Understanding How Medicare Coverage Affects HSA Eligibility to Avoid Surprise Tax Penalties

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Health Savings Accounts ("HSA") are an increasingly popular savings arrangement that allows enrollees to pay for certain out-of-pocket medical expenses on a tax-favored basis. Although there are many rules that govern HSA eligibility and contribution limits, one way an individual loses eligibility to contribute is if he/she becomes entitled to Medicare. Because Medicare entitlement disqualifies an individual from making HSA contributions, individuals should carefully consider how Medicare interacts with HSA eligibility.

Background

Under Section 223 of the Internal Revenue Code, to be HSA-eligible and contribute to an HSA, an individual: (i) must be covered by a qualifying High-Deductible Health Plan ("HDHP"); (ii) must not have impermissible health coverage, such as a health flexible spending arrangement; (iii) cannot be claimed as a dependent on another individual's tax return; and (iv) cannot be enrolled in Medicare. Beginning with the first month in which an individual is entitled to Medicare, his/her HSA contribution limit is reduced to zero. In other words, an individual is not eligible to contribute to an HSA once Medicare coverage begins. The difficulty is determining when Medicare entitlement begins because there are common circumstances in which Medicare enrollment may be automatic, delayed by choice, and even retroactive (depending on the individual's situation).

Medicare is divided into two main parts: hospital insurance that covers hospital care, skilled nursing facility care, hospice, and home health services ("Part A"), and supplementary medical insurance that covers physicians' services and other health care expenses ("Part B"). In most cases, it is not necessary to pay a premium for Part A benefits. However, a premium is required for Part B benefits.

To be "entitled to Medicare," an individual generally must be both eligible for Medicare and enrolled in Medicare. Individuals enrolled in either Part A or Part B of Medicare cannot contribute to an HSA. However, simply refraining from Medicare enrollment may not be enough to maintain HSA eligibility — in some cases, an individual is automatically enrolled in Medicare without ever submitting an application for Medicare benefits.

Social Security Retirement Benefits Impact Medicare Entitlement

An individual's enrollment in Medicare benefits is tied to whether or not he/she has started receiving Social Security retirement benefits. Employees may be surprised to know that applying for Social Security retirement benefits can trigger Medicare benefits.

For Social Security retirement benefits due to age, "full retirement" age is the age at which a person may first become eligible to full or unreduced benefits (usually age 65 or 66). However, regardless of a person's full retirement age, a person may start receiving Social Security benefits (at a reduced amount) as early as age 62, if certain requirements are met. This means that an individual may receive reduced Social Security retirement benefits before he/she is eligible for age-based Medicare at age 65.

Automatic Medicare Enrollment

For individuals already receiving Social Security retirement benefits at least four months prior to age 65, enrollment in Medicare Part A and Part B is automatic upon reaching age 65. Although an individual who is automatically enrolled may refuse Part B coverage because it is a voluntary program that requires premium payments, he/she generally cannot waive Part A. Therefore, if an individual is receiving Social Security retirements benefits, she cannot opt out of Part A in order to continue funding her HSA.

> ***Example 1 — Enroll In Medicare at Age 65:***
> Current employee turns 62 and becomes eligible for reduced Social Security retirement benefits, but does not apply for benefits. Three months before the employee turns age 65, she submits an application to enroll in Medicare. Employee's Medicare entitlement date is the month she turns age 65. Employee is ineligible for the HSA as of the month she attains age 65 because that is when she becomes both eligible and enrolled in Medicare.
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> ***Example 2 — Begins Social Security Benefits Before Age 65:*** Current employee turns age 63 and becomes eligible for reduced Social Security retirement benefits. Employee applies for and receives Social Security benefits at age 63. When Employee turns age 65, she is automatically enrolled in Part A of Medicare because she is already receiving Social Security benefits. She is not eligible to contribute to the HSA as of the month she attains age 65 because she is enrolled in Part A of Medicare.

