

## Sec. 220. Medical Savings Accounts

**(a) Deduction allowed.** In the case of an individual who is an eligible individual for any month during the taxable year, there shall be allowed as a deduction for the taxable year an amount equal to the aggregate amount paid in cash during such taxable year by such individual to a medical savings account of such individual.

### **(b) Limitations**

**(1)** In general. The amount allowable as a deduction under subsection (a) to an individual for the taxable year shall not exceed the sum of the monthly limitations for months during such taxable year that the individual is an eligible individual.

**(2)** Monthly limitation. The monthly limitation for any month is the amount equal to 1/12 of \*

(A) in the case of an individual who has self-only coverage under the high deductible health plan as of the first day of such month, 65 percent of the annual deductible under such coverage, and

(B) in the case of an individual who has family coverage under the high deductible health plan as of the first day of such month, 75 percent of the annual deductible under such coverage ,

**(3)** Special rule for married individuals. In the case of individuals who are married to each other, if either spouse has family coverage

(A) both spouses shall be treated as having only such family coverage (and if such spouses each have family coverage under different plans, as having the family coverage with the lowest annual deductible), and  
(B) the limitation under paragraph (1) (after the application of subparagraph (A) of this paragraph) shall be divided equally between them unless they agree on a different division.

**(4)** Deduction not to exceed compensation

(A) Employees. The deduction allowed under subsection (a) for contributions as an eligible individual described in sub clause (I) of subsection (c)(1)(A)(iii) shall not exceed such individual's wages, salaries, tips, and other employee compensation which are attributable to such individual's employment by the employer referred to in such sub clause.

(B) Self-employed individuals. The deduction allowed under subsection (a) for contributions as an eligible individual described in sub clause (II) of subsection (e)(1)(A)(iii) shall not exceed such individual's earned income (as defined in section 401 (e)(1)) derived by the taxpayer from the trade or business with respect to which the high deductible health plan is established.

(C) Community property laws not to apply The limitations under this paragraph shall be determined without regard to community property laws.

**(5)** Coordination with exclusion for employer contributions. No deduction shall be allowed under this section for any amount paid for any taxable year to a medical savings account of an individual if

(A) any amount is contributed to any medical savings account of such individual for such year which is excludable from gross income under section 106(b), or

(B) if such individual's spouse is covered under the high deductible health plan covering such individual, any amount is contributed for such year to any medical savings account of such spouse which is so excludable.

**(6)** Denial of deduction to dependents. No deduction shall be allowed under this section to any individual with respect to whom a deduction under section 151 is allowable to another taxpayer for a taxable year beginning in the calendar year in which such individual's taxable year begins.

**(7)** Medicate eligible individuals. The limitation under this subsection for any month with respect to an individual shall be zero for the first month such individual is entitled to benefits under title XVIII of the Social Security Act and for each month thereafter.

### **(c) Definitions**

For purposes of this section

**(1)** Eligible individual

(A) In general. The term "eligible individual" means, with respect to any one, any individual if

(i) such individual is covered under a high deductible health plan as of the 1st day of such month,

(ii) such individual is not, while covered under a high deductible health plan, covered under any health plan (I) which is not a high deductible health plan, and

(II) which provides coverage for any benefit which is covered under the high deductible health plan, and

(iii) (I) the high deductible health plan covering such individual is established and maintained by the employer of such individual or of the spouse of such individual and such employer is a small employer, or (II) such individual is an employee (within the meaning of section 4-OJ-(c)(1)) or the spouse of such an employee and the high deductible health plan covering such individual is not established or maintained by any employer of such individual or spouse.

**(B)** Certain coverage disregarded Subparagraph (A) (ii) shall be applied without regard to

(i) coverage for any benefit provided by permitted insurance, and

(ii) coverage (whether through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

**(C) Continued eligibility of employee and spouse establishing medical savings accounts** If, while an employer is a small employer

(i) any amount is contributed to a medical savings account of an individual who is an employee of such employer or the spouse of such an employee, and

(ii) such amount is excludable from gross income under section 106(b) or allowable as a deduction under this section, such individual shall not cease to meet the requirement of subparagraph (A)(iii)(I) by reason of such employer ceasing to be a small employer so long as such employee continues to be an employee of such employer.

**(D) Limitations on eligibility.** For limitations on number of taxpayers who are eligible to have medical savings accounts, see subsection (i).

