RAYMOND JAMES

Getting to know HSAs

A powerful healthcare savings tool and its role is long-term financial planning

Created as part of the Medicare Prescription Drug and Modernization Act of 2003 and rapidly growing in popularity, health savings accounts (HSAs) are a tax-advantaged way for individuals to save for healthcare expenses. Due to the highly advantageous features of this triple tax benefit account, you should consider the role an HSA could play in your retirement savings picture.

KEY FEATURES

ELIGIBILITY

- Anyone with an HSA qualified high-deductible health policy (HDHP) is eligible, it is not dependent on an employer offering.
- There are no income limits affecting eligibility.
- The HSA belongs to the individual not the employer.
- An HSA can be set up with any qualified trustee or custodian.
- As long as an individual has not enrolled in Medicare Part A or B, they are eligible and may contribute to an HSA. Once an individual enrolls in Medicare, they may no longer contribute to an HSA.
- There is also a requirement that they not have any other health coverage or an FSA, and they can't be claimed as a tax dependent on anyone else's tax return. See IRS Publication 969 for full requirements.

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CONTRIBUTIONS

- In 2022, individuals can contribute **$3,650** to an HSA and families can contribute **$7,300**. In 2023, individuals can contribute **$3,850** and **$7,750**, respectively.
- An individual over 55 can contribute an additional **$1,000** catch-up contribution for a total of **$4,650** in 2022, and **$4,850** in 2023.
- If a spouse is also 55 they can contribute an additional **$1,000** to their respective HSA for a total family contribution of **$9,300** in 2022, and **$9,750** in 2023.
- Anyone can make a contribution to an HSA on another person's behalf and, per IRS HSA rules, the account holder is the one who claims the deduction.
- There are no limits on the amount that can be carried forward each year.
- For qualified individuals, HSAs are the only type of tax-preferenced investment account that enjoys the benefits of tax-deductible contributions, tax-deferred growth of earnings and tax-free distributions (for qualified medical expenses).

INVESTMENT AND WITHDRAWAL STRATEGIES

- Individuals can invest the funds in bank accounts, money markets, mutual funds and stocks. They may not invest in collectibles, art, automobiles or real estate.
- A common funding strategy is to contribute to a 401(k) to receive the full company match, then switch to fully fund the HSA before maxing out 401(k) contributions. In most cases, this provides the most tax efficient way for assets to grow.
- The law allows a once-in-a-lifetime transfer of IRA assets to fund an HSA.
    - ▸ The amount transferred may not exceed the amount of one year's contribution and individuals must be otherwise eligible to open an HSA. This reduces the allowed contribution to the HSA as well so it's not a good idea if you are looking for tax reduction in the current year.
- Withdrawals from an HSA for qualified medical expenses are tax-free.
    - ▸ The only requirement at the time of distribution for tax-free treatment from an HSA is that the withdrawal either cover a current medical expense, or be used to reimburse a prior one (that was itself paid out of pocket, was not reimbursed from another source, and was not previously claimed as an itemized deduction).
- Medical expenses can occur now and be reimbursed in the future and still be qualified, as long as documentation of the medical expense is maintained and the medical expense occurred after the HSA was originally established.
- Non-qualified withdrawals are taxable as ordinary income plus a 20% penalty tax, with the penalty waived for:
    - ▸ Those over age 65
    - ▸ Those who are disabled
    - ▸ If withdrawn as a non-spouse beneficiary after the death of the HSA owner
- If a spouse is the designated beneficiary of an HSA, it will be treated as the spouse's HSA after the owner's death and continue the preferential tax treatment (including future tax-free withdrawals).

HSAs vs. OTHER HEALTHCARE SAVINGS ACCOUNTS

	Health Savings Account	Flexible Spending Account	Health Reimbursement Arrangement	Archer Medical Savings Account
What is it?	Tax-advantaged savings accounts for individuals created as part of the Medicare Modernization Act of 2003	Accounts that, like HSAs, allow individuals to pay for certain medical expenses with pretax dollars and submit qualified expenses for reimbursement	Accounts funded by tax-deductible contributions from employers who then use them to reimburse qualified medical expenses	Savings accounts for medical expenses created as part of the Medicare Modernization Act of 2003 and expired on December 31, 2007 (no new accounts can be established but accounts established before that date can continue to use and receive contributions)
What insurance coverage is required?	Qualifying high-deductible health plan	No health plan is required to have an FSA	Minimum essential coverage	High-deductible health plan
Who owns the account?	Individuals	Employers	Employers	Employees of small businesses and self-employed individuals
Who contributes?	Individuals and employers	Individuals (contributing pretax earnings) and employers (with certain limitations)	Employers	Individuals and employers
How much can be contributed?	In 2022, individuals can contribute $3,650 for single individuals, $7,300 for families. In 2023, $3,850 for single individuals and $7,750 for families.	$2,850 in 2022	No limit	Up to 75% of the annual deductible of your HDHP (65% for self-only plans)
Are contributions invested?	Contributions can be invested. The HSA account holder typically needs to take action to invest funds beyond the default low interest cash account.	No	No	Yes
What expenses qualify?	Qualified medical, dental, and vision expenses as defined by the IRS	Qualified medical, dental, and vision expenses as defined by the IRS	Medical and dental expenses as defined by the IRS (this will vary by employer)	Qualified medical, dental, and vision expenses as defined by the IRS
What happens to remaining funds at the end of the year?	Remaining funds are carried over	Remaining funds are generally forfeited; however, $570 can be carried over in addition to the maximum contribution amount	Funds may or may not roll over at thresholds specified by the plan	Remaining funds roll over

LIMITED PURPOSE FSA (LPFSA)

The LPFSA is much like a medical FSA except individuals may only use funds to pay for qualified dental and vision expenses incurred during the plan year. The maximum LPFSA amount one can contribute in a calendar year is $2,850 in 2022.

