

LEGISLATIVE BRIEF

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Health Savings Accounts (HSAs) – Distribution Rules

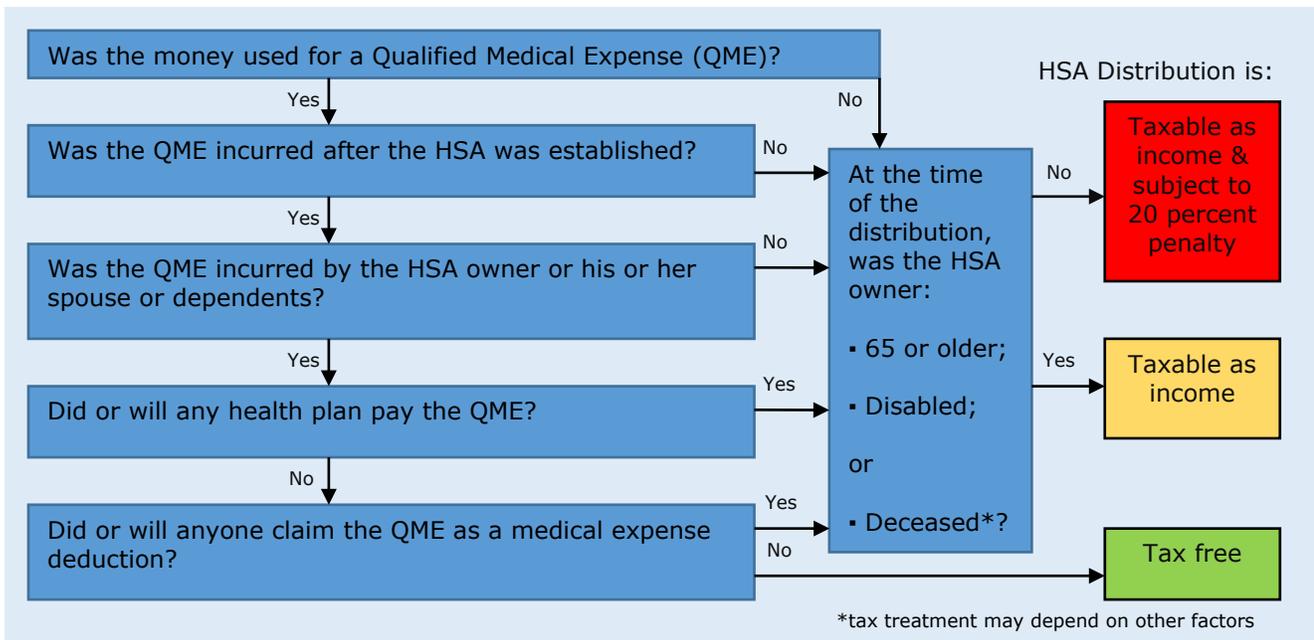
A Health Savings Account (HSA) is a trust or account used to pay medical expenses that a high deductible health plan (HDHP) does not pay. HSAs offer triple tax advantages to account owners, including tax exemptions for contributions, earnings and distributions. To obtain the last exemption, HSA holders must follow strict rules for spending HSA funds.

Employers that offer HSA programs generally have very little, if any, involvement in HSA distributions. HSA owners have sole discretion for how and when to use HSA funds, and an HSA custodian or trustee tracks and reports all HSA activity. Nevertheless, some distribution rules may apply to or affect employers. This Legislative Brief makes special note of these while summarizing the rules applicable to HSA owners who receive money from an HSA.

WHAT IS AN HSA DISTRIBUTION?

In simple terms, an HSA distribution is any money an HSA owner takes out of an HSA. HSA owners and anyone they designate are free to take money from an HSA for any purpose. If certain rules are followed, the distribution is not taxable. However, if any portion of a distribution is not used in accordance with HSA rules, that portion is taxable as income to the HSA owner. When an HSA distribution is taxable, it is also subject to a 20 percent penalty unless the HSA owner is over age 65, disabled or deceased.

This chart provides a guide for determining whether an HSA distribution is taxable and subject to the 20 percent penalty. The specific requirements are discussed in more detail below.



