Health Savings Account (HSA)—Withdrawal and Spending 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.

HSA funds may be used on a tax-free basis if they are used to pay for qualified medical expenses that were incurred after the HSA was established. Individuals do not need to meet the eligibility criteria for making HSA contributions to receive a tax-free withdrawal from their HSAs. For medical expenses incurred after an HSA is established, there is no time limit for when an HSA owner may take a withdrawal. All unused funds remain in an HSA from year to year and may be used for qualified medical expenses incurred in the future.

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.

What Is an HSA Withdrawal?

In simple terms, an HSA withdrawal is any money an HSA owner takes out of his or her HSA. HSA owners and anyone they designate are free to take money from an HSA for any purpose. If certain rules are followed, the withdrawal 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 withdrawal is taxable, it is also subject to a 20% penalty unless the HSA owner is over age 65, disabled or deceased.

How Are HSA Withdrawals 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.

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.

Neither an employer nor an HSA custodian or trustee is required to determine whether HSA withdrawals 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).

When May HSA Withdrawals Occur?

HSA funds cannot be used for expenses incurred prior to the date the HSA was established. In other words, a withdrawal is taxable (and possibly subject to the 20% 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 withdrawal. 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.

Even if an HSA owner becomes **ineligible to make (or receive) HSA contributions**, 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.

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.

$300 HSA funds contributed in Year 1 (HSA owner is no longer eligible for contributions after Year 1)	**Tax-free Withdrawals**		
	$50 Qualified Medical Expense incurred in Year 2	$50 Qualified Medical Expense incurred in Year 3	$50 Qualified Medical Expense incurred in Year 4
	$150 balance may remain in HSA indefinitely.		

Who May Benefit from HSA Withdrawals?

HSA withdrawals 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 withdrawal 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 more than the federal exemption amount; 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 allow HSA owners to pay for their child's medical care after age 19 (age 24 if the dependent is a full-time student).

In addition, spouses and dependents do not have to be HSA-eligible in order to have their qualifying medical expenses reimbursed on a tax-free basis.

How Are HSA Withdrawals Taxed?

HSA withdrawals 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% penalty.

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

- Reaching age 65; or
- Becoming disabled.

Thus, an HSA owner who is over age 65 or disabled may use distributions for any purpose without having to pay the 20% 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 withdrawals	**minus**	**Total amount used for qualified medical expenses**	**=**	**Total amount taxable as income**
HSA owner is under age 65 and not disabled				
Total	**minus**	**Total amount used for qualified medical**	**=**	**Total amount taxable as income and subject**

withdrawals	expenses	to 20% 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% 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% 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 Withdrawals Reported?

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

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HSA owners report their withdrawals 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% 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.

Examples of Qualifying Medical Expenses				Examples of Non-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	•Medicine and drugs (including OTC drugs) •Menstrual care products •Psychiatric care •Special education •Smoking cessation •Wheelchairs		•Cosmetic surgery •Babysitting •Dancing lessons •Diaper services •Hair transplants •Health club dues •Swimming lessons •Teeth whitening •Vacation or travel

In general, insurance premiums 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 in 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. 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 Withdrawals?

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.

LINKS AND RESOURCES

- IRS Publication 969, Health Savings Accounts and Other Tax-favored Health Plans
- Internal Revenue Code Section 223 (federal tax law for HSAs)
- IRS Notice 2004-50 (IRS guidance on a wide variety of HSA compliance issues)

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