Individuals are permitted to enroll in an LPFSA even if they are also enrolled in an HSA medical plan and have an HSA. The LPFSA participants are eligible to roll over up to $570 into the next plan year providing they have an active LPFSA account.

Can someone make contributions to an HSA if they are covered under an FSA or Health Reimbursement Arrangement (HRA)?

An individual may be ineligible to make contributions to an HSA if they are currently covered under an FSA or HRA that duplicates coverage provided by the HSA. However, if the individual has an FSA or an HRA, they will be eligible to participate in an HSA if:

- Their FSA or HRA is a limited-purpose account that repays or reimburses only vision, dental, or preventative care expenses.
- Their FSA or HRA is a high-deductible arrangement (called a post-deductible arrangement by the IRS) that pays or reimburses healthcare expenses only after the minimum annual HDHP deductible has been satisfied.
- They suspend their HRA by electing to forgo payment or reimbursement of HRA benefits incurred during the suspension period. Their employer can continue to make contributions during the suspension.
- Their HRA is a retirement HRA that only reimburses medical expenses they incur once they retire (though contributions can be made before they retire).

HSA PLANNING STRATEGIES

The tax benefits from HSAs can be compared to those of 529 college savings plans and Roth IRAs. Similar to 529 college savings plans, HSAs allow for tax-free distributions as long as they are used to pay for certain expenses, in this case medical expenses. And like 529s, but unlike Roth IRAs, there are no income limitations to contribute to an HSA. However, unlike either 529s or Roth IRAs, contributions to HSAs are also tax-deductible.

This tax benefit makes it critical to consider these accounts as part of an overall financial plan. Those who qualify for an HSA should consider saving their first dollars for retirement in a 401(k) up to the amount where an employer match will be received, then saving the next amount of dollars available in an HSA up to the maximum annual limits, then shifting back to the employer plan. While this is a mental shift for many, the fact is that contributing the maximum to an HSA every year has the potential for more beneficial tax treatment than any other type of tax-preferenced account.

> In fact, saving in an HSA is so powerful that it may even be preferable for clients to pay current medical expenses out of pocket just to preserve the HSA account balance to be used as a future health retirement account (and keep the balance growing tax free for as long as possible). The tax benefits of an HSA have even been found to beat a 401(k) match for clients with a certain fact pattern.[1]

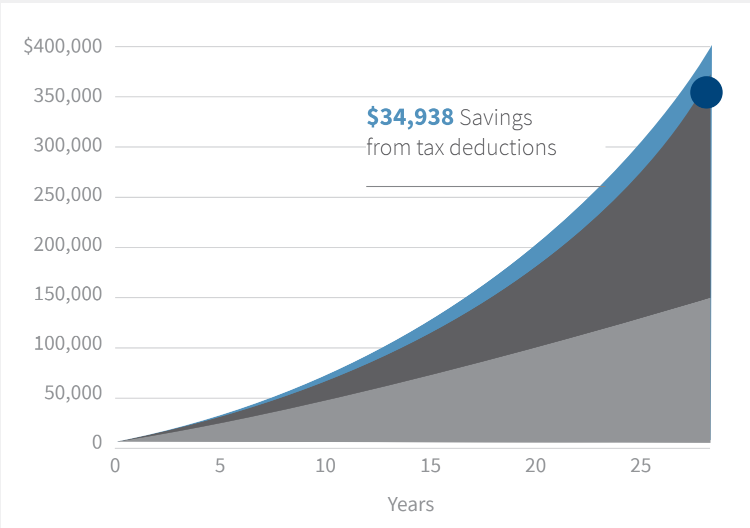
The illustration on the next page, created by JP Morgan, assumes an individual contributes the 2018 maximum of $3,450 each year for 30 years, with a 2.25% inflation rate for the contribution amount. The assumed rate of return is 6%.

Another interesting planning point involves parents who wish to gift money to their children. Anyone can make a contribution to an HSA on another person's behalf and, per IRS HSA rules, **the account holder is the one who claims the deduction.** *(See IRS Publication 969, pages 2 & 4.)*

1. "Could a Health Savings Account Be Better Than An Employer Matched 401(k)," Greg Geisler, Journal of Financial Planning

Health savings account (HSA) savings are triple tax advantaged[2]

2018 maximum annual individual contributions, 6% return and 24% marginal tax rate



ENDING BALANCE

$370,000 Tax fee for qualified health care expenses in retirement

$224,427 Tax-deferred earnings

$145,574 Contributions

2. Must have a qualifying high-deductible health plan to make other expenses. See IRS Publication 502 for details.

The above example is for illustrative purposes only and not indicative of any investment. Federal taxes; states may differ. Does not include account fees. Present value of illustrated HSA after 30 years is $189,803. If the annual tax deduction is invested with an after-tax return of 4.56%, the cumulative hypothetical return is $34,809. Assumes cash or income used for health care expenses is not withdrawn from an account with a tax liability. The example assumes the HSA is fully invested; if $2,000 was held in a cash account the illustrated cumulative HSA account value would be $360,516. 2018 contribution limit is $3,450 adjusted for inflation of 2.25% for 30 years.

