The Advanced Consulting Group

White paper

Using an HSA to pay for long-term care

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Nationwide strives to constantly innovate and expand its services and products to help its clients plan for and live in retirement. Toward that end, Nationwide has very recently rolled out two new product offerings: (1) a health savings account (usually referred to as an "HSA"), which will be offered to clients of Nationwide's retirement plan business, and (2) a linked benefit long-term-care ("LTC") policy known as CareMatters II, which is LTC coverage linked to fixed universal life insurance that will replace the original linked LTC policy, YourLife CareMatters®. So, let us look at both HSAs and LTC policies in more detail, as well as see how these two products can partner with one another to enhance long-term planning and saving for retirement.

HSA background

An HSA is a tax-exempt trust or custodial account set up with a qualified HSA trustee to pay or reimburse qualified medical expenses.[1] This means that amounts contributed to an HSA (and any earnings on those contributions) are not subject to federal income tax — so long as they are used to pay for qualified medical expenses. If amounts contributed to an HSA are later distributed to pay for any expense other than a qualified medical expense, that amount (as well as any earnings on those HSA contributions) is subject to regular income tax. In addition, if such distribution for the non-qualified medical expense occurs before the HSA-owner reaches age 65, it will also be subject to an additional 20% penalty tax![2]

Qualified medical expenses are defined by the Internal Revenue Code (the "Code") to be the costs of diagnosis, cure, mitigation, treatment, or prevention of disease, and for the purpose of affecting any part or function of the body.[3] This definition is quite broad, and consequently many medical, prescription drug, dental, and vision-related expenses are safely considered to be qualified medical expenses. Another noteworthy qualified medical expense to be aware of is the cost of "any qualified long-term care insurance contract."[4] This means that an individual may use funds from his or her HSA (subject to the age-based limits described below) to directly pay for or be reimbursed for LTC premiums on a tax-free basis.

In order to be eligible to contribute to an HSA (*i.e.*, to be "HSA-eligible"), an individual must (1) be covered under a high deductible health plan (an "HDHP"), (2) have no other disqualifying coverage, (3) not be enrolled in Medicare, and (4) not be claimed as a dependent on someone else's tax return.[5]

A HDHP is a health plan that has a higher minimum annual deductible than "typical" health plans, but still has an IRS imposed maximum limit on the sum of the annual deductible and out-of-pocket medical expenses[6] that one must pay. The following table[7] shows the minimum annual deductible and maximum annual deductible and other out-of-pocket expenses for self-only and family (i.e., HSA-eligible individual plus at least one other individual) HDHP coverage for 2019:

	Self-only coverage	Family coverage
Minimum annual deductible	$1,350	$2,700
Maximum annual deductible and other out-of-pocket expenses	$5,750	$13,500

Other "disqualifying coverage" that prevents HSA eligibility is generally any other health coverage that is not an HDHP.[8] Such disqualifying coverage includes coverage by a spouse's non-HDHP insurance plan or coverage under a general-purpose health FSA or another employer-provided HRA.[9]

Once an individual determines that he or she is HSA-eligible, that person may contribute to his or her own HSA in one of two ways. The first is by working with his or her employer to coordinate pre-tax employee contributions (*i.e.*, payroll deferrals) via that employer's Code Section 125 cafeteria plan to an HSA established by the individual employee. This reduces the amount of the employee's compensation subject to both federal income[10] and FICA[11] tax. The other possible method is for an individual to make post-tax contributions to his or her own HSA, which can then be deducted from gross income when the individual files his or her federal and state income tax return.

