain an eligible individual during the testing period (December 1, 2007, through December 31, 2008), he must include in his 2008 income the contributions made in 2007 that would not have been made except for the last-month rule. Chris uses the worksheet for line 3 in the Form 8889 instructions to determine this amount.

January . . . . .	-0-
February . . . . .	-0-
March . . . . .	-0-
April . . . . .	-0-
May . . . . .	-0-
June . . . . .	-0-
July . . . . .	-0-
August . . . . .	-0-
September . . . . .	-0-
October . . . . .	-0-
November . . . . .	-0-
December . . . . .	\$5,650.00
<b>Total for all months . . . . .</b>	<b>\$5,650.00</b>
<b>Limitation.</b> Divide the total by 12	<b>\$470.83</b>

Chris would include \$5,179.17 (\$5,650.00 – \$470.83) in his gross income on his 2008 tax return. Also, a 10% additional tax applies to this amount.

**Example 2.** Erika, age 39, has self-only HDHP coverage on January 1, 2007. Erika changes to family HDHP coverage on November 1, 2007. Because Erika has family HDHP coverage on December 1, 2007, she contributes \$5,650 for 2007.

Erika fails to be an eligible individual in March 2008. Because she did not remain an eligible individual during the testing period (December 1, 2007, through December 31, 2008), she must include in income the contribution made that would not have been made except for the last-month rule. Erika uses the worksheet for line 3 in the Form 8889 instructions to determine this amount.

January . . . . .	\$2,850.00
February . . . . .	\$2,850.00
March . . . . .	\$2,850.00
April . . . . .	\$2,850.00
May . . . . .	\$2,850.00
June . . . . .	\$2,850.00
July . . . . .	\$2,850.00
August . . . . .	\$2,850.00
September . . . . .	\$2,850.00
October . . . . .	\$2,850.00
November . . . . .	\$5,650.00
December . . . . .	\$5,650.00
<b>Total for all months . . . . .</b>	<b>\$39,800.00</b>
<b>Limitation.</b> Divide the total by 12	<b>\$3,316.67</b>

Erika would include \$2,333.33 (\$5,650 - \$3,316.67) in her gross income on her 2008 tax return. Also, a 10% additional tax applies to this amount.

**Additional contribution.** For 2007, if you are an eligible individual who is age 55 or older, your contribution limit is increased by \$800. For example, if you have self-only coverage, you can contribute up to \$3,650 (the contribution limit for self-only coverage (\$2,850) plus the additional contribution of \$800). However, see *Enrolled in Medicare*, later.



For 2008, the additional contribution amount is \$900.



If you have more than one HSA in 2007, your total contributions to all the HSAs cannot be more than the limits discussed earlier.

**Reduction of contribution limit.** You must reduce the amount that can be contributed (including any additional contribution) to your HSA by the amount of any contribution made to your Archer MSA (including employer contributions) for the year. A special rule applies to married people, discussed next, if each spouse has family coverage under an HDHP.

**Rules for married people.** If either spouse has family HDHP coverage, both spouses are treated as having family HDHP coverage. If each spouse has family coverage under a separate plan, both are treated as having family coverage under the plan with the lower annual deductible to determine if the plan is an HDHP. You must reduce the limit on contributions, before taking into account any additional contributions, by the amount contributed to both spouse's Archer MSAs. After that reduction, the contribution limit is split equally between the spouses unless you agree on a different division.



The rules for married people apply only if both spouses are eligible individuals.

If both spouses are 55 or older and not enrolled in Medicare, each spouse's contribution limit is increased by the additional contribution. If both spouses meet the age requirement, the total contributions under family coverage cannot be more than \$7,250.

**Example.** For 2007, Mr. Auburn and his wife are both eligible individuals. They each have family coverage under separate HDHPs. Mr. Auburn is 58 years old and Mrs. Auburn is 53. Mr. and Mrs. Auburn can split the family contribution limit (\$5,650) equally or they can agree on a different division. If they split it equally, Mr. Auburn can contribute \$3,625 to an HSA (one-half the maximum contribution for family coverage (\$2,825) + \$800 additional contribution) and Mrs. Auburn can contribute \$2,825 to an HSA.

**Employer contributions.** You must reduce the amount you, or any other person, can contribute to your HSA by the amount of any contributions made by your employer that are excludable from your income. This includes amounts contributed to your account by your employer through a cafeteria plan.

**Enrolled in Medicare.** Beginning with the first month you are enrolled in Medicare, your contribution limit is zero.

**Example.** You turned age 65 in July 2007 and enrolled in Medicare. You had an HDHP with self-only coverage and are eligible for an additional contribution of \$800. Your contribution limit is \$1,825 ( $\$3,650 \div 6 + 12$ ).

**Qualified HSA funding distribution.** A qualified HSA funding distribution may be made from your IRA, other than a SEP IRA or SIMPLE IRA, to your HSA. The maximum amount depends on the HDHP coverage (self-only or family) you have on the first day of the month in which the contribution is made. The distribution must be made directly by the trustee of the IRA to the trustee of the HSA. The distribution is not included in your income, is not deductible, and reduces the amount that can be contributed to your HSA. The qualified HSA funding distribution is shown on Form 8889, Part I, line 10.

You can make only one qualified HSA funding distribution during your lifetime. However, if you make a distribution during a month when you have self-only HDHP coverage, you can make another qualified HSA funding distribution in a later month in that tax year if you change to family HDHP coverage. The total qualified HSA funding distribution cannot be more than the contribution limit for family HDHP coverage.

**Funding distribution – testing period.** You must remain an eligible individual during the testing period. For a qualified HSA funding distribution, the testing period begins with the month in which the qualified HSA funding distribution is contributed and ends on the last day of the 12th month following that month. For example, if a qualified HSA funding distribution is contributed to your HSA on August 15, 2007, your testing period runs from August 1, 2007, through August 31, 2008.

If you fail to remain an eligible individual during the testing period, other than because of death or becoming disabled, you will have to include in income the qualified HSA funding distribution. You include this amount in income in the year in which you fail to be an eligible individual. This amount is also subject to a 10% additional tax. The income and the additional tax are shown on Form 8889, Part III.

## Rollovers

A rollover contribution is not included in your income, is not deductible, and does not reduce your contribution limit.

**Archer MSAs and other HSAs.** You can roll over amounts from Archer MSAs and other HSAs into an HSA. Rollover contributions do not need to be in cash. Rollovers are not subject to the annual contribution limits.

You must roll over the amount within 60 days after the date of receipt. You can make only one rollover contribution to an HSA during a 1-year period.

**Note.** If you instruct the trustee of your HSA to transfer funds directly to the trustee of another HSA, the transfer is not considered a rollover. There is no limit on the number of these transfers. Do not include the amount transferred in income, deduct it as a contribution, or include it as a distribution on Form 8889, line 12a.