HSA contributions made through payroll deduction or qualified employer 457 cafeteria plans may also avoid federal payroll and unemployment taxes unless someone is self-employed. These tax reductions may result in lower Social Security and unemployment insurance benefit amounts. Contributions outside of an employer plan are generally tax deductible but do not avoid payroll and unemployment taxes. This is not intended to be individual tax advice; consult a tax advisor.

Therefore, parents can contribute $3,450 to a child with an individual HSA plan or $6,900 to a family plan and the child will still get to deduct the HSA contribution on their tax return. And HSA contributions are “above the line” tax deductions; whether or not the child itemizes their deductions, they will still receive the deduction.

This planning technique could be particularly relevant for parents considering paying for a medical expense directly. In this case, the parent should consider making a contribution to their child’s HSA instead of directly paying the medical expense. The child can then use the HSA money to pay the expense. This enables the child to receive an income tax deduction that would otherwise go to waste if the parent paid the medical expense directly to the service provider. Reducing the child’s adjusted gross income (AGI) could also open up other tax benefits that are limited by the amount of AGI.

Note that the above situation assumes that the amount of medical expense to be paid is modest and fits within the parents’ gift tax annual exclusion amount of $15,000 per individual or $30,000 per couple in 2018 (the direct payment of medical expenses is not counted as a gift for gift tax purposes) and the gift to the HSA when aggregated with all other contributions does not exceed the HSA maximum for the year.

If another taxpayer is entitled to claim an exemption for an individual, the individual then cannot claim a deduction for an HSA contribution. This is true even if the other person does not actually claim their exemption.

HSA ELIGIBILITY

Anyone can open an HSA but the individual must have a corresponding qualified HDHP. **There are no income limits affecting eligibility.**

More technically, an HSA can be established for any individual that meets all of the following criteria:

1. Covered by a qualified HDHP (an individual is considered to be an eligible individual for the entire year if they are an eligible individual on the first day of the last month or their tax year)
2. Not eligible to be claimed as a dependent on another person's tax return
3. Not receiving Medicare benefits
4. Does not have other health coverage *(see below)*
5. Spouse does not have an FSA or HRA through their employer (see spousal eligibility section)
6. Not enrolled in TRICARE through the Department of Defense
7. Has not received medical benefits (non-dental, vision or preventive) from Indian Health Service (IHS) or the Department of Veterans Affairs (VA), which was not treatment for a service-connected disability at any time in the previous three months

OTHER HEALTH COVERAGE

To be eligible for an HSA, an individual (and their spouse, if the individual has family coverage) generally cannot have any other health coverage that is not an HDHP.

An individual can have additional insurance that provides benefits only for the following items:

- Liabilities incurred under workers' compensation laws, tort liabilities or liabilities related to ownership or use of property
- A specific illness or disease
- A fixed amount per day (or other period) of hospitalization

An individual can have coverage (whether provided through insurance or otherwise) for the following items:

- Accidents
- Disability
- Dental care
- Vision care
- Long-term care

Plans in which substantially all of the coverage is through the items listed above are not HDHPs. For example, if an individual's plan provides coverage substantially all of which is for a specific disease or illness, the plan is not an HDHP for purposes of establishing an HSA.

PRESCRIPTION DRUG PLANS

An individual can have a prescription drug plan, either as part of their HDHP or a separate plan (or rider), and be eligible for an HSA if the plan does not provide benefits until the minimum annual deductible of the HDHP has been met. If an individual can receive benefits before that deductible is met, they are not eligible.

OTHER EMPLOYEE HEALTH PLANS

An employee covered by an HDHP and a health flexible spending arrangement (FSA) or a health reimbursement arrangement (HRA) that pays or reimburses qualified medical expenses generally cannot make contributions to an HSA.

However, an employee can make contributions to an HSA while covered under an HDHP and one or more of the following arrangements:

- Limited-purpose FSA or HRA
- Suspended HRA
- Post-deductible health FSA or HRA
- Retirement HRA

SPOUSAL ELIGIBILITY

- Spouses cannot have a joint HSA. Eligible spouses must open separate HSAs. Usually this is only advantageous if the spouse is age 55 or older to get the additional catch-up contribution.
- If a spouse has a non-HDHP, the other spouse is not generally prohibited from getting an HDHP. This is true as long as the spouse's non-HDHP **does not cover the other spouse;** the other spouse remains eligible and can participate in an HSA.
- However, if the spouse participates in an FSA or HRA, the other spouse would not be eligible for an HSA if the spouse can use the FSA or HRA for the other spouse's general health expenses. Even though someone is not covered by their spouse's health insurance, the IRS has determined that the spouse's FSA or HRA is considered "other insurance," thus rendering the other spouse ineligible for an HSA. It is typically possible to exclude a spouse from coverage under an HRA, which is usually tied closely to the medical plan and the enrollment therein.
- If a spouse has a family non-HDHP and the other spouse **is not exempted from that coverage,** the other spouse would not be an eligible individual and would not be able to participate in an HSA.
- However, if, for example, the spouse had a family non-HDHP to cover himself and the couple's two children only, then the other spouse would still be eligible to open an HSA.
- If both spouses have a qualified HDHP and family coverage, each can still open an HSA.