LTC policy background

As described above, the IRS considers the premiums for traditional long-term care insurance contracts to be a qualified medical expense that may be paid for or reimbursed from an HSA on a tax-free basis, subject to age based limitations. The following table shows the limits on the amount of HSA funds that may be used to pay for LTC premiums on a tax-free basis, based on the age of the HSA-owner:[12]

Attained age of HSA-owner before end of tax year	Annual LTC premium limit
Age 40 or under	$420
Age 41 to 50	$780
Age 51 to 60	$1,560
Age 61 to 70	$4,160
Age 71+	$5,200

However, unlike traditional long-term care contracts, LTC riders on life insurance-based policies present a challenge to this general rule, because although LTC riders and linked-benefit LTC policies are intended to be qualified long-term care insurance contracts under Section 7702B of the Code, the LTC coverage provided by these riders are attached to a life insurance chassis, and thus are subject to additional rules. One such important rule comes from the Pension Protection Act 2006, which states that if the cost for an LTC rider on a life insurance policy is paid for by a deduction from the cash surrender value, then it will not be considered a qualified medical expense.

Thankfully, not all LTC riders on life insurance policies are structured to be paid for by such a deduction from the life insurance policy's cash surrender value. If the riders providing the LTC coverage (LTC Acceleration Rider, Extension of Benefits Rider, and Inflation Rider) attached to the life insurance policy are paid for with separate identifiable premiums, then these separate premiums will be considered a qualified medical expense. In this circumstance, the LTC policy owner can request a tax-free HSA distribution to pay for the LTC premiums up to his or her age-based limit. However, please keep in mind that an individual cannot use HSA dollars to pay for LTC premiums and also take a Code Section 213 medical deduction for those same premiums paid. That individual may choose between those two options. While the savings are equivalent between both those options, if an individual has HSA dollars to use, it is generally the easier route to take because there is no 10% floor eligibility requirement.

From an administrative standpoint, it is not typical for the HSA provider to pay the life insurance carrier directly for the LTC premium. It is more common for the policy owner to pay LTC premiums out-of-pocket and then request a tax-free distribution from his or her HSA to be reimbursed (up to the allowable age-based amount described above). Finally, note that the life insurance premium itself cannot be paid for or reimbursed by tax-free dollars from an HSA, because it is not a qualified medical expense.

Using an HSA to help pay for Nationwide CareMatters II®

Nationwide has been offering LTC coverage on life insurance for nearly 20 years. In the past, the charges for the original LTC rider, LTC rider II, LTC rider on SUL II, and YourLife CareMatters were deducted each month directly from cash surrender value. This means that they were structured in such a manner as to preclude payment from an HSA on a tax-free basis.

However, Nationwide's newest linked benefit LTC policy, CareMatters II, is structured differently. CareMatters II is designed so that each component of the policy has its own separate identifiable premium. Because the separate premiums for the LTC acceleration rider, the extension of benefits rider, and the inflation rider all have separate premiums, they will each be considered qualified medical expenses. This means that cumulative annual premium amounts (up to the age-based limits described in the table above) for Nationwide's CareMatters II may be paid by tax-free distributions from an HSA!

Final thoughts

- Contributing to HSAs is a great way to reduce current taxable income as well as plan and save for healthcare and LTC expenses on a tax-free basis.
- Annual premiums for CareMatters II may be paid from tax-free dollars from any HSA, including Nationwide's new HSA.
- With the addition of HSAs and CareMatters II, Nationwide now offers two new products that, both individually and collectively, can help clients plan and save for healthcare and LTC expenses during retirement on a tax-free basis.

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1 IRC §223(d)(1), IRS Publication 969 (2018).
2 IRC §223(f)(4), IRS Publication 969 (2018).
3 IRC 223(d)(2), IRC 213(d)(1).
4 *Id*.
5 IRC 223(c)(1), IRS Notice 2004-2, IRS Publication 969 (2018).
6 Out-of-pocket expenses include copayments and other amounts, but do not include premiums.
7 The limits in this table do not apply to deductibles and expenses for out-of-network services if the HDHP 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.
8 IRS Notice 2004-2.
9 IRS Publication 969 (2018).
10 And generally state income tax as well.
11 FICA stands for the "Federal Insurance Contributions Act." FICA is composed of the old-age, survivors, and disability insurance taxes (*i.e.*, Social Security) and the hospital insurance tax (*i.e.*, Medicare).
12 IRS Publication 502.