**Qualified HSA distribution.** This is a distribution from a health FSA or an HRA that is transferred to your HSA. To be a qualified HSA distribution certain conditions must be



met. See *Qualified HSA distribution* under *Flexible Spending Arrangements (FSAs)* and *Health Reimbursement Arrangements (HRAs)*, later.

**Testing period.** You must remain an eligible individual during the testing period. For a qualified HSA distribution, the testing period begins with the month in which the qualified HSA distribution is contributed and ends on the last day of the 12th month following that month. For example, if a qualified HSA distribution is contributed to your HSA on December 31, 2007, your testing period runs from December 1, 2007, through December 31, 2008.

If you fail to remain an eligible individual during the testing period, other than because of death or becoming disabled, you will have to include in income the qualified HSA distribution. You include this amount in income in the year in which you fail to be an eligible individual. This amount is also subject to a 10% additional tax. The income and the additional tax are shown on Form 8889, Part III.

## When To Contribute

You can make contributions to your HSA for 2007 until April 15, 2008.

## Reporting Contributions on Your Return

Contributions made by your employer are not included in your income. Contributions to an employee's account by an employer using the amount of an employee's salary reduction through a cafeteria plan are treated as employer contributions. You can claim contributions you made and contributions made by any other person, other than your employer, on your behalf, as an adjustment to income.

Contributions by a partnership to a bona fide partner's HSA are not contributions by an employer. The contributions are treated as a distribution of money and are not included in the partner's gross income. Contributions by a partnership to a partner's HSA for services rendered are treated as guaranteed payments that are deductible by the partnership and includible in the partner's gross income. In both situations, the partner can deduct the contribution made to the partner's HSA.

Contributions by an S corporation to a 2% shareholder-employee's HSA for services rendered are treated as guaranteed payments and are deductible by the S corporation and includible in the shareholder-employee's gross income. The shareholder-employee can deduct the contribution made to the shareholder-employee's HSA.

**Form 8889.** Report all contributions to your HSA on Form 8889 and file it with your Form 1040 or Form 1040NR. You should include all contributions made for 2007, including those made by April 15, 2008, that are designated for 2007. Contributions made by your employer and qualified HSA funding distributions are also shown on the form.

You should receive Form 5498-SA, HSA, Archer MSA, or Medicare Advantage MSA Information, from the trustee showing the amount contributed to your HSA during the year. Your employer's contributions also will be shown in box 12 of Form W-2, Wage and Tax Statement, with code

W. Follow the instructions for Form 8889. Report your HSA deduction on Form 1040 or Form 1040NR, line 25.

**Excess contributions.** You will have excess contributions if the contributions to your HSA for the year are greater than the limits discussed earlier. Excess contributions are not deductible. Excess contributions made by your employer are included in your gross income. If the excess contribution is not included in box 1 of Form W-2, you must report the excess as "Other income" on your tax return.

Generally, you must pay a 6% excise tax on excess contributions. See Form 5329, Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts, to figure the excise tax. The excise tax applies to each tax year the excess contribution remains in the account.

You may withdraw some or all of the excess contributions and not pay the excise tax on the amount withdrawn if you meet the following conditions.

- You withdraw the excess contributions by the due date, including extensions, of your tax return for the year the contributions were made.
- You withdraw any income earned on the withdrawn contributions and include the earnings in "Other income" on your tax return for the year you withdraw the contributions and earnings.



*If you fail to remain an eligible individual during any of the testing periods, discussed earlier, the amount you have to include in income is not an excess contribution. If you withdraw any of those amounts, the amount is treated the same as any other distribution from an HSA, discussed next.*

## Distributions From an HSA

You will generally pay medical expenses during the year without being reimbursed by your HDHP until you reach the annual deductible for the plan. When you pay medical expenses during the year that are not reimbursed by your HDHP, you can ask the trustee of your HSA to send you a distribution from your HSA.

You can receive tax-free distributions from your HSA to pay or be reimbursed for qualified medical expenses you incur after you establish the HSA. If you receive distributions for other reasons, the amount you withdraw will be subject to income tax and may be subject to an additional 10% tax. You do not have to make distributions from your HSA each year.



*If you are no longer an eligible individual, you can still receive tax-free distributions to pay or reimburse your qualified medical expenses.*

A distribution is money you get from your health savings account. The trustee will report any distribution to you and the IRS on Form 1099-SA, Distributions From an HSA, Archer MSA, or Medicare Advantage MSA.

**Qualified medical expenses.** Qualified medical expenses are those expenses that would generally qualify for

the medical and dental expenses deduction. These are explained in Publication 502, Medical and Dental Expenses. However, even though non-prescription medicines (other than insulin) do not qualify for the medical and dental expenses deduction, they do qualify as expenses for HSA purposes. Qualified medical expenses are those incurred by the following persons.

1. You and your spouse.
2. All dependents you claim on your tax return.
3. Any person you could have claimed as a dependent on your return except that:
  - a. The person filed a joint return,
  - b. The person had gross income of \$3,400 or more, or
  - c. You, or your spouse if filing jointly, could be claimed as a dependent on someone else's 2007 return.



*You cannot deduct qualified medical expenses as an itemized deduction on Schedule A (Form 1040) that are equal to the tax-free distribution from your HSA.*

**Special rules for insurance premiums.** Generally, you cannot treat insurance premiums as qualified medical expenses for HSAs. You can, however, treat premiums for long-term care coverage, health care coverage while you receive unemployment benefits, or health care continuation coverage required under any federal law as qualified medical expenses for HSAs. If you are age 65 or older, you can treat insurance premiums (other than premiums for a Medicare supplemental policy, such as Medigap) as qualified medical expenses for HSAs.



*The premiums for long-term care coverage that you can treat as qualified medical expenses are subject to limits based on age and are adjusted annually. See Limit on long-term care premiums you can deduct in the instructions for Schedule A (Form 1040).*

**Health coverage tax credit.** You cannot claim this credit for premiums that you pay with a tax-free distribution from your HSA. See Publication 502 for more information on this credit.

**Deemed distributions from HSAs.** The following situations result in deemed taxable distributions from your HSA.

- You engaged in any transaction prohibited by section 4975 with respect to any of your HSAs, at any time in 2007. Your account ceases to be an HSA as of January 1, 2007, and you must include the fair market value of all assets in the account as of January 1, 2007, on Form 8889, line 14a.
- You used any portion of any of your HSAs as security for a loan at any time in 2007. You must include the fair market value of the assets used as security for the loan as income on Form 1040 or Form 1040NR, line 21.



**Recordkeeping.** You must keep records sufficient to show that:

- The distributions were exclusively to pay or reimburse qualified medical expenses,
- The qualified medical expenses had not been previously paid or reimbursed from another source, and
- The medical expenses had not been taken as an itemized deduction in any year.

Do not send these records with your tax return. Keep them with your tax records.