(2) High deductible health plan

(A) In general. The term "high deductible health plan" means a health plan

(i) in the case of self-only coverage, which has an annual deductible which is not less than \$1,500 and not more than \$2,250,

(ii) in the case of family coverage, which has an annual deductible which is not less than \$3,000 and not more than \$4,500, and

(iii) the annual out-of-pocket expenses required to be paid under the plan (other than for premiums) for covered benefits does not exceed (I) \$3,000 for self-only coverage, and (II) \$5,500 for family coverage.

(B) Special rules

(i) Exclusion of certain plans. Such term does not include a health plan if substantially all of its coverage is coverage described in paragraph (1)(B).

(ii) Safe harbor for absence of preventive care deductible A plan shall not fail to be treated as a high deductible health plan by reason of failing to have a deductible for preventive care if the absence of a deductible for such care is required by State law.

(3) Permitted insurance

The term "permitted insurance" means

(A) insurance if substantially all of the coverage provided under such insurance relates to

(i) liabilities incurred under workers' compensation laws,

(ii) tort liabilities,

(iii) liabilities relating to ownership or use of property, or

(iv) such other similar liabilities as the Secretary may specify by regulations,

(B) insurance for a specified disease or illness, and

(C) insurance paying a fixed amount per day (or other period) of hospitalization.

(4) Small employer

(A) In general. The term "small employer" means, with respect to any calendar year, any employer if such employer employed an average of 50 or fewer employees on business days during either of the 2 preceding calendar years. For purposes of the preceding sentence, a preceding calendar year may be taken into account only if the employer was in existence throughout such year. (B) Employers not in existence in preceding year In the case of an employer which was not in existence throughout the 1st preceding calendar year, the determination under subparagraph (A) shall be based on the average number of employees that it is reasonably expected such employer will employ on business days in the current calendar year. (C) Certain growing employers retain treatment as small employer

The term "small employer" includes, with respect to any calendar year, any employer if

(i) such employer met the requirement of subparagraph (A) (determined without regard to subparagraph (B)) for any preceding calendar year after 1996,

(ii) any amount was contributed to the medical savings account of any employee of such employer with respect to coverage of such employee under a high deductible health plan of such employer during such preceding calendar year and such amount was excludable from gross income under section 106(b) or allowable as a deduction under this section, and (iii) such employer employed an average of 200 or fewer employees on business days during each preceding calendar year after 1996.

(D) Special rules

(i) Controlled groups. For purposes of this paragraph, all persons treated as a single employer under subsection (b), (c), (m), or (o) of section 414 shall be treated as 1 employer.

(ii) Predecessors

Any reference in this paragraph to an employer shall include a reference to any predecessor of such employer.

(5) Family coverage. The term "family coverage" means any coverage other than self-only coverage.

#### **(d) Medical savings account**

For purposes of this section

**(1) Medical savings account.** The term "medical savings account" means a trust created or organized in the

United States exclusively for the purpose of paying the qualified medical expenses of the account holder, but only if the written governing instrument creating the trust meets the following requirements:

(A) Except in the case of a rollover contribution described in subsection (f)(5), no contribution will be accepted

(i) unless it is in cash, or

(ii) to the extent such contribution, when added to previous contributions to the trust for the calendar year, exceeds 75 percent of the highest annual limit deductible permitted under subsection (c)(2)(A)(ii) for such calendar year.

(B) The trustee is a bank (as defined in section 408(n)), an insurance company (as defined in section 816), or another person who demonstrates to the satisfaction of the Secretary that the manner in which such person will administer the trust will be consistent with the requirements of this section.

(C) No part of the trust assets will be invested in life insurance contracts.

(D) The assets of the trust will not be commingled with other property except in a common trust fund or common investment fund.

(E) The interest of an individual in the balance in his account is non-forfeitable.

**(2) Qualified medical expenses**

(A) In general. The term "qualified medical expenses" means, with respect to an account holder, amounts paid by such holder for medical care (as defined in section 213(d)) for such individual, the spouse of such individual, and any dependent (as defined in section 152) of such individual, but only to the extent such amounts are not compensated for by insurance or otherwise.

(B) Health insurance may not be purchased from account

(i) In general. Subparagraph (A) shall not apply to any payment for insurance.

(ii) Exceptions

Clause (i) shall not apply to any expense for coverage under

(I) a health plan during any period of continuation coverage required under any Federal law,

(II) a qualified long-term care insurance contract (as defined in section 7702(b)), or

(III) a health plan during a period in which the individual is receiving unemployment compensation under any Federal or State law.