However, the total amount that may be contributed to their HSAs is still the IRS defined contribution limit for that tax year.

HSAs AND MEDICARE

As long as an individual has not enrolled in Medicare Part A or B, they are eligible and may contribute to an HSA. Once an individual enrolls in Medicare, they may no longer contribute to an HSA. For most, this means they will no longer be eligible as of the first day of the month they turn 65.

For example, if someone turns 65 on July 21 and enrolls in Medicare, they are no longer eligible for an HSA as of July 1.

Their maximum contribution for that year would be six divided by 12 (they were eligible for the first six months of the year) times the applicable federal limit (including the catch-up amount).

Beginning with the first month someone is enrolled in Medicare, their contribution limit is zero.

Example:
Bob turned 65 in July 2022 and enrolled in Medicare. He had a qualified HDHP with self-only coverage and was eligible for an additional contribution of $1,000.

Bob's contribution limit:

$$\left(\left(\underbrace{\$4,650}_{\text{MAXIMUM CONTRIBUTION}} / 12\right) \text{x}\underbrace{6}_{\text{NUMBER OF ELIGIBLE MONTHS}}\right) = \$2,325$$

QUALIFIED HIGH DEDUCTIBLE HEALTH PLANS

To be eligible to contribute to an HSA, an individual must have a **qualified** HDHP, one with specified minimum limits for the annual deductible and maximum limits for out-of-pocket expenses.

- Specifically, for **individual** coverage in 2022 the HDHP must have an annual deductible of at least **$1,400** and require that annual out-of-pocket expenses (includes copayments and deductibles but not insurance premiums) paid do not exceed **$7,050**. In 2023, with an annual deductible of at least **$1,500**, expenses paid cannot exceed **$7,500**.
- For **family** coverage, which covers an eligible individual and at least one other, in 2022 the HDHP must have an annual deductible of not less than **$2,800** and require that out-of-pocket expenses paid do not exceed **$14,000**. In 2023, with an annual deductible of at least **$3,000**, expenses paid cannot exceed **$15,000**.

A qualified HDHP may provide preventive care benefits without a deductible or with a deductible less than the minimum annual deductible.

Not all high-deductible policies are HSA eligible
The policy must make everything subject to the same deductible (other than preventive care, which must be covered by all health plans without any deductible or cost-sharing). Some plans, for example, are not eligible because they have a separate deductible for prescription drugs.

Family plans that do not meet the high deductible rules
There are some family plans that have deductibles for both the family as a whole and for individual family members. Under these plans, if an individual meets the individual deductible for one family member, they do not have to meet the higher annual deductible amount for the family. If either the deductible for the family as a whole or the deductible for an individual family member is less than the minimum annual deductible for family coverage, the plan does not qualify as an HDHP.

CONTRIBUTIONS

Any eligible individual may contribute to an HSA. For an HSA established on behalf of an employee, both the employee and the employer may make contributions.

Additionally, family members (or any other person) may make contributions on behalf of other family members as long as the other family member is an eligible individual (i.e., has a qualified HDHP and is not otherwise insured). Contributions on behalf of another family member are deductible by the HSA owner (regardless of whether the person receiving the contribution itemizes their taxes).

If another taxpayer is entitled to claim an exemption for an individual, the individual then cannot claim a deduction for an HSA contribution. This is true even if the other person does not actually claim their exemption.

For individuals age 55 or older at the end of the tax year, the HSA contribution limit is increased by $1,000.

Maximum contribution guidelines 55 or older

	2022	2023
Self only	$3,650 with a $1,000 catch-up Total maximum = **$4,650**	$3,850 with a $1,000 catch-up Total maximum = **$4,850**
Family	$7,300 with a $1,000 catch-up Total maximum = **$8,300**	$7,750 with a $1,000 catch-up Total maximum = **$8,750**

$1,500
INDIVIDUAL

$1,500
INDIVIDUAL

$1,500
INDIVIDUAL

Family Plan Example:
Jack has family health insurance coverage in 2022. The annual deductible for the family plan is $3,650. This plan also has an individual deductible of $1,500 for each family member. The plan does not qualify as an HDHP because the deductible for an individual family member is less than the minimum annual deductible ($2,800) for family coverage.

The insurer or employer can confirm if the plan is HSA eligible.

Note, if both spouses meet the age requirement and are not enrolled in Medicare, the total contributions under family coverage cannot be more than **$9,300** in 2022 and **$9,750** in 2023.

If an individual has more than one HSA, their total contributions to all the HSAs cannot be more than the limits discussed above.

During the first year of HSA eligibility, the amounts above may be reduced if an individual fails to meet a testing period. In addition, if an individual is an existing HSA owner, the amounts above may be reduced if they fail to maintain their eligibility for the full tax year. Additionally, in the first year of coverage, an individual can start an HSA mid-year and contribute up to the full applicable federal limit; including a full catch-up amount if age 55 or older, so long as they start their HDHP coverage no later than December 1 of that year. This is true even if they changed coverage during the year.

Contributions to an HSA must be made in cash. Contributions of stock or property are not allowed.

TESTING PERIOD FOR CONTRIBUTIONS

The testing period requires that the individual maintain HSA eligibility for a period beginning on December 1 of the year they started and ending on December 31 of the next year.