## Reporting Distributions on Your Return

How you report your distributions depends on whether or not you use the distribution for qualified medical expenses (defined earlier).

- If you use a distribution from your HSA for qualified medical expenses, you do not pay tax on the distribution but you have to report the distribution on Form 8889. However, the distribution of an excess contribution taken out after the due date, including extensions, of your return is subject to tax even if used for qualified medical expenses. Follow the instructions for the form and file it with your Form 1040 or Form 1040NR.
- If you do not use a distribution from your HSA for qualified medical expenses, you must pay tax on the distribution. Report the amount on Form 8889 and file it with your Form 1040 or Form 1040NR. If you have a taxable HSA distribution, include it in the total on Form 1040 or Form 1040NR, line 21, and enter "HSA" and the amount on the dotted line next to line 21. You may have to pay an additional 10% tax on your taxable distribution.

**Additional tax.** There is an additional 10% tax on the part of your distributions not used for qualified medical expenses. Figure the tax on Form 8889 and file it with your Form 1040 or Form 1040NR. Report the additional tax on Form 1040, line 63, or Form 1040NR, line 58, and enter "HSA" and the amount on the dotted line next to that line.

**Exceptions.** There is no additional tax on distributions made after the date you are disabled, reach age 65, or die.

## Balance in an HSA

An HSA is generally exempt from tax. You are permitted to take a distribution from your HSA at any time; however, only those amounts used exclusively to pay for qualified medical expenses are tax free. Amounts that remain at the end of the year are generally carried over to the next year (see *Excess contributions*, earlier). Earnings on amounts in an HSA are not included in your income while held in the HSA.



## Death of HSA Holder

You should choose a beneficiary when you set up your HSA. What happens to that HSA when you die depends on whom you designate as the beneficiary.

**Spouse is the designated beneficiary.** If your spouse is the designated beneficiary of your HSA, it will be treated as your spouse's HSA after your death.

**Spouse is not the designated beneficiary.** If your spouse is not the designated beneficiary of your HSA:

- The account stops being an HSA, and
- The fair market value of the HSA becomes taxable to the beneficiary in the year in which you die.

If your estate is the beneficiary, the value is included on your final income tax return.



*The amount taxable to a beneficiary other than the estate is reduced by any qualified medical expenses for the decedent that are paid by the beneficiary within 1 year after the date of death.*

## Filing Form 8889

You must file Form 8889 with your Form 1040 or Form 1040NR if you (or your spouse, if married filing a joint return) had any activity in your HSA during the year. You must file the form even if only your employer or your spouse's employer made contributions to the HSA.

## Employer Participation

This section contains the rules that employers must follow if they decide to make HSAs available to their employees. Unlike the previous discussions, "you" refers to the employer and not to the employee.

**Health plan.** If you want your employees to be able to have an HSA, they must have an HDHP. You can provide no additional coverage other than those exceptions listed previously under *Other health coverage*.

**Contributions.** You can make contributions to your employees' HSAs. You deduct the contributions on the "Employee benefit programs" line of your business income tax return for the year in which you make the contributions. If you are filing Form 1040, Schedule C, this is Part II, line 14.

**Comparable contributions.** If you decide to make contributions, you must make comparable contributions to all comparable participating employees' HSAs. Your contributions are comparable if they are either:

- The same amount, or
- The same percentage of the annual deductible limit under the HDHP covering the employees.

**Comparable participating employees.** Comparable participating employees:

- Are covered by your HDHP and are eligible to establish an HSA,

- Have the same category of coverage (either self-only or family coverage), and
- Have the same category of employment (part-time, full-time, or former employees).

The comparability rules do not apply to contributions made through a cafeteria plan.

**Note.** For purposes of making contributions to HSAs of non-highly compensated employees, highly compensated employees shall not be treated as comparable participating employees.

**Excise tax.** If you made contributions to your employees' HSAs that were not comparable, you must pay an excise tax of 35% of the amount you contributed.

**Employment taxes.** Amounts you contribute to your employees' HSAs are generally not subject to employment taxes. You must report the contributions in box 12 of the Form W-2 you file for each employee. This includes the amounts the employee elected to contribute through a cafeteria plan. Enter code "W" in box 12.

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## Medical Savings Accounts (MSAs)

Archer MSAs were created to help self-employed individuals and employees of certain small employers meet the medical care costs of the account holder, the account holder's spouse, or the account holder's dependent(s).

A Medicare Advantage MSA is an Archer MSA designated by Medicare to be used solely to pay the qualified medical expenses of the account holder who is eligible for Medicare.

## Archer MSAs

An Archer MSA is a tax-exempt trust or custodial account that you set up with a U.S. financial institution (such as a bank or an insurance company) in which you can save money exclusively for future medical expenses.

**What are the benefits of an Archer MSA?** You may enjoy several benefits from having an Archer MSA.

- You can claim a tax deduction for contributions you make even if you do not itemize your deductions on Form 1040 or Form 1040NR.
- The interest or other earnings on the assets in your Archer MSA are tax free.
- Distributions may be tax free if you pay qualified medical expenses. See *Qualified medical expenses*, later.
- The contributions remain in your Archer MSA from year to year until you use them.
- An Archer MSA is "portable" so it stays with you if you change employers or leave the work force.

## Qualifying for an Archer MSA

To qualify for an Archer MSA, you must be either of the following.

- An employee (or the spouse of an employee) of a small employer (defined later) that maintains a self-only or family HDHP for you (or your spouse).
- A self-employed person (or the spouse of a self-employed person) who maintains a self-only or family HDHP.

You can have no other health or Medicare coverage except what is permitted under *Other health coverage*, later. You must be an eligible individual on the first day of a given month to get an Archer MSA deduction for that month.



*If another taxpayer is entitled to claim an exemption for you, you cannot claim a deduction for an Archer MSA contribution. This is true even if the other person does not actually claim your exemption.*

**Small employer.** A small employer is generally an employer who had an average of 50 or fewer employees during either of the last 2 calendar years. The definition of small employer is modified for new employers and growing employers.

**Growing employer.** A small employer may begin HDHPs and Archer MSAs for his or her employees and then grow beyond 50 employees. The employer will continue to meet the requirement for small employers if he or she:

- Had 50 or fewer employees when the Archer MSAs began,
- Made a contribution that was excludable or deductible as an Archer MSA for the last year he or she had 50 or fewer employees, and
- Had an average of 200 or fewer employees each year after 1996.

**Changing employers.** If you change employers, your Archer MSA moves with you. However, you may not make additional contributions unless you are otherwise eligible.

**High deductible health plan (HDHP).** To be eligible for an Archer MSA, you must have an HDHP. An HDHP has:

- A higher annual deductible than typical health plans, and
- A maximum limit on the annual out-of-pocket medical expenses that you must pay for covered expenses.

**Limits.** The following table shows the limits for annual deductibles and the maximum out-of-pocket expenses for high deductible health plans for 2007.

