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Health Savings Accounts

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What is a health savings account (HSA)?

A health savings account (HSA) is a savings vehicle established to set aside funds tax free to pay for health care expenses. HSAs, created as part of the Medicare Prescription Drug and Modernization Act of 2003, expand upon the benefits offered by Archer medical savings accounts (Archer MSAs). Like Archer MSAs, HSAs allow individuals who have high-deductible health plans (HDHPs) to save money for health-care expenses tax free. But whereas Archer MSAs can be established only by employees of small businesses and self-employed individuals, HSAs can be established by any qualified individual covered by an HDHP.

Caution: The Archer MSA program expired on December 31, 2007.

Who can establish an HSA?

Generally, if you are covered under an HDHP, you are eligible to establish an HSA. In 2010, a qualifying HDHP health plan (1) has an annual deductible of at least \$1,200 for individual coverage or \$2,400 for family coverage (\$1,150 for individual coverage or \$2,300 for family coverage in 2009), and (2) limits annual out-of-pocket expenses (e.g., co-pays, deductibles) to \$5,950 for individual coverage or \$11,900 for family coverage (\$5,800 for individual coverage or \$11,600 for family coverage in 2009).

You will not be eligible to open an HSA, even if you are covered under an HDHP, if any of the following apply:

- You are already covered under a non-HDHP, including a comprehensive major medical plan, a plan sponsored by your employer or your spouse's employer, or a prescription drug plan or rider with a low deductible or no deductible. (Some health plans are exempted from this provision, including dental or vision care insurance, long-term care insurance, disability insurance, and accident insurance.)
- You can be claimed as a dependent on another person's income tax return.
- You are entitled to Medicare coverage (i.e., you are age 65 or older), and have enrolled in Medicare.

Caution: To qualify as an HDHP, a plan offering family coverage must specify that no payment can be made from the plan for any individual (except for exempt preventative care benefits to which a deductible does not need to apply) until the family deductible is satisfied.

Caution: If your spouse has non-HDHP family coverage, but that plan does not cover you, you may still contribute to an HSA if you are otherwise eligible to do so. However, your spouse will not be eligible to contribute to an HSA.

Tip: HDHP deductibles and out-of-pocket expense limits are indexed annually for inflation.

How do you establish an HSA?

An HSA is a tax-exempt trust or custodial account that can be established through any qualified trustee or custodian, including a bank, an insurance company, or a third-party administrator. In some cases, this may be the same institution offering the HDHP. You can open an HSA on your own or, if available, through your employer. Employers may offer HSAs as part of a cafeteria plan.

Who can make contributions to an HSA?

You, your eligible family members, or others who wish to do so can make contributions to your HSA. If you're

employed, your employer may also make contributions to your HSA. Contributions may be made directly or through salary reduction under a cafeteria plan (if offered by your employer). However, no contributions can be made to your HSA once you retire.

Caution: Employers who make contributions to employee HSAs must generally make comparable contributions to the HSAs of all comparable participating employees (either the same percentage of the deductible amount or the same dollar amount). Otherwise, the employer must pay an excise tax equal to 35 percent of the actual contributions made. An employer, can, however, make larger HSA contributions for nonhighly compensated employees than for highly compensated employees without violating the comparability rule. In addition, the comparability rule is applied separately to part-time employees and does not apply to contributions made through a cafeteria plan. However, contributions to an HSA made under a cafeteria plan are subject to Section 125 nondiscrimination rules.

How much can you contribute to an HSA?

For 2010, you can contribute up to \$3,050 for individual coverage or \$6,150 for family coverage, to your HSA (\$3,000 for individual coverage or \$5,950 for family coverage for 2009). This annual limit is the sum of the limits determined separately for each month (i.e., the amount you can contribute in each month is computed by dividing the annual contribution limit by 12).

Example(s): For example, Jason is covered by an HDHP starting on January 1, 2010 and will remain covered for the rest of the year. Since his maximum annual contribution limit is \$3,050, his monthly contribution limit is \$254 (\$3,050 divided by 12).

You can choose to make monthly contributions to your HSA, or you can make a lump-sum contribution any time before your tax return becomes due (i.e., for most individuals, by April 15th of the year following the year for which contributions are being made), as long as your contributions have already accrued.

What if you become eligible for an HSA after the beginning of the year? In this case, your maximum contribution for the year is the annual maximum dollar amount for the year, even though you weren't eligible for the entire year. However, you must remain in the HSA-eligible plan for the entire calendar year following the last month of the year in which you made that contribution. Otherwise, the contribution will be included in your gross income for the calendar year in which you ceased to be eligible, and will be subject to an additional 10 percent penalty tax.

You may also be eligible to make additional "catch-up contributions" to your HSA if you are 55 or older. The catch-up contribution amount is \$1,000. If eligible, both you and your spouse can make separate catch-up contributions to an HSA. However, no regular or catch-up contributions can be made once you reach age 65 and are enrolled in Medicare.

Caution: Contributions you make to an Archer MSA or to another HSA will reduce the amount you can contribute to your HSA for the same year.

Can you make contributions to an HSA if you are covered under an FSA or HRA?