(C) Medical expenses of individuals who are not eligible individuals Subparagraph (A) shall apply to an amount paid by an account holder for medical care of an individual who is not described in clauses (i) and (ii) of subsection (c)(1)(A) for the month in which the expense for such care is incurred only if no amount is contributed (other than a reliever contribution) to any medical savings account of such account holder for the taxable year which includes such month. This subparagraph shall not apply to any expense for coverage described in sub clause (I) or (III) of subparagraph (B)(ii).

**(3) Account holder.** The term "account holder" means the individual on whose behalf the medical savings account was established.

**(4) Certain rules to apply.** Rules similar to the following rules shall apply for purposes of this section:

(A) Section 213(d)(2) (relating to no deduction for relievers).

(B) Section 219(f)(3) (relating to time when contributions deemed made).

(C) Except as provided in section 106(b), section 219(t)(5) (relating to employer payments).

(D) Section 408(g) (relating to community property laws).

(E) Section 408(h) (relating to custodial accounts).

**(e) Tax treatment of accounts**

(1) In general

A medical savings account is exempt from taxation under this subtitle unless such account has ceased to be a medical savings account. Notwithstanding the preceding sentence, any such account is subject to the taxes imposed by section 511 (relating to imposition of tax on unrelated business income of charitable, etc. organizations).

(2) Account terminations

Rules similar to the rules of paragraphs (2) and (4) of section 408(e) shall apply to medical savings accounts, and any amount treated as distributed under such rules shall be treated as not used to pay qualified medical expenses.

**(f) Tax treatment of distributions**

(1) Amounts used for qualified medical expenses

Any amount paid or distributed out of a medical savings account which is used exclusively to pay qualified medical expenses of any account holder shall not be includible in gross income.

(2) Inclusion of amounts not used for qualified medical expenses

Any amount paid or distributed out of a medical savings account which is not used exclusively to pay the qualified medical expenses of the account holder shall be included in the gross income of such holder.

(3) Excess contributions returned before due date of return

(A) In general

If any excess contribution is contributed for a taxable year to any medical savings account of an individual, paragraph (2) shall not apply to distributions from the medical savings accounts of such individual (to the extent such distributions do not exceed the aggregate excess contributions to all such accounts of such individual for such year) if

(i) such distribution is received by the individual on or before the last day prescribed by law (including extensions of time) for filing such individual's return for such taxable year, and  
(ii) such distribution is accompanied by the amount of net income attributable to such excess contribution. Any net income described in clause (ii) shall be included in the gross income of the individual for the taxable year in which it is received.

(B) Excess contribution

For purposes of subparagraph (A), the term "excess contribution" means any contribution (other than a rollover contribution) which is neither excludable from gross income under section 106(b) nor deductible under this section.

(4) Additional tax on distributions not used for qualified medical expenses

(A) In general

The tax imposed by this chapter on the account holder for any taxable year in which there is a payment or distribution from a medical savings account of such holder which is includible in gross income under paragraph (2) shall be increased by 15 percent of the amount which is so includible.

(B) Exception for disability or death

Subparagraph (A) shall not apply if the payment or distribution is made after the account holder becomes disabled within the meaning of section 72(m)(7) or dies.

(C) Exception for distributions after medicare eligibility

Subparagraph (A) shall not apply to any payment or distribution after the date on which the account holder attains the age specified in section 1811 of the Social Security Act.

(5) Rollover contribution

An amount is described in this paragraph as a rollover contribution if it meets the requirements of subparagraphs (A) and (B).

(A) In general

Paragraph (2) shall not apply to any amount paid or distributed from a medical savings account to the account holder to the extent the amount received is paid into a medical savings account for the benefit of such holder not later than the 60th day after the day on which the holder receives the payment or distribution.

(B) Limitation

This paragraph shall not apply to any amount described in subparagraph (A) received by an individual from a medical savings account if, at any time during the 1-year period ending on the day of such receipt, such individual received any other amount described in subparagraph (A) from a medical savings account which was not includible in the individual's gross income because of the application of this paragraph.

(6) Coordination with medical expense deduction

For purposes of determining the amount of the deduction under section 213(d)(1)(B), any payment or distribution out of a medical savings account for qualified medical expenses shall not be treated as an expense paid for medical care.

(7) Transfer of account incident to divorce

The transfer of an individual's interest in a medical savings account to an individual's spouse or former spouse under a divorce or separation instrument described in subparagraph (A) of section 71(b)(2) shall not be considered a taxable transfer made by such individual notwithstanding any other provision of this subtitle, and such interest shall, after such transfer, be treated as a medical savings account with respect to which such spouse is the account holder.