If the individual fails to remain an eligible individual during the testing period, for reasons other than death or disability, they will have to include in income the total contributions made to their HSA that would not have been made except for the last-month rule.

IRS Form
8889

Example: Tom, age 49, becomes an eligible individual on December 1, 2022. He has family HDHP coverage on that date. Under the last-month rule, he contributes $7,300 to his HSA. Tom fails to be an eligible individual in June 2023. Because he did not remain an eligible individual during the testing period (December 1, 2022, to December 31, 2023), he must include in his 2023 income the contributions made in 2022 that would not have been made except for the last-month rule. Tom uses the worksheet within the IRS Form 8889 instructions to determine this amount.

$7,300 / 12 = $608.33

Tom would include $6,691.67 ($7,300 - $608.33) in his gross income on his 2022 tax return. Also, a 10% additional tax applies to this amount.

The individual would include this amount in their income in the year in which they failed to be an eligible individual. This amount is also subject to a 10% additional tax. The income and additional tax are calculated on Form 8869, Part III.

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Example: Wendy was eligible all of 2022 but she never opened or funded an HSA. Starting in 2023, she was no longer eligible. Wendy can still make an HSA contribution in 2023 for 2022 (because she was eligible in 2022).

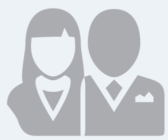
If this is not an individual's first year of their HSA and they stop their HSA eligibility mid-year, they are only allowed to contribute 1/12 of the applicable federal limit times the number of months they were eligible. However, an individual can also make an HSA contribution even if they are no longer eligible if they are making it for a period when they were eligible.

EMPLOYER CONTRIBUTIONS

An individual must reduce the amount they, or any other person, can contribute to their HSA by the amount of any contributions made by their employer that are excludable from their income. This includes amounts contributed to their account by their employer through a cafeteria plan.

RULES FOR MARRIED PEOPLE

If either spouse has family HDHP coverage, both spouses are treated as having family HDHP coverage. If each spouse has family coverage under a separate plan, the contribution limit for 2022 is $7,300 and $7,750 in 2023. When applicable, people must reduce the limit on contributions, before taking into account any additional contributions, by the amount contributed to both spouses' Archer MSAs. After that reduction, the contribution limit is split equally between the spouses unless they agree on a different division. The rules for married people apply only if both spouses are eligible individuals. If both spouses are 55 or older and not enrolled in Medicare, each spouse's contribution limit is increased to $9,300 in 2022 or $9,750 in 2023. Each spouse must make the additional contribution to his or her own HSA; the catch-up amounts cannot be combined and put into one HSA.



$4,650 / $4,650

Example:
Greg and Lisa are both eligible individuals in 2022. They each have family coverage under separate HDHPs. Greg is 58 years old, Lisa is 55. They can split the family contribution limit ($7,300) equally or they can agree on a different division. If they split it equally, one of them can contribute $4,650 to an HSA (half of the maximum contribution for family coverage $3,650 plus the $1,000 additional contribution) and the other can also contribute $4,650 to another HSA.

CARRY OVER LIMITS

There are no limits and the entire balance can be carried over from year to year.

INVESTING FUNDING

Individuals can invest the funds in bank accounts, money markets, mutual funds and stocks. They cannot invest in collectibles, art, automobiles or real estate.

CONTRIBUTION DEADLINE

An individual can make an HSA contribution until their tax filing due date (April 15 of the year following the tax year for most people). If they fail to be an eligible individual during 2022, they can still make contributions, up until April 15, 2023, for the months they were an eligible individual.

An individual's employer can make contributions to their HSA between January 1, 2023, and April 15, 2023, that are allocated to 2022. The employer must notify the employee and the trustee of the employee's HSA that the contribution is for 2022. The contribution will be reported on the individual's 2023 W-2. This is very atypical and the process will vary by custodian.

QUALIFIED FUNDING DISTRIBUTION – TRANSFER OF IRA TO HSA

The law allows a once in a lifetime transfer of IRA assets (traditional or Roth) to fund an HSA. The amount transferred may not exceed the amount of one year's contribution and individuals must be otherwise eligible to open an HSA.

The maximum qualified HSA funding distribution depends on the HDHP coverage (self-only or family) an individual has on the first day of the month in which the contribution is made and the individual's age as of the end of the tax year. The distribution must be made directly by the trustee of the IRA to the trustee of the HSA.

The distribution is not included in the individual's income, is not deductible, and **reduces the amount that can be contributed to their HSA.** The qualified HSA funding distribution is shown on Form 8889 for the year in which the distribution is made.

Example: In 2022 Barney is an eligible individual, age 57, with self-only HDHP coverage. Barney can make a qualified HSA funding distribution of $4,650.

An individual can make only one qualified HSA funding distribution during their lifetime. However, if they make a distribution during a month when they have self-only HDHP coverage, they can make another qualified HSA funding distribution in a later month **in that tax year** if they change to family HDHP coverage. The total qualified HSA funding distribution cannot be more than the contribution limit for family HDHP coverage plus any additional contribution to which they are entitled.

Note, this distribution cannot be made from an ongoing SEP IRA or SIMPLE IRA. For this purpose, a SEP IRA or SIMPLE IRA is ongoing if an employer contribution is made for the plan year ending with or within the tax year in which the distribution would be made.