Type of Coverage	Minimum Annual Deductible	Maximum Annual Deductible	Maximum Annual Out-of-Pocket Expenses
Self-only	\$1,900	\$2,850	\$3,750
Family	\$3,750	\$5,650	\$6,900

**Family plans that do not meet the high deductible rules.** There are some family plans that have deductibles for both the family as a whole and for individual family members. Under these plans, if you meet the individual deductible for one family member, you do not have to meet the higher annual deductible amount for the family. If either the deductible for the family as a whole or the deductible for an individual family member is below the minimum annual deductible for family coverage, the plan does not qualify as an HDHP.

**Example.** You have family health insurance coverage in 2007. The annual deductible for the family plan is \$4,500. This plan also has an individual deductible of \$2,000 for each family member. The plan does not qualify as an HDHP because the deductible for an individual family member is below the minimum annual deductible (\$3,750) for family coverage.

**Other health coverage.** You (and your spouse, if you have family coverage) generally cannot have any other health coverage that is not an HDHP. However, you can still be an eligible individual even if your spouse has non-HDHP coverage provided you are not covered by that plan. However, you can have additional insurance that provides benefits only for the following items.

- Liabilities incurred under workers' compensation laws, torts, or ownership or use of property.
- A specific disease or illness.
- A fixed amount per day (or other period) of hospitalization.

You can also have coverage (whether provided through insurance or otherwise) for the following items.

- Accidents.
- Disability.
- Dental care.
- Vision care.
- Long-term care.

## Contributions to an MSA

Contributions to an Archer MSA must be made in cash. You cannot contribute stock or other property to an Archer MSA.

**Who can contribute to my Archer MSA?** If you are an employee, your employer may make contributions to your Archer MSA. (You do not pay tax on these contributions.) If your employer does not make contributions to your Archer MSA, or you are self-employed, you can make your own

contributions to your Archer MSA. Both you and your employer cannot make contributions to your Archer MSA in the same year. You do not have to make contributions to your Archer MSA every year.



*If your spouse is covered by your HDHP and an excludable amount is contributed by your spouse's employer to an Archer MSA belonging to your spouse, you cannot make contributions to your own Archer MSA that year.*

## Limits

There are two limits on the amount you or your employer can contribute to your Archer MSA:

- The annual deductible limit.
- An income limit.

**Annual deductible limit.** You (or your employer) can contribute up to 75% of the annual deductible of your HDHP (65% if you have a self-only plan) to your Archer MSA. You must have the HDHP all year to contribute the full amount. If you do not qualify to contribute the full amount for the year, determine your annual deductible limit by using the worksheet for line 5 in the Instructions for Form 8853, Archer MSAs and Long-Term Care Insurance Contracts.

**Example 1.** You have an HDHP for your family all year in 2007. The annual deductible is \$4,000. You can contribute up to \$3,000 ( $\$4,000 \times 75\%$ ) to your Archer MSA for the year.

**Example 2.** You have an HDHP for your family for the entire months of July through December, 2007 (6 months). The annual deductible is \$4,000. You can contribute up to \$1,500 ( $\$4,000 \times 75\% \div 12 \times 6$ ) to your Archer MSA for the year.



*If you and your spouse each have a family plan, you are treated as having family coverage with the lower annual deductible of the two health plans. The contribution limit is split equally between you unless you agree on a different division.*

**Income limit.** You cannot contribute more than you earned for the year from the employer through whom you have your HDHP.

If you are self-employed, you cannot contribute more than your net self-employment income. This is your income from self-employment minus expenses (including the one-half of self-employment tax deduction).

**Example 1.** Bob Smith earned \$25,000 from ABC Company in 2007. Through ABC, he had an HDHP for his family for the entire year. The annual deductible was \$4,000. He can contribute up to \$3,000 to his Archer MSA ( $75\% \times \$4,000$ ). He can contribute the full amount because he earned more than \$3,000 at ABC.

**Example 2.** Joe Craft is self-employed. He had an HDHP for his family for the entire year in 2007. The annual deductible was \$4,000. Based on the annual deductible, the maximum contribution to his Archer MSA would have been \$3,000 ( $75\% \times \$4,000$ ). However, after deducting his business expenses, Joe's net self-employment income is \$1,950 for the year. Therefore, he is limited to a contribution of \$1,950.

**Individuals enrolled in Medicare.** Beginning with the first month you are enrolled in Medicare, you cannot contribute to an Archer MSA. However, you may be eligible for a Medicare Advantage MSA, discussed later.

## When To Contribute

You can make contributions to your Archer MSA for 2007 until April 15, 2008.

## Reporting Contributions on Your Return

Report all contributions to your Archer MSA on Form 8853 and file it with your Form 1040 or Form 1040NR. You should include all contributions you, or your employer, made for 2007, including those made by April 15, 2008, that are designated for 2007.

You should receive Form 5498-SA, HSA, Archer MSA, or Medicare Advantage MSA Information, from the trustee showing the amount you (or your employer) contributed during the year. Your employer's contributions should be shown in box 12 of Form W-2, Wage and Tax Statement, with code R. Follow the instructions for Form 8853 and complete the worksheet for line 5. Report your Archer MSA deduction on Form 1040, line 36, or Form 1040NR, line 34.

**Excess contributions.** You will have excess contributions if the contributions to your Archer MSA for the year are greater than the limits discussed earlier. Excess contributions are not deductible. Excess contributions made by your employer are included in your gross income. If the excess contribution is not included in box 1 of Form W-2, you must report the excess as "Other income" on your tax return.

Generally, you must pay a 6% excise tax on excess contributions. See Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, to figure the excise tax. The excise tax applies to each tax year the excess contribution remains in the account.

You may withdraw some or all of the excess contributions and not pay the excise tax on the amount withdrawn if you meet the following conditions.

- You withdraw the excess contributions by the due date, including extensions, of your tax return.
- You withdraw any income earned on the withdrawn contributions and include the earnings in "Other income" on your tax return for the year you withdraw the contributions and earnings.



## Distributions From an MSA

You will generally pay medical expenses during the year without being reimbursed by your HDHP until you reach the annual deductible for the plan. When you pay medical expenses during the year that are not reimbursed by your HDHP, you can ask the trustee of your Archer MSA to send you a distribution from your Archer MSA.

You can receive tax-free distributions from your Archer MSA to pay for qualified medical expenses (discussed later). If you receive distributions for other reasons, the amount will be subject to income tax and may be subject to an excise tax as well. You do not have to make withdrawals from your Archer MSA each year.



*If you no longer qualify to make contributions, you can still receive tax-free distributions to pay or reimburse your qualified medical expenses.*

A distribution is money you get from your Archer MSA. The trustee will report any distribution to you and the IRS on Form 1099-SA, Distributions From an HSA, Archer MSA, or Medicare Advantage MSA.

