

MEDICAL SAVINGS ACCOUNTS

To better serve you, the Arizona Department of Revenue offers online assistance and filing of your business taxes. To file your taxes online or to register to use the website, go to www.aztaxes.gov.

What is an MSA?

An MSA is a trust created or organized in the United States for the purpose of paying the qualified medical expenses of the account holder.

What are the MSA provisions?

The provisions, with some exceptions, are based on the federal MSA provisions contained in Internal Revenue Code (I.R.C.) § 220.

For Arizona purposes, an MSA must be established and maintained as provided by I.R.C. § 220. Therefore, under the Arizona provisions, participation in an MSA is conditioned upon coverage under a high deductible health plan. This is a health insurance plan that has deductibles and out-of-pocket limitations specified under I.R.C. § 220. Under I.R.C. § 220, a high deductible health plan, in the case of individual coverage, is a health plan with an annual deductible of at least \$1,500 and not more than \$2,250. In the case of family coverage, a high deductible health plan is a health plan with an annual deductible of at least \$3,000 and not more than \$4,500. In addition, the maximum out-of-pocket expenses must be no more than \$3,000 for individual coverage and no more than \$5,500 for family coverage. After 1998, the deductibles and out-of-pocket limitations will be indexed (by the Internal Revenue Service) annually for inflation.

Who may set up an MSA under Arizona law?

To set up an MSA under Arizona law, a person must be either an employee or self-employed. It does not matter if the person is an Arizona resident or a nonresident.

In the case where the person is an employee, the employee must be covered under an employer-sponsored high deductible health plan. The employee cannot be covered under any other health plan (other than a plan that provides certain permitted coverage). Either the employee or the employer can make contributions to the employee's MSA. However, the employee cannot make contributions to an MSA for a year in which their employer makes any contributions to the MSA on behalf of the employee. Likewise, if the employee's spouse is covered under the high deductible plan covering the employee and the spouse's employer makes a contribution to an MSA for the spouse, the employee may not make MSA contributions for the year. For example, suppose individual A works for a small employer and is covered under a high deductible plan that covers A and her spouse, B. A's employer makes a contribution for a year to an MSA for A. B is not entitled to make contributions to an MSA for that year.

In the case of a self-employed person, he or she must be covered under a high deductible health plan. The self-employed person must not be covered under any other health plan (other than a plan that provides certain

permitted coverage). A self-employed person who is also an employee, cannot set up an MSA (by reason of being self-employed) if the high deductible plan under which the individual is covered is established or maintained by an employer of the self-employed person (or his or her spouse). However, in this case the self-employed person may still qualify for an MSA as an employee.

A person covered by Medicare cannot set up an MSA.

Can a person set up an MSA under Arizona law if he or she cannot set up an MSA under federal law?

There are only two situations in which a person can set up an MSA under Arizona law when he or she cannot have one under I.R.C. § 220. These two situations are as follows:

1. A person may set up an MSA even though his or her employer is not a small employer (50 or fewer employees).
2. A person may set up an MSA even though the maximum number of MSAs that can be set up under federal law (750,000) has been reached.

All of the other conditions set forth in I.R.C. § 220 must be met.

What other coverage or insurance can a person have in addition to a high deductible health plan and still qualify for an MSA?

In addition to the high deductible health plan, a person can have coverage (whether provided through insurance or otherwise) for any of the following:

- Accidents
- Disability
- Dental care
- Vision care
- Long-term care
- Any benefit provided by certain permitted insurance

The term "permitted insurance" means:

- Medicare supplemental insurance
- Insurance if substantially all of the coverage provided under the insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance) or (d) other similar liabilities as the Internal Revenue Service may prescribe by regulations
- Insurance for a specified illness
- Insurance that provides a fixed payment for hospitalization

Should an entity that offers MSAs under Arizona law notify the department that it offers the accounts?

Yes. An entity that offers MSAs should notify the department that it offers the accounts. The entity should notify the department of its intent before offering MSAs.

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The entity should send its notice to the following address:
Arizona Department of Revenue
Individual Income Tax Audit Section
1600 W Monroe, Room 510
Phoenix AZ 85007

Are contributions to an MSA during the tax year subject to a maximum?

Contributions to an MSA during the tax year are subject to a maximum. The maximum is a percentage of the health insurance plan's deductible. In the case of individual coverage, the maximum is 65% of the deductible. In the case of family coverage, the maximum is 75% of the deductible. For example, an individual with a \$1,500 deductible would be able to contribute \$975 (65 percent of \$1,500).

Is an account holder subject to Arizona income tax on contributions to his or her MSA?

An account holder is not subject to Arizona income tax on eligible contributions made to his or her MSA. If the account holder included the contributions in federal adjusted gross income, the account holder may take a subtraction for those contributions. The account holder cannot take a subtraction that is more than his or her compensation (without application of community property laws) as defined in I.R.C. § 220.

How can an account holder use the funds in his or her MSA?

An account holder may use the funds in an MSA to pay for most medical expenses incurred by the account holder and his or her spouse or dependents. However, the person for whom the expenses were incurred must have been covered under the high deductible health plan for the month in which the expenses were incurred. The account holder cannot use MSA funds to pay for medical expenses that are reimbursed by insurance or otherwise.

With the exception of most insurance expenses, a person can use funds in an MSA to pay for those types of medical expenses described in I.R.C. § 213(d). For example, the kind of medical expenses that a person can deduct as an itemized deduction on his or her federal income tax return. An account holder may also use MSA funds to pay for the following types of insurance:

- Long-term care insurance
- Premiums for health care continuation coverage
- Premiums for health coverage while an individual is receiving unemployment compensation under federal or state law.

Can an account holder deduct, as an itemized deduction, medical expenses paid or reimbursed from an MSA?