Testing period for distributions

An individual must remain an eligible individual during the testing period. For a qualified HSA funding distribution, the testing period begins with the month in which the qualified HSA funding distribution is contributed and ends on the last day of the 12th month following that month.

Example:
If a qualified HSA funding distribution is contributed to an individual's HSA on August 10, 2022, the testing period begins in August 2022, and ends on August 31, 2022. If the individual fails to remain an eligible individual during the testing period, other than because of death or becoming disabled, they will have to include in income the qualified HSA funding distribution. The individual would include this amount in income in the year in which they failed to be an eligible individual. This amount is also subject to a 10% additional tax. The income and the additional tax are calculated on Form 8889, Part III. The testing period rule that applies under the last-month rule (discussed earlier) does not apply to amounts contributed to an HSA through a qualified HSA funding distribution.

If an individual remains an eligible individual during the entire funding distribution testing period, then no amount of that funding distribution is included in income and will not be subject to the additional tax for failing to meet the last-month rule testing period.

ROLLOVERS AND TRANSFERS

If an individual chooses to switch to a different HSA custodian, they can transfer their funds. Similar to an IRA rollover, a rollover contribution is not included in the individual's income, is not deductible and does not reduce the contribution limit.

- The individual does not have to be an eligible individual to make a rollover contribution from an existing HSA to a new HSA.
- Rollover contributions do not need to be in cash. Rollovers are not subject to the annual contribution limits.
- An individual must roll over the amount within 60 days after the date of receipt.
- An individual can make only one rollover contribution to an HSA during a one-year period.

If an individual instructs the trustee of an existing HSA to transfer funds directly to the trustee of another of their HSAs, the transfer is not considered a rollover. There is no limit to the number of these transfers. The individual does not include the amount transferred in income, deduct it as a contribution, or include it as a distribution on Form 8889.

TRANSFERABILITY

If someone loses their job, their HSA belongs to them. If someone loses their job and elects to retain their HDHP under COBRA, they may even pay the COBRA premiums from their HSA. There are additional requirements to be able to pay COBRA premiums. See IRS Publication 969 for more detail.

CUSTODIAN

An HSA can be set up with any qualified trustee or custodian. A qualified HSA trustee can be a bank, an insurance company, or anyone already approved by the IRS to be a trustee of IRAs.

The HSA can be established through a trustee that is different from the individual's health plan provider. Most employers and insurers have relationships with specific HSA administrators, but employees are not required to use their plans. However, there are benefits to sticking with the plan they offer – it may streamline the claims-paying process, and it could be the only way to get an employer contribution.

CHOOSING A CUSTODIAN

Individuals can search for HSAs administrators using the HSASearch.com tool from consulting firm Devenir. They should look for a plan with low fees and investment choices that match the way they plan to use the HSA. If they expect to use the money for current medical expenses, they should look for an HSA with a low-cost savings account and a debit card that makes it easy to tap the money.

TAX REPORTING

CONTRIBUTIONS

Per IRS rules, contributions made by an employer to an employee's HSA **are not** subject to Social Security, Medicare, or FUTA taxes, or federal income tax withholding if it is reasonable to believe at the time of payment of the contributions they'll be excludable from the income of the employee.

Employee contributions to their HSAs or MSAs through a payroll deduction plan must be included in wages and are subject to Social Security, Medicare, and FUTA taxes and income tax withholding.

However, if an employee's HSA contributions are made as a salary reduction arrangement, they are considered employer contributions and exempt from Social Security and Medicare tax. This means that if someone makes HSA contributions directly through payroll, they likely won't be paying FICA taxes on those contributions.

However, if someone chooses not to use their employer's HSA provider and makes contributions outside of payroll, those contributions would be deemed employee contributions and therefore subject to FICA.

Note that if FICA taxes are not paid, credit for future Social Security payments also will not be received and future Social Security payments may therefore be reduced. This trade-off should be considered.

Generally, an employee can claim contributions they made and contributions made by any other person, other than their employer, on their behalf, as an adjustment to income, for example:

- Contributions by a partnership to a bona fide partner's HSA are not contributions by an employer. The contributions are treated as a distribution of money and are not included in the partner's gross income.
- Contributions by a partnership to a partner's HSA for services rendered are treated as guaranteed payments that are deductible by the partnership and includible in the partner's gross income.

In both situations, the partner can deduct the contribution made to the partner's HSA.

Also, contributions by an S Corporation to a 2% shareholder employee's HSA for services rendered are treated as guaranteed payments and are deductible by the S Corporation and includible in the shareholder-employee's gross income. The shareholder-employee can deduct the contribution made to the shareholder-employee's HSA.

FORM 8889

All contributions to HSAs should be reported on Form 8889 and file it with Form 1040 or Form 1040NR. Be sure to include all contributions made for the current year, including those made by April 15 of the following year that are designated for the current year. Contributions made by the employer and qualified HSA funding distributions are also shown on the form.

DEEMED DISTRIBUTIONS FROM HSAS / PROHIBITED TRANSACTIONS

Similar to the rules that apply to IRAs, any deemed distribution will not be treated as used to pay qualified medical expenses. These distributions are included in income and are subject to the additional 20% tax. Refer to Publication 969 for more details.

HEALTH COVERAGE TAX CREDIT

This credit cannot be claimed for premiums that are paid with a tax-free distribution from one's HSA. See Publication 502 for more information on this credit.