**Qualified medical expenses.** Qualified medical expenses are those expenses that would generally qualify for the medical and dental expenses deduction. These are explained in Publication 502, Medical and Dental Expenses. However, even though non-prescription medicines (other than insulin) do not qualify for the medical and dental expenses deduction, they do qualify as expenses for MSA purposes. Qualified medical expenses are those incurred by the following persons.

1. You and your spouse.
2. All dependents you claim on your tax return.
3. Any person you could have claimed as a dependent on your return except that:
  - a. The person filed a joint return,
  - b. The person had gross income of \$3,400 or more, or
  - c. You, or your spouse if filing jointly, could be claimed as a dependent on someone else's 2007 return



*You cannot deduct qualified medical expenses as an itemized deduction on Schedule A (Form 1040) that are equal to the tax-free distribution from your Archer MSA. This is the amount on line 9 of Form 8853.*

**Special rules for insurance premiums.** Generally, you cannot treat insurance premiums as qualified medical expenses for Archer MSAs. You can, however, treat premiums for long-term care coverage, health care coverage while you receive unemployment benefits, or health care continuation coverage required under any federal law as qualified medical expenses for Archer MSAs.

**Health coverage tax credit.** You cannot claim this credit for premiums that you pay with a tax-free distribution

from your Archer MSA. See Publication 502 for information on this credit.

**Deemed distributions from Archer MSAs.** The following situations result in deemed taxable distributions from your Archer MSA.

- You engaged in any transaction prohibited by section 4975 with respect to any of your Archer MSAs at any time in 2007. Your account ceases to be an Archer MSA as of January 1, 2007, and you must include the fair market value of all assets in the account as of January 1, 2007, on line 8a of Form 8853.
- You used any portion of any of your Archer MSAs as security for a loan at any time in 2007. You must include the fair market value of the assets used as security for the loan as income on Form 1040 or Form 1040NR, line 21.



**Recordkeeping.** You must keep records sufficient to show that:

- The distributions were exclusively to pay or reimburse qualified medical expenses,
- The qualified medical expenses had not been previously paid or reimbursed from another source, and
- The medical expenses had not been taken as an itemized deduction in any year.

Do not send these records with your tax return. Keep them with your tax records.

## Reporting Distributions on Your Return

How you report your distributions depends on whether or not you use the distribution for qualified medical expenses (defined earlier).

- If you use a distribution from your Archer MSA for qualified medical expenses, you do not pay tax on the distribution but you have to report the distribution on Form 8853. Follow the instructions for the form and file it with your Form 1040 or Form 1040NR.
- If you do not use a distribution from your Archer MSA for qualified medical expenses, you must pay tax on the distribution. Report the amount on Form 8853 and file it with your Form 1040 or Form 1040NR. If you have a taxable Archer MSA distribution, include it in the total on Form 1040 or Form 1040NR, line 21, and enter "MSA" and the amount on the dotted line next to line 21. You may have to pay an additional tax on your taxable distribution.



*If an amount (other than a rollover) is contributed to your Archer MSA this year (by you or your employer), you also must report and pay tax on a distribution you receive from your Archer MSA this year*

that is used to pay medical expenses of someone who is not covered by an HDHP, or is also covered by another health plan that is not an HDHP, at the time the expenses are incurred.

**Rollovers.** Generally, any distribution from an Archer MSA that you roll over into another Archer MSA or an HSA is not taxable if you complete the rollover within 60 days. You can make only one rollover contribution to an Archer MSA during a 1-year period. See the Form 8853 instructions for more information.

**Additional tax.** There is a 15% additional tax on the part of your distributions not used for qualified medical expenses. Figure the tax on Form 8853 and file it with your Form 1040 or Form 1040NR. Report the additional tax on Form 1040, line 63, or Form 1040NR, line 58, and enter "MSA" and the amount on the dotted line next to that line.

**Exceptions.** There is no additional tax on distributions made after the date you are disabled, reach age 65, or die.

## Balance in an Archer MSA

An Archer MSA is generally exempt from tax. You are permitted to take a distribution from your Archer MSA at any time; however, only those amounts used exclusively to pay for qualified medical expenses are tax free. Amounts that remain at the end of the year are generally carried over to the next year (see *Excess contributions*, earlier). Earnings on amounts in an Archer MSA are not included in your income while held in the Archer MSA.

## Death of the Archer MSA Holder

You should choose a beneficiary when you set up your Archer MSA. What happens to that Archer MSA when you die depends on whom you designate as the beneficiary.

**Spouse is the designated beneficiary.** If your spouse is the designated beneficiary of your Archer MSA, it will be treated as your spouse's Archer MSA after your death.

**Spouse is not the designated beneficiary.** If your spouse is not the designated beneficiary of your Archer MSA:

- The account stops being an Archer MSA, and
- The fair market value of the Archer MSA becomes taxable to the beneficiary in the year in which you die.

If your estate is the beneficiary, the fair market value of the Archer MSA will be included on your final income tax return.



*The amount taxable to a beneficiary other than the estate is reduced by any qualified medical expenses for the decedent that are paid by the beneficiary within 1 year after the date of death.*

## Filing Form 8853

You must file Form 8853 with your Form 1040 or Form 1040NR if you (or your spouse, if married filing a joint return) had any activity in your Archer MSA during the year. You must file the form even if only your employer or your spouse's employer made contributions to the Archer MSA.

## Employer Participation

This section contains the rules that employers must follow if they decide to make Archer MSAs available to their employees. Unlike the previous discussions, "you" refers to the employer and not to the employee.

**Health plan.** If you want your employees to be able to have an Archer MSA, you must make an HDHP available to them. You can provide no additional coverage other than those exceptions listed previously under *Other health coverage*.

**Contributions.** You can make contributions to your employees' Archer MSAs. You deduct the contributions on the "Employee benefit programs" line of your business income tax return for the year in which you make the contributions. If you are filing Form 1040, Schedule C, this is Part II, line 14.

**Comparable contributions.** If you decide to make contributions, you must make comparable contributions to all comparable participating employees' Archer MSAs. Your contributions are comparable if they are either:

- The same amount, or
- The same percentage of the annual deductible limit under the HDHP covering the employees.

**Comparable participating employees.** Comparable participating employees:

- Are covered by your HDHP and are eligible to establish an Archer MSA,
- Have the same category of coverage (either self-only or family coverage), and
- Have the same category of employment (either part-time or full-time).

**Excise tax.** If you made contributions to your employees' Archer MSAs that were not comparable, you must pay an excise tax of 35% of the amount you contributed.

**Employment taxes.** Amounts you contribute to your employees' Archer MSAs are generally not subject to employment taxes. You must report the contributions in box 12 of the Form W-2 you file for each employee. Enter code "R" in box 12.