Delaying Medicare Enrollment

Individuals who have not yet applied for Social Security retirement benefits must affirmatively file an application for Medicare Part A and/or Part B benefits in order to enroll. Consequently, a Medicare-eligible individual may postpone her Medicare entitlement to continue making HSA contributions. The Centers for Medicare & Medicaid Services ("CMS"), which administers the Medicare Program, has confirmed that a Medicare-eligible individual seeking to continue HSA contributions should not apply for Medicare benefits or Social Security retirement benefits.[1]

Note: A late enrollment penalty is normally assessed if an individual delays Part B enrollment. The penalty may be avoided if the individual is covered by an employer-sponsored group health plan based on his/her (or his/her spouse's) current employment, and he/she timely enrolls during a special enrollment period. Consolidated Omnibus Budget Reconciliation Act ("COBRA") continuation coverage does not qualify as health coverage based on current employment, thus a late enrollment penalty will still be assessed. For example, an individual over age 65 who postpones

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1 https://www.medicare.gov/sign-up-change-plans/get-parts-a-and-b/special-conditions/special-conditions.html

Part B benefits because she is covered under her current employer's group health plan as an active employee will not be assessed the late penalty when she later enrolls in Part B, assuming her enrollment is timely.

Retroactive Coverage Issue

Although some individuals can effectively postpone HSA ineligibility, it is important to note that Medicare Part A coverage is retroactively effective for individuals who delay Medicare (or Social Security) benefits. If an individual does not enroll in Medicare when he/she is first eligible (and is not enrolled in Social Security), his/her later enrollment in Medicare Part A is retroactive for six months. Therefore, if an employee initially declines Social Security retirement benefits and Medicare coverage in order to contribute to the HSA and later elects to enroll in Medicare, the individual will be retroactively enrolled in Medicare Part A for the preceding six months, making his/her HSA ineligible for those six months.

The following explanation can be found on the Medicare website:

> "Premium-free Part A coverage begins 6 months back from the date you apply for Medicare (or Social Security/ RRB benefits), but no earlier than the first month you were eligible for Medicare. To avoid a tax penalty, you should stop contributing to your HSA at least 6 months before you apply for Medicare."

> ***Example 3 — Enroll in Medicare After Age 65:***
> Current employee turns age 62 and does not apply for Social Security retirement benefits. When the employee turns age 65, she does not enroll in Medicare and does not apply for Social Security benefits. Employee retires at age 68 and applies for Medicare and Social Security benefits at that time.

> Employee's Part A Medicare entitlement is retroactively effective six months prior to her application for Medicare benefits (age 67 ½), because she applied for Medicare and Social Security benefits more than 6 months after becoming initially eligible. Accordingly, employee is not eligible for the HSA as of age 67 ½, even though she delayed Medicare enrollment until age 68, because that is the date her Medicare Part A benefits become effective.

Further IRS Guidance Regarding Contribution Limits in the Year of Medicare Entitlement

The Internal Revenue Service ("IRS") has released two information letters explaining the HSA contribution limit for the year in which an individual reaches age 65 and enrolls in Medicare.

Information Letter 2016-0014 states that for the year in which an individual attains age 65, the amount of the maximum HSA contribution is prorated based on the number of months the individual is HSA-eligible (*e.g.*, has HDHP coverage, does not have disqualifying coverage, is not enrolled in Medicare). For example, if an individual is enrolled in self-only HDHP coverage for nine months before enrolling in Medicare (and she satisfied all other HSA eligibility requirements during the nine months), she would be allowed an HSA contribution of $2,512.50 ($3,350 x 9/12). Additionally, she would be allowed a catch-up contribution of $750 ($1,000 x 9/12) because she is over age 55.

Information Letter 2016-0003 applies the proration principle (described above) to spouses who turn 65 in the same year. For example, two married spouses are enrolled in family HDHP coverage for four months before the wife enrolls in Medicare in April. For those four months, the spouses are allowed an HSA contribution of $2,250 ($6,750 x 4/12) that is divided between the couple's individual HSAs. In addition, the wife is allowed a catch-up contribution of $330 ($1,000 x 4/12). The husband, who turns 65 in October and continued with self-only HDHP coverage after his wife enrolled in Medicare, would be allowed an additional contribution of $1,396 ($3,350 x 5/12). He would also be allowed a catch-up contribution of $750 ($1,000 x 9/12). Note, this example assumes that each spouse satisfied all of the HSA eligibility rules during the months in which they were enrolled in HDHP coverage.

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