EXCESS CONTRIBUTIONS

An individual will have excess contributions if the contributions to their HSA for the year are greater than the limits discussed earlier. Excess contributions are not deductible. Excess contributions made by an employer are included in the employee's gross income. If the excess contribution is not included in box 1 of Form W-2, the individual must report the excess as "other income" on their tax return.

Generally, an individual must pay a 6% excise tax on excess contributions. See Form 5329, Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts, to figure the excise tax. The excise tax applies to each tax year the excess contribution remains in the account.

An individual may withdraw some or all of the excess contributions and not pay the excess tax on the amount withdrawn if they meet the following conditions:

- The individual withdraws the excess contributions by the due date, including extensions, of their tax return for the year the contributions were made.
- The individual withdraws any income earned on the withdrawn contributions and includes the earnings in "other income" on their tax return for the year they withdraw the contributions and earnings.

If an individual fails to remain an eligible individual during any of the testing periods, the amount they have to include in income is not an excess contribution. If an individual withdraws any of those amounts, the amount is treated the same as any other distribution from an HSA.

DEDUCTING AN EXCESS CONTRIBUTION IN A LATER YEAR

An individual may be able to deduct excess contributions for previous years that are still in their HSA.

The excess contribution an individual can deduct for the current year is the lesser of the following two amounts:

- Their maximum HSA contribution limit for the year minus any amounts contributed to their HSA for the year.
- The total excess contributions in their HSA at the beginning of the year.

Amounts contributed for the year include contributions by the individual, their employer and any other person. They also include any qualified HSA funding distribution made to the individual's HSA. Any excess contribution remaining at the end of a tax year is subject to the excise tax. See Form 5329.

DISTRIBUTIONS

Withdrawals from an HSA for qualified medical expenses are tax-free. How one reports distributions depends on whether or not the distribution was used for qualified medical expenses.

- If an individual uses a distribution from their HSA for qualified medical expenses, they do not pay tax on the distribution but they have to report the distribution on Form 8889. However, the distribution of an excess contribution taken out after the due date, including extensions, of one's return is subject to tax even if used for qualified medical expenses. Follow the instructions for the form and file it with Form 1040 or Form 1040NR.
- If an individual does not use a distribution from their HSA for qualified medical expenses, they must pay tax on the distribution. The amount is reported on Form 8889 and is filed with Form 1040 or Form 1040NR. An additional 20% tax on the taxable distribution may also have to be paid.

HSA administration and maintenance fees withdrawn by the trustee are not reported as distributions from the HSA. If any monies remain in the HSA at the time of death, a surviving spouse can continue the HSA in their own name and continue the preferential tax treatment (including future tax-free withdrawals).

Additional Tax

There is an additional 20% tax on the part of distributions not used for qualified medical expenses with the penalty waived for:

1. Those over age 65
2. Those who are disabled
3. If withdrawn as a non-spouse beneficiary after the death of the HSA owner

The tax and penalty is figured on Form 8889 and filed with Form 1040 or Form 1040NR. There is no additional tax on distributions made after the date an individual is disabled, reaches age 65 or dies.

Recordkeeping

Records must be maintained and be sufficient to show that:

1. The distributions were exclusively to pay or reimburse qualified medical expenses.
2. The qualified medical expenses had not been previously paid or reimbursed from another source.
3. The medical expenses had not been taken as an itemized deduction in any year.

These records are not sent in with the tax return; they are kept with one's tax records.

Filing Form 8889

Form 8889 must be filed with Form 1040 or Form 1040NR if an individual (or their spouse, if married filing a joint return) had any activity in their HSA during the year. In this case, the individual must file the form even if only their employer or their spouse's employer made contributions to the HSA.

If, during the tax year, an individual is the beneficiary of two or more HSAs or they are a beneficiary of an HSA and they have their own HSA, they must complete a separate Form 8889 for each HSA.

As always when it comes to tax related matters, individuals should seek the advice and assistance of their tax professional.

QUALIFIED MEDICAL EXPENSES

Qualified medical expenses are those expenses that would generally qualify for the medical and dental expenses deduction. These are explained in IRS Publication 502, Medical and Dental Expenses.

A medicine or drug will be a qualified medical expense for HSA purposes only if the medicine or drug:

1. Requires a prescription
2. Is available without a prescription (an over-the-counter medicine or drug) and the individual gets a prescription for it
3. Is insulin

Non-prescription medicines (other than insulin) are not considered qualified medical expenses for HSA purposes.

For HSA purposes, expenses incurred before an individual establishes their HSA are not qualified medical expenses. State law determines when an HSA is established. An HSA that is funded by amounts rolled over from another HSA is established on the date the prior account was established.

If, under the last-month rule, an individual is considered to be an eligible individual for the entire year for determining the contribution amount, only those expenses incurred after the individual actually establishes their HSA are qualified medical expenses.

Qualified medical expenses are those incurred by the following persons:

1. The individual and their spouse

2. All dependents the individual claims on their tax return

3. Any person the individual could have claimed as a dependent on their return except that:

- The person filed a joint return,
- The person had gross income of $4,000 or more, or
- The individual, or their spouse if filing jointly, could be claimed as a dependent on someone else's tax return.

An individual cannot deduct qualified medical expenses as an itemized deduction on Schedule A (Form 1040) that are equal to the tax-free distribution from their HSA.