## Medicare Advantage MSAs

A Medicare Advantage MSA is an Archer MSA designated by Medicare to be used solely to pay the qualified medical

expenses of the account holder. To be eligible for a Medicare Advantage MSA, you must be enrolled in Medicare and have a high deductible health plan (HDHP) that meets the Medicare guidelines.

A Medicare Advantage MSA is a tax-exempt trust or custodial savings account that you set up with a financial institution (such as a bank or an insurance company) in which the Medicare program can deposit money for qualified medical expenses. The money in your account is not taxed if it is used for qualified medical expenses, and it may earn interest or dividends.

An HDHP is a special health insurance policy that has a high deductible. You choose the policy you want to use as part of your Medicare Advantage MSA plan. However, the policy must be approved by the Medicare program.

Medicare Advantage MSAs are administered through the federal Medicare program. You can get information by calling 1-800-Medicare (1-800-633-4227) or through the Internet at [www.medicare.gov](http://www.medicare.gov).

**Note.** You must file Form 8853, Archer MSAs and Long-Term Care Insurance Contracts, with your tax return if you have a Medicare Advantage MSA.

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## Flexible Spending Arrangements (FSAs)

A health flexible spending arrangement (FSA) allows employees to be reimbursed for medical expenses. FSAs are usually funded through voluntary salary reduction agreements with your employer. No employment or federal income taxes are deducted from your contribution. The employer may also contribute.

For information on the interaction between a health FSA and an HSA, see *Other employee health plans* under *Qualifying for an HSA*, earlier.

**What are the benefits of an FSA?** You may enjoy several benefits from having an FSA.

- Contributions made by your employer can be excluded from your gross income.
- No employment or federal income taxes are deducted from the contributions.
- Withdrawals may be tax free if you pay qualified medical expenses. See *Qualified medical expenses*, later.
- You can withdraw funds from the account to pay qualified medical expenses even if you have not yet placed the funds in the account.

## Qualifying for an FSA

Health FSAs are employer-established benefit plans. These may be offered in conjunction with other employer-provided benefits as part of a cafeteria plan. Employers have complete flexibility to offer various combinations of benefits in designing their plan. You do not

have to be covered under any other health care plan to participate.

Self-employed persons are not eligible for an FSA.



*Certain limitations may apply if you are a highly compensated participant or a key employee.*

## Contributions to an FSA

You contribute to your FSA by electing an amount to be voluntarily withheld from your pay by your employer. This is sometimes called a salary reduction agreement. The employer may also contribute to your FSA if specified in the plan.

You do not pay federal income tax or employment taxes on the salary you contribute or the amounts your employer contributes to the FSA. However, contributions made by your employer to provide coverage for long-term care insurance must be included in income.

## When To Contribute

At the beginning of the plan year, you must designate how much you want to contribute. Then, your employer will deduct amounts periodically (generally, every payday) in accordance with your annual election. You can change or revoke your election only if there is a change in your employment or family status that is specified by the plan.

## Amount of Contribution

There is no limit on the amount of money you or your employer can contribute to the accounts; however, the plan must prescribe either a maximum dollar amount or maximum percentage of compensation that can be contributed to your health FSA.

Generally, contributed amounts that are not spent by the end of the plan year are forfeited. See *Balance in an FSA*, later. For this reason, it is important to base your contribution on an estimate of the qualifying expenses you will have during the year.

## Distributions From an FSA

Generally, distributions from a health FSA must be paid only to reimburse you for qualified medical expenses you incurred during the period of coverage. You must be able to receive the maximum amount of reimbursement (the amount you have elected to contribute for the year) at any time during the coverage period, regardless of the amount you have actually contributed. The maximum amount you can receive tax free is the total amount you elected to contribute to the health FSA for the year.

You must provide the health FSA with a written statement from an independent third party stating that the medical expense has been incurred and the amount of the expense. You must also provide a written statement that the expense has not been paid or reimbursed under any



other health plan coverage. The FSA cannot make advance reimbursements of future or projected expenses.

Debit cards, credit cards, and stored value cards given to you by your employer can be used to reimburse participants in a health FSA. If the use of these cards meets certain substantiation methods, you may not have to provide additional information to the health FSA. For information on these methods, see Revenue Ruling 2003-43 on page 935 of Internal Revenue Bulletin (IRB) 2003-21 at [www.irs.gov/pub/irs-irbs/irb03-21.pdf](http://www.irs.gov/pub/irs-irbs/irb03-21.pdf), Notice 2006-69 on page 107 of IRB 2006-31 at [www.irs.gov/pub/irs-irbs/irb06-31.pdf](http://www.irs.gov/pub/irs-irbs/irb06-31.pdf), and Notice 2007-2 on page 254 of IRB 2007-2 at [www.irs.gov/pub/irs-irbs/irb07-02.pdf](http://www.irs.gov/pub/irs-irbs/irb07-02.pdf).

**Qualified medical expenses.** Qualified medical expenses are those specified in the plan that would generally qualify for the medical and dental expenses deduction. These are explained in Publication 502, Medical and Dental Expenses. However, even though non-prescription medicines (other than insulin) do not qualify for the medical and dental expenses deduction, they do qualify as expenses for FSA purposes.

You cannot receive distributions from your FSA for the following expenses.

- Amounts paid for health insurance premiums.
- Amounts paid for long-term care coverage or expenses.
- Amounts that are covered under another health plan.

If you are covered under both a health FSA and an HRA, see Notice 2002-45, Part V, which is on page 93 of Internal Revenue Bulletin 2002-28 at [www.irs.gov/pub/irs-irbs/irb02-28.pdf](http://www.irs.gov/pub/irs-irbs/irb02-28.pdf).



*You cannot deduct qualified medical expenses as an itemized deduction on Schedule A (Form 1040) that are equal to the distribution you receive from the FSA.*

**Qualified HSA distribution.** This is a distribution from your health FSA that is transferred to your HSA, discussed earlier. The distribution must not be more than the lesser of the balance in the health FSA on:

- September 21, 2006, or
- The date of the distribution.

If you were not covered by a health FSA on September 21, 2006, you cannot elect to make a qualified HSA distribution from the health FSA. If you were covered by a health FSA with an employer on September 21, 2006, but change employers after that date, you cannot elect to make a qualified HSA distribution from your second employer's health FSA.

The following conditions must be met to make a qualified HSA distribution.

- The plan must have been amended to allow these distributions.
- You must elect to make the rollover.

- The year-end balance in the health FSA must be frozen.
- The funds must be transferred within 2½ months after the end of the health FSA's plan year and result in a zero balance in the health FSA.
- The distribution must be contributed directly to the HSA trustee by the employer.

Only one qualified HSA distribution is allowed for each health FSA.

For more information, see Notice 2007-22 on page 670 of Internal Revenue Bulletin 2007-10 at [www.irs.gov/pub/irs-irbs/irb07-10.pdf](http://www.irs.gov/pub/irs-irbs/irb07-10.pdf).