Health Savings Account (HSA) Distribution Rules

HOW ARE HSA DISTRIBUTIONS ADMINISTERED?

HSA funds must be held by an approved HSA custodian or trustee. **Once money is in an HSA, it belongs solely to the account owner, who has complete control over how to spend it.** An employer that contributes funds to an employee's HSA cannot make a custodian or trustee refund the money, even if the amounts deposited exceed contribution limits.

Neither an employer nor an HSA custodian or trustee is required to determine whether HSA distributions are used for qualified medical expenses. This is one of the main features that distinguishes HSAs from health flexible spending accounts (FSAs) and health reimbursement arrangements (HRAs).

Employers can choose the custodian or trustee to set up employees' HSAs, but they cannot restrict employees from making withdrawals or transferring HSA funds to a different HSA. If an employer chooses an HSA that allows employees to access their HSA funds through a health-care restricted debit card, the account funds must also be readily available to the HSA owner through cash withdrawal or other distribution methods. The employer must notify employees about the alternate means of accessing funds.

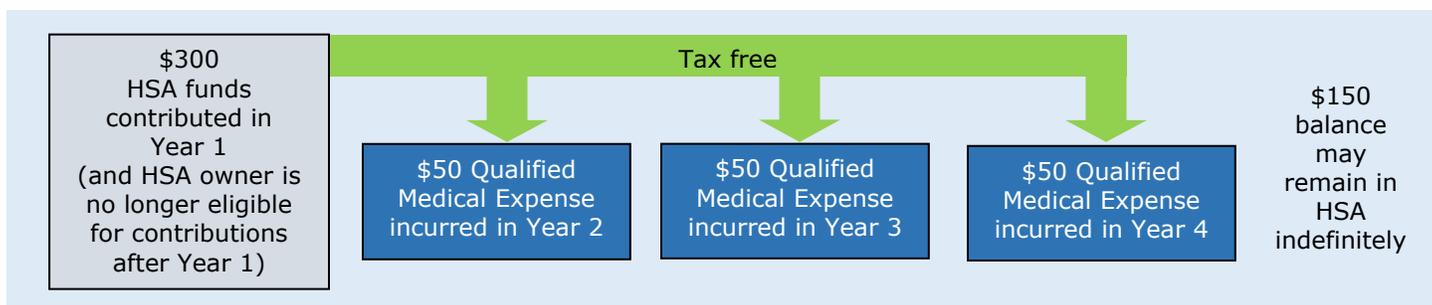
An HSA custodian or trustee can place reasonable administrative restrictions on HSA owner's distributions, generally limited to setting a minimum dollar amount for single distributions and a maximum number of distributions per month. The custodian or trustee may also withdraw funds from an HSA to cover its administrative fees, but these amounts are not considered distributions.

WHEN MAY HSA DISTRIBUTIONS OCCUR?

HSA funds cannot be used for expenses incurred prior to the date the HSA was established. In other words, a distribution is taxable (and possibly subject to the 20 percent penalty) if the HSA owner uses it to pay for medical care that was obtained before the HSA existed. State law determines the exact HSA establishment date for this purpose.

For medical expenses incurred after an HSA is established, there is no time limit for when an HSA owner may take a distribution. Similarly, HSA owners are not obligated to take distributions at any time. All unused funds remain in an HSA from year to year and may be used for qualified medical expenses incurred in the future.

Also, even if an HSA owner becomes ineligible to receive contributions into an HSA, he or she may still use tax-free distributions from an existing HSA to pay qualified medical expenses at any time, as long as the expenses were incurred after the HSA establishment date. For example, an HSA owner who only qualifies to have contributions made into an HSA in Year 1 may still use the HSA funds to pay qualified medical expenses that are incurred in Year 2 or later.