You may be ineligible to make contributions to an HSA if you are currently covered under a flexible spending account (FSA) or a health reimbursement arrangement (HRA) that duplicates coverage provided by the HSA. However, if you have an FSA or an HRA, you will be eligible to participate in an HSA if:

- Your FSA or HRA is a limited purpose account that repays or reimburses only vision, dental, or preventative care expenses
- Your FSA or HRA is a high-deductible arrangement (called a post-deductible arrangement by the IRS) that pays or reimburses health-care expenses only after the minimum annual HDHP deductible has been satisfied

- You suspend your HRA for a time by electing to forgo payment or reimbursement of HRA benefits incurred during the suspension period (your employer can continue to make contributions during the suspension)
- Your HRA is a retirement HRA that only reimburses medical expenses you incur once you retire (though contributions can be made before you retire).

Can your contributions earn interest?

Yes. As the account owner, you can direct your contributions to a savings or investment option offered by the qualified trustee or custodian of your HSA. Any interest and investment earnings on contributions grow tax deferred until withdrawn, and like contributions, will be tax free when withdrawn if used to pay qualified medical expenses.

How are contributions taxed?

Individual contributions you make to your HSA that do not exceed the maximum contribution limit are tax deductible on your federal income tax return. Because you deduct these contributions "above-the-line" when computing your adjusted gross income, you can deduct HSA contributions even if you don't itemize. You can also deduct contributions made by a family member on your behalf.

If your employer makes contributions to your HSA, these are excludable from your gross income. Any contributions made through a cafeteria plan are treated as employer contributions. However, you cannot deduct employer contributions to your HSA.

Tip: Employer contributions will be reported in Box 12 of your Form W-2.

Tip: Employer contributions are not taxable to the employer and are not subject to FICA or FUTA taxes.

How are distributions taxed?

You can withdraw money from your HSA for qualified medical expenses for yourself, your spouse, and your dependents. Distributions from an HSA for qualified medical expenses are not taxable. However, distributions for nonqualified expenses are considered taxable income and are subject to an additional 10 percent penalty.

Tip: The 10 percent penalty for nonqualified expenses does not apply if the distribution is made as a result of the beneficiary's death or disability or when the beneficiary reaches age 65.

What are qualified medical expenses?

Qualified medical expenses are health-care expenses, as defined by Internal Revenue Code 213(d), that are paid by you, your spouse, or your dependents. These include laboratory fees, prescription and nonprescription drugs, dental treatment, ambulance service, eyeglasses, and hearing aids, as well as many other health care expenses. HSA funds may also be used to cover health insurance deductibles and co-payments.

Generally, health insurance premiums, including HDHP premiums, are not qualified expenses, except for the following types of health coverage (1) COBRA coverage; (2) Qualified long-term care insurance (3) Health coverage maintained while receiving unemployment compensation and (4) Retiree health insurance other than a Medicare supplemental policy (Medigap).

Tip: The HSA trustee or employer is not responsible for ensuring that amounts distributed from an HSA are used for qualified medical expenses.

For a list of qualified medical expenses, see IRS Publication 502.

Are rollovers permitted?

Some rollovers are permitted. For example, you may roll over funds from an existing Archer MSA to an HSA, and you may roll over funds from one HSA to another. Rollovers are not subject to the limits that apply to contributions. Funds must be rolled over into your HSA within 60 days of receiving the distribution in order to be exempt from income tax and the additional 10 percent penalty that applies to nonqualified distributions.

The Tax Relief and Health Care Act of 2006 also authorized limited rollovers to HSAs from other types of accounts. If eligible, you can make a one-time transfer of funds to your HSA from an HRA or an FSA, as long as you do so before January 1, 2012. The maximum amount you can transfer is the lesser of the balance as of the date of transfer or the balance as of September 21, 2006.

If eligible, you may also roll over funds from your IRA (other than a SEP or SIMPLE IRA) to your HSA, generally once during your lifetime. However, the amount you roll over can't exceed the annual HSA contribution limit for that year, and is reduced by any amount you've already contributed to your HSA for the year.

What happens to funds remaining in your HSA?

At the end of the year

One of the advantages of HSAs is that unlike FSAs, HSAs do not have a "use it or lose it" provision. Funds remaining in your account at the end of the year are not forfeited and can continue to accumulate tax free year after year until withdrawn.

If you change jobs

An HSA is portable. Because the account is yours, you can keep it and continue to make contributions even if you change employers or leave the workforce.

If you divorce

If all or part of your interest is transferred to your spouse as part of a divorce settlement, it will not be considered a taxable transfer, and the transferred interest will continue to be treated as an HSA.

If you retire

Although you can no longer open or make contributions to an HSA once you reach age 65 and are enrolled in Medicare, you can take tax-free distributions from your account to pay for medical expenses. You can withdraw funds from your account for nonmedical purposes without owing a penalty (although the amount you withdraw will be subject to income tax).

If you die

Funds remaining in your HSA upon your death become the property of your designated beneficiary. If the beneficiary is your spouse, he or she becomes the account holder and the account remains an HSA. If the beneficiary is not your spouse, the account ceases to be an HSA as of the day of your death, and the fair market value of the funds are includable in your beneficiary's gross income.

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