If you do not remain an eligible individual for HSA purposes during the testing period, the distribution is included in your income and is subject to a 10% additional tax. See *Qualified HSA distribution* under *Health Savings Accounts (HSAs)*, earlier.

## Balance in an FSA

Flexible spending accounts are “use-it-or-lose-it” plans. This means that amounts in the account at the end of the plan year cannot be carried over to the next year. However, the plan can provide for a grace period of up to 2½ months after the end of the plan year. If there is a grace period, any qualified medical expenses incurred in that period can be paid from any amounts left in the account at the end of the previous year. Your employer is not permitted to refund any part of the balance to you. See *Qualified HSA distribution*, earlier.

## Employer Participation

For the health FSA to maintain tax-qualified status, employers must comply with certain requirements that apply to cafeteria plans. For example, there are restrictions for plans that cover highly compensated employees and key employees. The plans must also comply with rules applicable to other accident and health plans. Chapters 1 and 2 of Publication 15-B, Employer's Tax Guide to Fringe Benefits, explain these requirements.

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## Health Reimbursement Arrangements (HRAs)

A health reimbursement arrangement (HRA) must be funded solely by an employer. The contribution cannot be paid through a voluntary salary reduction agreement on the part of an employee. Employees are reimbursed tax free for qualified medical expenses up to a maximum dollar amount for a coverage period. An HRA may be offered with other health plans, including FSAs.

For information on the interaction between an HRA and an HSA, see *Other employee health plans* under *Qualifying for an HSA*, earlier.

**What are the benefits of an HRA?** You may enjoy several benefits from having an HRA.

- Contributions made by your employer can be excluded from your gross income.
- Reimbursements may be tax free if you pay qualified medical expenses. See *Qualified medical expenses*, later.
- Any unused amounts in the HRA can be carried forward for reimbursements in later years.

## Qualifying for an HRA

HRAs are employer-established benefit plans. These may be offered in conjunction with other employer-provided health benefits. Employers have complete flexibility to offer various combinations of benefits in designing their plan. You do not have to be covered under any other health care plan to participate.

Self-employed persons are not eligible for an HRA.



*Certain limitations may apply if you are a highly compensated participant.*

## Contributions to an HRA

HRAs are funded solely through employer contributions and may not be funded through employee salary deferrals under a cafeteria plan. These contributions are not included in the employee's income. You do not pay federal income taxes or employment taxes on amounts your employer contributes to the HRA.

## Amount of Contribution

There is no limit on the amount of money your employer can contribute to the accounts. Additionally, the maximum reimbursement amount credited under the HRA in the future may be increased or decreased by amounts not previously used. See *Balance in an HRA*, later.

## Distributions From an HRA

Generally, distributions from an HRA must be paid to reimburse you for qualified medical expenses you have incurred. The expense must have been incurred on or after the date you are enrolled in the HRA.

Debit cards, credit cards, and stored value cards given to you by your employer can be used to reimburse participants in an HRA. If the use of these cards meets certain substantiation methods, you may not have to provide additional information to the HRA. For information on these methods, see Revenue Ruling 2003-43 on page 935 of Internal Revenue Bulletin (IRB) 2003-21 at [www.irs.gov/pub/irs-irbs/irb03-21.pdf](http://www.irs.gov/pub/irs-irbs/irb03-21.pdf), Notice 2006-69 on page 107 of IRB 2006-31 at [www.irs.gov/pub/irs-irbs/irb06-31.pdf](http://www.irs.gov/pub/irs-irbs/irb06-31.pdf), and Notice 2007-2 on page 254 of IRB 2007-2 at [www.irs.gov/pub/irs-irbs/irb07-02.pdf](http://www.irs.gov/pub/irs-irbs/irb07-02.pdf).

If any distribution is, or can be, made for other than the reimbursement of qualified medical expenses, any distribution (including reimbursement of qualified medical expenses) made in the current tax year is included in gross income. For example, if an unused reimbursement is payable to you in cash at the end of the year, or upon termination of your employment, any distribution from the HRA is included in your income. This also applies if any unused amount upon your death is payable in cash to your beneficiary or estate, or if the HRA provides an option for you to transfer any unused reimbursement at the end of the year to a retirement plan. However, see *Qualified HSA distribution*, later.

If the plan permits amounts to be paid as medical benefits to a designated beneficiary (other than the employee's spouse or dependents), any distribution from the HRA is included in income. However, if, before August 15, 2006, the plan contains such a provision, this rule will not apply until plan years beginning after December 31, 2008.

Reimbursements under an HRA can be made to the following persons.

1. Current and former employees.
2. Spouses and dependents of those employees.
3. Any person you could have claimed as a dependent on your return except that:
  - a. The person filed a joint return,
  - b. The person had gross income of \$3,400 or more, or
  - c. You, or your spouse if filing jointly, could be claimed as a dependent on someone else's 2007 return.
4. Spouses and dependents of deceased employees.

**Qualified medical expenses.** Qualified medical expenses are those specified in the plan that would generally qualify for the medical and dental expenses deduction. These are explained in Publication 502, *Medical and Dental Expenses*. However, even though non-prescription medicines (other than insulin) do not qualify for the medical and dental expenses deduction, they do qualify as expenses for HRA purposes.

Qualified medical expenses from your HRA include the following.

- Amounts paid for health insurance premiums.
- Amounts paid for long-term care coverage.
- Amounts that are not covered under another health plan.

If you are covered under both an HRA and a health FSA, see Notice 2002-45, Part V, which is on page 93 of Internal Revenue Bulletin 2002-28 at [www.irs.gov/pub/irs-irbs/irb02-28.pdf](http://www.irs.gov/pub/irs-irbs/irb02-28.pdf).



*You cannot deduct qualified medical expenses as an itemized deduction on Schedule A (Form 1040) that are equal to the distribution from the HRA.*

**Qualified HSA distribution.** This is a distribution from your HRA that is transferred to your HSA, discussed earlier. The distribution must not be more than the lesser of the balance in the HRA on:

- September 21, 2006, or
- The date of the distribution.

If you were not covered by an HRA on September 21, 2006, you cannot elect to make a qualified HSA distribution from the HRA.

The following conditions must be met to make a qualified HSA distribution.

- The plan must have been amended to allow these distributions.
- You must elect to make the rollover.
- The year-end balance in the HRA must be frozen.
- The funds must be transferred within 2½ months after the end of the HRA's plan year and result in a zero balance in the HRA.
- The distribution must be contributed directly to the HSA trustee by the employer.

Only one qualified HSA distribution is allowed for each HRA.

For more information, see Notice 2007-22 on page 670 of Internal Revenue Bulletin 2007-10 at [www.irs.gov/pub/irs-irbs/irb07-10.pdf](http://www.irs.gov/pub/irs-irbs/irb07-10.pdf).

If you do not remain an eligible individual for HSA purposes during the testing period, the distribution is included in your income and is subject to a 10% additional tax. See *Qualified HSA distribution* under *Health Savings Accounts (HSAs)*, earlier.