If one's domestic partner is covered under their medical plan and meets the IRS qualifications of a tax dependent, HSA funds can be used for his/her medical expenses.

Generally, health insurance premiums are not qualified medical expenses; however, in certain circumstances they can be qualified (e.g., certain amounts of long-term care insurance or Medicare Part A, B or D for qualified individuals).

The only requirement at the time of distribution for tax-free treatment from an HSA is that the withdrawal either cover a current medical expense or be used to reimburse a prior one (that was itself paid out of pocket, not reimbursed from another source and not previously claimed as an itemized deduction).

This means that medical expenses can occur now and be reimbursed later in the future and still be qualified, as long as documentation of the medical expense is maintained and as long as the medical expense occurred after the HSA was originally established.

An individual can receive tax-free distributions from their HSA to pay or be reimbursed for qualified medical expenses they incur after they establish the HSA. If the individual receives distributions for other reasons, the amount they withdraw will be subject to income tax and may be subject to an additional 20% tax.

QUALIFIED MEDICAL EXPENSES

Qualified medical expenses are a defined term created by the IRS and include expenses paid by the account beneficiary for medical care, such as:

- Medical care
- Acupuncture
- Ambulance costs
- Artificial limbs
- Artificial teeth
- Bandages
- Birth control pills
- Contact lenses
- Crutches
- Doctor visits
- Some dental expenses
- Vision care (eyeglasses, contacts, lasik surgery)
- Hearing aids
- Lab fees
- Prescriptions
- Payment for long-term care
- X-rays

HSAs cannot be used for cosmetic surgery unless prescribed by a physician as being medically necessary.

An individual does not have to make distributions from their HSA each year.

If an individual is no longer an eligible individual, they can still receive tax-free distributions to pay or reimburse their qualified medical expenses.

An individual's total distributions include amounts paid with a debit card that restricts payments to healthcare and amounts withdrawn from the HSA by other individuals that the individual has designated. The trustee will report any distribution to the individual and the IRS on Form 1099-SA.

WITHDRAWING FUNDS

An individual can withdraw the funds at any time; however, if the funds are withdrawn for any expense other than a qualified medical expense, the IRS will impose a 20% penalty tax. After an individual reaches age 65 they can withdraw the funds without penalty but the amounts withdrawn will be taxable as ordinary income.

REIMBURSEMENTS

As long as the individual's HSA was established at the time the expense was incurred, the individual saved the receipt and it was not otherwise reimbursed, they can reimburse themselves for the expense from their HSA – even years later.

BALANCE IN AN HSA

Amounts that remain at the end of the year are generally carried over to the next year. Earnings on amounts in an HSA are not included in income while held in the HSA.

USING HSA TO PAY FOR HEALTH INSURANCE PREMIUMS

Generally, insurance premiums cannot be treated as qualified medical expenses **unless the premiums are for:**

1. Long-term care insurance (subject to IRS mandated limits based on age and adjusted annually)
2. Healthcare continuation coverage (such as COBRA)
3. Healthcare coverage while receiving unemployment compensation under federal or state law
4. Medicare and other healthcare coverage if the individual was 65 or older (other than premiums for a Medicare supplemental policy, such as Medigap)

Note also that items 2 and 3 can be for a spouse or a dependent meeting the requirement for that type of coverage. For item 4, if the account beneficiary is not 65 or older, Medicare premiums for coverage of a spouse or a dependent (who is 65 or older) generally **are not** qualified medical expenses. If an account beneficiary has attained age 65, premiums for Medicare for the account beneficiary, the account beneficiary's spouse, or the account beneficiary's dependents are qualified medical expenses.

Individuals can even reimburse themselves for the money that Social Security withholds from their benefits to pay Medicare Part B and/or D and they can also make tax-free HSA withdrawals to pay Medicare Part B and/or D and Medicare Advantage premiums (but not Medigap premiums).

USING HSA TO PAY FOR LONG TERM CARE INSURANCE

Individual purchasers of tax-qualified long-term care (LTC) insurance can pay the LTC premiums from their employee HSAs on a tax-free basis up to the limits listed below.

LTC insurance is tax-qualified if it pays benefits when the policy holder is unable to perform at least two activities of daily living or when they have severe cognitive impairment.

The amount that can be withdrawn tax-free for premiums depends on one's age.

The 2022 premium limits are:

Age 40 or younger	2022 deductible limit is $450
Age 41 to 50	$850
Age 51 to 60	$1,690
Age 61 to 70	$4,510
Age 71 or older	$5,640

The amounts increase slightly each year to account for inflation.

A health savings account can also be used to pay for some long-term care expenditures. See IRS Publication 969 for more details.

For questions relating to their specific HSA and qualified medical distributions, individuals can work directly with their HSA custodian.

DEATH OF AN HSA HOLDER

What happens to an HSA when an individual dies depends on whom they designate as the beneficiary.

If a spouse is the designated beneficiary of an HSA, it will be treated as the spouse's HSA after the owner's death. If a spouse is not the designated beneficiary:

- The account stops being an HSA and becomes a savings or brokerage account.
- The fair market value of the HSA becomes taxable to the beneficiary in the year in which they die.

If the estate is the beneficiary, the value is included on the final income tax return. The amount taxable to a beneficiary other than the estate is reduced by any qualified medical expenses for the decedent that are paid by the beneficiary within one year after the date of death.

To learn more about health savings accounts, talk to your advisor.

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