(8) Treatment after death of account holder

(A) Treatment if designated beneficiary is spouse

If the account holder's surviving spouse acquires such holder's interest in a medical savings account by reason of being the designated beneficiary of such account at the death of the account holder, such medical savings account shall be treated as if the spouse were the account holder.

(B) Other cases

(i) In general

If, by reason of the death of the account holder, any person acquires the account holder's interest in a medical savings account in a case to which subparagraph

(A) does not apply

(I) such account shall cease to be a medical savings account as of the date of death, and

(I-I) an amount equal to the fair market value of the assets in such account on such date shall be includible if such person is not the estate of such holder, in such person's gross income for the taxable year which includes such date, or if such person is the estate of such holder, in such holder's gross income for the last taxable year of such holder.

\* (ii) Special rules

(I) Reduction of inclusion for pre-death expenses

The amount includible in gross income under clause (i) by any person (other than the estate) shall be reduced by the amount of qualified medical expenses which were incurred by the decedent before the date of the decedent's death and paid by such person within 1 year after such date.

(II) Deduction for estate taxes

An appropriate deduction shall be allowed under section 691 (c) to any person (other than the decedent or the decedent's spouse) with respect to amounts included in gross income under clause (i) by such person.

(g) Cost-of-living adjustment

In the case of any taxable year beginning in a calendar year after 1998, each dollar amount in subsection (c) (2) shall be increased by an amount equal to \*

(1) such dollar amount, multiplied by

(2) the cost-of-living adjustment determined under section 1 (f) (3) for the calendar year in which such taxable year begins by substituting "calendar year 1997" for "calendar year 1992" in subparagraph (B) thereof. If any increase under the preceding sentence is not a multiple of \$50, such increase shall be rounded to the nearest multiple of \$50.

(h) Reports

The Secretary may require the trustee of a medical savings account to make such reports regarding such account to the Secretary and to the account holder with respect to contributions, distributions, and such other matters as the Secretary determines appropriate. The reports required by this subsection shall be filed at such time and in such manner and furnished to such individuals at such time and in such manner as may be required by the Secretary.

(i) Limitation on number of taxpayers having medical savings accounts

(1) In general

Except as provided in paragraph (5), no individual shall be treated as an eligible individual for any taxable year beginning after the cut-off year unless

(A) such individual was an active MSA participant for any taxable year ending on or before the close of the cut-off year, or

(B) such individual first became an active MSA participant for a taxable year ending after the cut-off year by reason of coverage under a high deductible health plan of an MSA - participating employer.

(2) Cut-off year

For purposes of paragraph (1), the term "cut-off year" means the earlier of

(A) calendar year 2000, or

(B) the first calendar year before 2000 for which the Secretary determines under subsection (j) that the numerical limitation for such year has been exceeded.

(3) Active MSA participant

For purposes of this subsection

(A) In general

The term "active MSA participant" means, with respect to any taxable year, any individual who is the account holder of any medical savings account into which any contribution was made which was excludable from gross income under section 106(b), or allowable as a deduction under this section, for such taxable year.

(B) Special rule for cut-off years before 2000

In the case of a cut-off year before 2000 (i) an individual shall not be treated as an eligible individual for any month of such year or an active MSA participant under paragraph (1)(A) unless such individual is, on or before the cut-off date, covered under a high deductible health plan, and (ii) an employer shall not be treated as an MSA -participating employer unless the employer, on or before the cut-off date, offered coverage under a high deductible health plan to any employee.

(C) Cut-off date

For purposes of subparagraph (B) (i)

In general, except as otherwise provided in this subparagraph, the cut-off date is October 1 of the cut-off year.

(ii) Employees with enrollment periods after October 1

In the case of an individual described in sub clause (I) of subsection (c) (1) (A) (iii), if the regularly scheduled enrollment period for health plans of the individual's employer occurs during the last 3 months of the cut-off year, the cut-off date is December 31 of the cut-off year.

(iii) Self-employed individuals

In the case of an individual described in sub clause (II) of subsection (c) (1) (A) (iii), the cut-off date is November 1 of the cut-off year.

(iv) Special rules for 1997

If 1997 is a cut-off year by reason of subsection (j) (1) (A)

(I) each of the cut-off dates under clauses (i) and (iii) shall be 1 month earlier than the date determined without regard to this clause, and

(II) clause (ii) shall be applied by substituting "4 months" for "3 months".