## Balance in an HRA

Amounts that remain at the end of the year can generally be carried over to the next year. Your employer is not permitted to refund any part of the balance to you. These amounts may never be used for anything but reimbursements for qualified medical expenses. See *Qualified HSA distribution*, earlier.

## Employer Participation

For an HRA to maintain tax-qualified status, employers must comply with certain requirements that apply to other accident and health plans. Chapters 1 and 2 of Publication 15-B, *Employer's Tax Guide to Fringe Benefits*, explain these requirements.

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## How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

**Contacting your Taxpayer Advocate.** The Taxpayer Advocate Service (TAS) is an independent organization within the IRS whose employees assist taxpayers who are experiencing economic harm, who are seeking help in resolving tax problems that have not been resolved through normal channels, or who believe that an IRS system or procedure is not working as it should.

You can contact the TAS by calling the TAS toll-free case intake line at 1-877-777-4778 or TTY/TDD 1-800-829-4059 to see if you are eligible for assistance. You can also call or write to your local taxpayer advocate, whose phone number and address are listed in your local telephone directory and in Publication 1546, *Taxpayer Advocate Service – Your Voice at the IRS*. You can file Form 911, *Request for Taxpayer Advocate Service Assistance (And Application for Taxpayer Assistance Order)*, or ask an IRS employee to complete it on your behalf. For more information, go to [www.irs.gov/advocate](http://www.irs.gov/advocate).

**Taxpayer Advocacy Panel (TAP).** The TAP listens to taxpayers, identifies taxpayer issues, and makes suggestions for improving IRS services and customer satisfaction. If you have suggestions for improvements, contact the TAP, toll free at 1-888-912-1227 or go to [www.improveirs.org](http://www.improveirs.org).

**Low Income Taxpayer Clinics (LITCs).** LITCs are independent organizations that provide low income taxpayers with representation in federal tax controversies with the IRS for free or for a nominal charge. The clinics also provide tax education and outreach for taxpayers with limited English proficiency or who speak English as a second language. Publication 4134, *Low Income Taxpayer Clinic List*, provides information on clinics in your area. It is available at [www.irs.gov](http://www.irs.gov) or at your local IRS office.

**Free tax services.** To find out what services are available, get Publication 910, *IRS Guide to Free Tax Services*. It contains a list of free tax publications and describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.

Accessible versions of IRS published products are available on request in a variety of alternative formats for people with disabilities.



**Internet.** You can access the IRS website at [www.irs.gov](http://www.irs.gov) 24 hours a day, 7 days a week to:

- *E-file* your return. Find out about commercial tax preparation and *e-file* services available free to eligible taxpayers.
- Check the status of your 2007 refund. Click on *Where's My Refund*. Wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2007 tax return available because you will need to know your social security number, your filing status, and the exact whole dollar amount of your refund.
- Download forms, instructions, and publications.
- Order IRS products online.



- Research your tax questions online.
- Search publications online by topic or keyword.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Figure your withholding allowances using the withholding calculator online at [www.irs.gov/individuals](http://www.irs.gov/individuals).
- Determine if Form 6251 must be filed using our Alternative Minimum Tax (AMT) Assistant.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.



**Phone.** Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call 1-800-829-3676 to order current-year forms, instructions, and publications, and prior-year forms and instructions. You should receive your order within 10 days.
- *Asking tax questions.* Call the IRS with your tax questions at 1-800-829-1040.
- *Solving problems.* You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to [www.irs.gov/localcontacts](http://www.irs.gov/localcontacts) or look in the phone book under *United States Government, Internal Revenue Service*.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call 1-800-829-4477 to listen to pre-recorded messages covering various tax topics.
- *Refund information.* To check the status of your 2007 refund, call 1-800-829-4477 and press 1 for automated refund information or call 1-800-829-1954. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2007 tax return available because you will need to know your social security number, your filing status, and the exact whole dollar amount of your refund.

**Evaluating the quality of our telephone services.** To ensure IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to listen in on or record random

telephone calls. Another is to ask some callers to complete a short survey at the end of the call.



**Walk-in.** Many products and services are available on a walk-in basis.

- *Products.* You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- *Services.* You can walk in to your local Taxpayer Assistance Center every business day for personal, face-to-face tax help. An employee can explain IRS letters, request adjustments to your tax account, or help you set up a payment plan. If you need to resolve a tax problem, have questions about how the tax law applies to your individual tax return, or you're more comfortable talking with someone in person, visit your local Taxpayer Assistance Center where you can spread out your records and talk with an IRS representative face-to-face. No appointment is necessary, but if you prefer, you can call your local Center and leave a message requesting an appointment to resolve a tax account issue. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. To find the number, go to [www.irs.gov/localcontacts](http://www.irs.gov/localcontacts) or look in the phone book under *United States Government, Internal Revenue Service*.



**Mail.** You can send your order for forms, instructions, and publications to the address below. You should receive a response within 10 days after your request is received.

National Distribution Center  
P.O. Box 8903  
Bloomington, IL 61702-8903



**CD/DVD for tax products.** You can order Publication 1796, IRS Tax Products CD/DVD, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms, instructions, and publications.
- Bonus: Historical Tax Products DVD - Ships with the final release.
- Tax Map: an electronic research tool and finding aid.
- Tax law frequently asked questions.

- Tax Topics from the IRS telephone response system.
- Fill-in, print, and save features for most tax forms.
- Internal Revenue Bulletins.
- Toll-free and email technical support.
- The CD which is released twice during the year.
  - The first release will ship the beginning of January 2008.
  - The final release will ship the beginning of March 2008.

Purchase the CD/DVD from National Technical Information Service (NTIS) at [www.irs.gov/cdorders](http://www.irs.gov/cdorders) for \$35 (no handling fee) or call 1-877-CDFORMS (1-877-233-6767) toll free to buy the CD/DVD for \$35 (plus a \$5 handling fee). Price is subject to change.



**CD for small businesses.** Publication 3207, The Small Business Resource Guide CD for 2007, is a must for every small business owner or any taxpayer about to start a business. This year's CD includes:

- Helpful information, such as how to prepare a business plan, find financing for your business, and much more.

- All the business tax forms, instructions, and publications needed to successfully manage a business.
- Tax law changes for 2007.
- Tax Map: an electronic research tool and finding aid.
- Web links to various government agencies, business associations, and IRS organizations.
- “Rate the Product” survey—your opportunity to suggest changes for future editions.
- A site map of the CD to help you navigate the pages of the CD with ease.
- An interactive “Teens in Biz” module that gives practical tips for teens about starting their own business, creating a business plan, and filing taxes.

An updated version of this CD is available each year in early April. You can get a free copy by calling 1-800-829-3676 or by visiting [www.irs.gov/smallbiz](http://www.irs.gov/smallbiz).



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