No. A person cannot deduct medical expenses paid or reimbursed from an MSA as an itemized deduction on his or her Arizona income tax return.

Can an account holder make withdrawals from his or her MSA for purposes other than eligible medical expenses?

An account holder may make withdrawals from the MSA for purposes other than eligible medical expenses. These withdrawals are income for Arizona purposes and may also be subject to a penalty. If the account holder did not include the amount withdrawn in federal adjusted gross income, the account holder must add that amount to Arizona gross income. An account holder does not have to add qualified medical payments or reimbursements made by the plan to Arizona gross income.

What penalty may apply to an MSA withdrawal?

MSA withdrawals that are subject to the federal withdrawal penalty are not subject to the Arizona withdrawal penalty. However, withdrawals used for other than qualified expenses that are not subject to the federal withdrawal penalty are subject to an Arizona withdrawal penalty. The penalty is equal to 10 percent of the withdrawal. However, an account holder may use withdrawals made on the last business day of the year for any purpose without incurring the withdrawal penalty. The withdrawal penalty does not apply after the account holder reaches the age of fifty-nine and one-half years, regardless of how the account holder uses the funds. The withdrawal penalty is not subject to abatement. The account holder must remit this penalty with his or her Arizona income tax return filed for the year in which the account holder makes the withdrawal.

Is the return of excess contributions a withdrawal subject to the withdrawal penalty?

The return of excess contributions made during the taxable year is not a withdrawal subject to the withdrawal penalty if all of the following apply.

1. The amount returned does not exceed the total amount of excess contributions made to all of the account holder's MSAs.
2. The taxpayer receives the distribution by the last day for filing his or her income tax return for the year.
3. The net income attributable to the excess contribution accompanies the distribution.

Can an account holder make a tax free and penalty free rollover from one MSA into another MSA?

An account holder can make a tax free and penalty free rollover from one MSA into another MSA if both of the following apply.

1. The account holder pays into the other MSA the amount paid or distributed from a MSA within 60 days of the day on which the account holder receives the payment or distribution.
2. The account holder makes only one rollover during a one year period.

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Is a transfer incident to divorce a withdrawal subject to tax or the withdrawal penalty?

The transfer of a person's interest in an MSA to the person's spouse or former spouse under a divorce or separation instrument is not a taxable transfer. This transfer is not subject to the withdrawal penalty. After the transfer, the person's spouse or former spouse is the account holder of the amount transferred.

What happens to an MSA if the account holder dies?

If the account holder's surviving spouse is the named beneficiary of the MSA, the MSA becomes the MSA of the surviving spouse. The surviving spouse does not have to include any amount of the MSA in his or her income as a result of the death. The transfer from the decedent to the surviving spouse is not a withdrawal subject to the withdrawal penalty. The surviving spouse does not have to add the amount transferred to Arizona gross income. The surviving spouse can also exclude from income amounts withdrawn from the MSA for medical expenses incurred by the decedent prior to death.

If the MSA passes to a named beneficiary other than the decedent's surviving spouse, the MSA ceases to be an MSA as of the date of death. The beneficiary must include the fair market value of MSA assets as of the date of death in income for the taxable year that includes the date of death. The beneficiary may reduce this amount by the amount in the MSA used, within one year of the date of death, to pay qualified medical expenses incurred prior to the death. The beneficiary must add the fair market value of the MSA (reduced by qualifying expenses) to Arizona gross income if he or she did not include that amount in federal adjusted gross income.

If there is no named beneficiary for the decedent's MSA, the MSA ceases to be an MSA as of the date of death. The fair market value of the assets in the MSA as of the date of death must be included in the decedent's income for the year of death. This rule applies in all cases in which there is no named beneficiary, even if the surviving spouse ultimately obtains the right to the MSA assets. These amounts must be added to Arizona gross income if not included in federal adjusted gross income.

What happens to an MSA established under former Arizona Law?

Persons who established accounts under former Arizona law are subject to special rules. Under these rules, the person may elect to maintain the account or may elect to terminate the account. If the person elects to maintain the account, the account will be subject to the new MSA provisions. If the person elects to terminate the account, the person must withdraw the funds by the last business day in 1997. The withdrawal penalty does not apply to this withdrawal on termination. However, the taxpayer must add the amount withdrawn to Arizona gross income.

Is an MSA subject to Arizona income tax?

The trust (MSA) is exempt from Arizona income tax. For Arizona income tax purposes, the trustee must file an Arizona fiduciary income tax return on Arizona Form 141 if both of the following apply:

1. The MSA is not a tax exempt trust for federal purposes.
2. The MSA has sufficient income to require the filing of such a return.

If the trustee must file Arizona Form 141, the trustee can subtract all income earned by the trust during the taxable year. The subtraction cannot exceed the amount of income included in Arizona gross income. The trustee does not have to add non-Arizona municipal interest income to the trust's Arizona gross income.

What information must the trust report to the account holder and the department?

The trustee must annually make reports regarding account information. The reports must contain information with respect to contributions, income earned during the taxable year, distributions, and such other matters as the department may require. The trustee must file the report with the department by January 31 of the calendar year following the calendar year to which the report relates. The trustee must also furnish the account holder with a copy of the report by the January 31 due date. The trustee must report the required information on Form 199 MSA. A trustee who fails to file the required information is subject to a \$500 penalty for each failure. The trustee should send Form 199 MSA to:

Arizona Department of Revenue
Individual Income Audit Section
1600 W Monroe, Room 510
Phoenix AZ 85007

For more information, call:

Phoenix (602) 255-3381
Toll free from area codes 520 & 928 (800) 843-7196

For hearing impaired—TDD only:

Phoenix (602) 542-4021
Toll free from area codes 520 & 928 (800) 397-0256

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