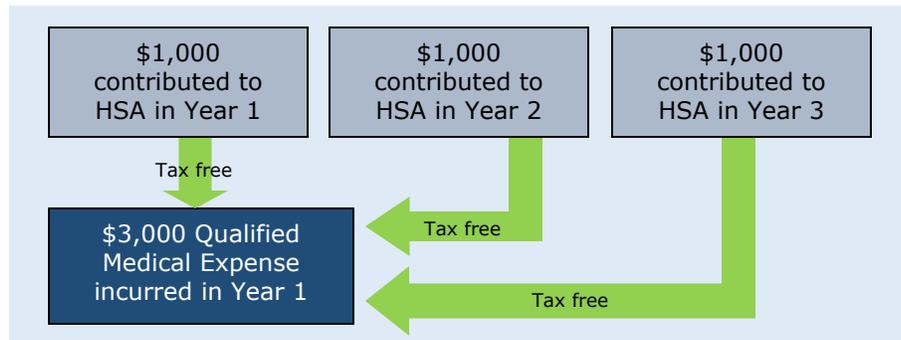


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Health Savings Account (HSA) Distribution Rules

In addition, the money used to pay a qualified medical expense does not have to be in the HSA at the time the expense is incurred.

For example, if an existing HSA has \$1,000 and the HSA owner incurs \$3,000 in medical expenses that year, he or she can pay the first \$1,000 from the current HSA funds and then wait for future HSA contributions to pay or reimburse him or herself for the remaining \$2,000.



WHO MAY BENEFIT FROM HSA DISTRIBUTIONS?

HSA distributions are not tax-free unless they are used to pay for qualified medical expenses. These expenses do not necessarily have to be incurred by the HSA owner. As long as an expense is not paid or reimbursed by any other source (such as the HDHP), an HSA distribution can also be used to pay qualified medical expenses incurred by the HSA owner's:

- Spouse (same-sex or opposite-sex);
- Dependents whom the HSA owner claims on a tax return (including some domestic partners); and
- Dependents whom the HSA owner could claim on a tax return, but:
 - The person filed a joint return;
 - The person had a gross income of \$3,950 or more; or
 - The HSA owner, or his or her spouse if filing jointly, could have been claimed as a dependent on someone else's tax return.

For this purpose, if parents of a child are divorced, separated or living apart for the last six months of the calendar year, the child is treated as the dependent of both parents regardless of which parent claims a child's exemption.

Also, it is important to note that dependents are defined differently for HSA purposes than they are for purposes of the Affordable Care Act (ACA). While the ACA allows parents to keep their adult children on their health care policies until age 26, the laws applicable to HSAs generally do not only allow HSA owners to pay for their child's medical care after age 19 (age 24 if the dependent is a full-time student).

HOW ARE HSA DISTRIBUTIONS TAXED?

HSA distributions are exempt from income taxes if all of the funds are used to pay qualified medical expenses that were incurred after the HSA was established. If any portion of a distribution is not used for qualified medical expenses, that portion is taxable as income and subject to a 20 percent penalty.

However, an HSA owner is **not** subject to the 20 percent penalty on any HSA distributions that he or she takes after:

- Reaching age 65; or
- Becoming disabled.

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Health Savings Account (HSA) Distribution Rules

Thus, an HSA owner who is over age 65 or disabled may use distributions for any purpose without having to pay the 20 percent penalty, but any amounts that are not used for qualifying medical expenses are still subject to income taxes.

HSA owner is over age 65 or disabled				
Total distributions	minus	Total amount used for qualified medical expenses	=	Total amount taxable as income

HSA owner is under age 65 and not disabled				
Total distributions	minus	Total amount used for qualified medical expenses	=	Total amount taxable as income and subject to 20 percent penalty

After an HSA owner dies, tax treatment of HSA funds depends on whom the HSA owner designated to inherit the HSA. If the HSA owner's spouse is the designated beneficiary, the account becomes the spouse's HSA. This transfer of ownership is not considered a distribution; therefore, the funds are neither taxable nor subject to the 20 percent penalty when the spouse receives the account.

If the HSA passes to anyone other than the HSA owner's spouse, the account ceases to be an HSA and the 20 percent penalty no longer applies. However, the funds in the account become taxable income for the beneficiary or the HSA owner's estate. If the deceased HSA owner incurred qualifying medical expenses before death, the beneficiary or estate does not have to pay income taxes on the amount of those expenses as long as they are paid within a year of the HSA owner's death.

HOW ARE HSA DISTRIBUTIONS REPORTED?