(4) MSA -participating employer

For purposes of this subsection, the term "MSA-participating employer" means any small employer if (A) such employer made any contribution to the medical savings account of any employee during the cut-off year or any preceding calendar year which was excludable from gross income under section 106(b), or (B) at least 20 percent of the employees of such employer who are eligible individuals for any month of the cut-off year by reason of coverage under a high deductible health plan of such employer each made a contribution of at least \$100 to their medical savings accounts for any taxable year ending with or within the cut-off year which was allowable as a deduction under this section.

(5) Additional eligibility after cut-off year

If the Secretary determines under subsection (j) (2) (A) that the numerical limit for the calendar year following a cut-off year described in paragraph (2) (B) has not been exceeded

(A) this subsection shall not apply to any otherwise eligible individual who is covered under a high deductible health plan during the first 6 months of the second calendar year following the cut-off year (and such individual shall be treated as an active MSA participant for purposes of this subsection if a contribution is made to any medical savings account with respect to such coverage), and

(B) any employer who offers coverage under a high deductible health plan to any employee during such 6-month period shall be treated as an MSA-participating employer for purposes of this subsection if the requirements of paragraph (4) are met with respect to such coverage.

For purposes of this paragraph, subsection (j) (2) (A) shall be applied for 1998 by substituting "750,000" for "600,000".

(j) Determination of whether numerical limits are exceeded

(1) Determination of whether limit exceeded for 1997

The numerical limitation for 1997 is exceeded if, based on the reports required under paragraph (4), the number of medical savings accounts established as of

(A) April 30, 1997, exceeds 375,000, or

(B) June 30, 1997, exceeds 525,000.

(2) Determination of whether limit exceeded for 1998 or 1999

(A) In general

The numerical limitation for 1998 or 1999 is exceeded if the sum of

(i) the number of MSA returns filed on or before April 15 of such calendar year for taxable years ending with or within the preceding calendar year, plus

(ii) the Secretary's estimate (determined on the basis of the returns described in clause (i)) of the number of MSA returns for such taxable years which will be filed after such date, exceeds 600,000 (750,000 in the case of 1999). For purposes of the preceding sentence, the term "MSA return" means any return on which any exclusion is claimed under section 106(b) or any deduction is claimed under this section.

(B) Alternative computation of limitation

The numerical limitation for 1998 or 1999 is also exceeded if the sum of

(i) 90 percent of the sum determined under subparagraph (A) for such calendar year, plus

(ii) the product of 2.5 and the number of medical savings accounts established during the portion of such year preceding July 1 (based on the reports required under paragraph (4)) for taxable years beginning in such year, exceeds 750,000.

(3) Previously uninsured individuals not included in determination

(A) In general

The determination of whether any calendar year is a cut-off year shall be made by not counting the medical savings account of any previously uninsured individual.

(B) Previously uninsured individual

For purposes of this subsection, the term "previously uninsured individual" means, with respect to any medical savings account, any individual who had no health plan coverage (other than coverage referred to in subsection (e) (1) (B)) at any time during the 6 month period before the date such individual's coverage under the high deductible health plan commences.

(4) Reporting by MSA trustees

(A) In general

Not later than August 1 of 1997, 1998, and 1999, each person who is the trustee of a medical savings account established before July 1 of such calendar year shall make a report to the Secretary (in such form and manner as the Secretary shall specify) which specifies

(i) the number of medical savings accounts established before such July 1 (for taxable years beginning in such calendar year) of which such person is the trustee,

(ii) the name and TIN of the account holder of each such account and

(iii) the number of such accounts which are accounts of previously uninsured individuals.

(B) Additional report for 1997

Not later than June 1, 1997, each person who is the trustee of a medical savings account established before May 1, 1997, shall make an additional report described in subparagraph (A) but only with respect to accounts established before May 1, 1997.

(C) Penalty for failure to file report

The penalty provided in section 6-6-9, -3(a) shall apply to any report required by this paragraph, except that

(i) such section shall be applied by substituting "\$25" for "\$50", and  
(ii) the maximum penalty imposed on any trustee shall not exceed \$5,000.

(D) Aggregation of accounts

To the extent practicable, in determining the number of medical savings accounts on the basis of the reports under this paragraph, all medical savings accounts of an individual shall be treated as 1 account and all accounts of individuals who are married to each other shall be treated as 1 account.

(5) Date of making determinations

Any determination under this subsection that a calendar year is a cut-off year shall be made by the Secretary and shall be punished not later than October 1 of such year.

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