Employers are not involved in the reporting process for HSA distributions. The HSA trustee or custodian tracks all HSA distributions and reports them to the account owner and the IRS using IRS Form 1099-SA.

HSA owners report their distributions and medical expenses to the IRS using [Form 8889](#). They must keep their own records of all payments made using HSA distributions, as they are solely responsible for substantiating all expenditures. If any portion of the total distributions does not meet all the requirements for spending HSA funds, the HSA owner must include that portion as taxable income and, if applicable, pay the 20 percent penalty.

WHAT IS A QUALIFIED MEDICAL EXPENSE?

For HSA purposes, qualified medical expenses generally include the expenses listed in [IRS Publication 502](#) for the medical expenses tax deduction. The expenses must be incurred primarily to alleviate or prevent a physical or mental defect or illness. Expenses that are merely beneficial to general health, such as vitamins, are not included.

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Examples of Qualifying Medical Expenses

- Addiction treatment
- Annual physical exams
- Ambulance services
- Artificial limbs
- Birth control
- Contact lenses
- Crutches
- Dental treatment
- Diagnostic devices
- Doctors' fees
- Eye exams
- Fertility enhancement
- Hearing aids
- Home Care
- Hospital services
- Laboratory fees
- Psychiatric care
- Special education
- Smoking cessation
- Wheelchairs

Examples of Non-Qualifying Medical Expenses

- Cosmetic surgery
- Babysitting
- Dancing lessons
- Diaper services
- Hair transplants
- Health club dues
- Swimming lessons
- Teeth whitening
- Vacation or travel

Medication

For HSA purposes, a medicine or drug is not a qualified medical expense unless it:

- Requires a prescription;
- Is available without a prescription but has been prescribed; or
- Is insulin.

Health Insurance Premiums

In general, payments for insurance are not qualified medical expenses for HSA purposes. However, there are exceptions for:

- Long-term care coverage;
- Health care coverage for an HSA owner who has reached age 65; and
- Health care coverage during:
 - Periods of coverage continuation (such as under COBRA); and
 - Periods during which an individual is receiving unemployment compensation under any federal or state law.

WHAT ARE THE RESTRICTIONS AGAINST DOUBLE TAX ADVANTAGES?

HSAs are designed to pay expenses that an HSA owner would otherwise pay out of pocket using after-tax income.

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Therefore, HSA funds cannot be used to pay expenses that any other source covers or pays. For example, if the HSA owner's spouse has a separate health plan that reimburses him or her for a certain expense, the HSA owner cannot use HSA funds to pay the expense and then later receive reimbursement from the spouse's health plan.

Similarly, an HSA owner cannot use HSA funds to reimburse an expense that he or she claimed as a medical expense deduction on a tax return. For example, if the HSA owner pays a medical expense out of pocket and claims a medical expense deduction for it in year 1, the HSA owner cannot take an HSA distribution to reimburse him or herself for that expense in year 2 or any other time.

ARE THERE ANY OTHER TAX EXCEPTIONS FOR HSA DISTRIBUTIONS?

Mistaken Distributions

If an HSA owner withdraws money to pay an expense that he or she reasonably, but mistakenly, believed to be a qualifying medical expense, he or she can avoid tax consequences by returning the funds to the HSA before April 15 of the year after he or she discovered the mistake.

Rollovers

HSA owners can move funds from one HSA into another without tax consequences one time per year. If an HSA owner withdraws HSA funds for this purpose, he or she must deposit the funds into the new HSA within 60 days.

Excess Contributions

If an HSA owner takes a distribution to correct a violation of HSA contribution limits, the amount of the corrective distribution is not taxed as income. However, the amount of the excess contribution must be included in the HSA owner's gross income. Specific time limits and other rules apply for determining whether a distribution actually corrects an excess contribution.

PROHIBITED TRANSACTIONS

Certain transactions can disqualify an HSA. Disqualification means that the account stops being an HSA and all of its funds immediately become a taxable distribution subject to the 20 percent penalty. In general, prohibited transactions include anything that may constitute tax fraud, such as pledging an HSA as security for a loan or selling assets to an HSA.

MORE INFORMATION

For more information on HSAs, contact your representative at The Ellis Company.

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