Health Insurance Smarts

Health Savings Accounts

Fact Sheet

Health Savings Accounts (HSAs) are special accounts that consumers set up to put money aside to be used for future health-care expenses.

What are the main features of an HSA?

- The monies deposited are not taxable at the time of the deposit. The accounts are considered tax-exempt trusts or custodial accounts.
- The monies may roll over from year to year. That means, unlike many Flexible Spending Accounts (FSAs), money deposited in one year doesn't have to be spent in the same year. Unspent money stays in the account until needed.
- The monies withdrawn from the account are called distributions and must be spent on qualifying/approved health-care expenses; otherwise there are penalties and taxes to pay. (see "Qualifying expenses" below)

How does one qualify to open an HSA?

An individual must meet eligibility requirements to open an HSA.

1. An individual's ***only*** health insurance coverage has to be a high-deductible health plan (HDHP). The deductible is how much money the consumer must spend before insurance begins to pay health-care expenses. In order to be considered a high deductible plan, the deductible for the insurance plan must be at least $1,400 for an individual, or $2,800 for a family. (These are calendar year 2020 criteria.)[1]
2. An individual cannot be enrolled in Medicare; and
3. An individual cannot be claimed as a dependent on another person's tax return.

How does it work?

- The individual (or her employer or anyone who wishes) contributes money into his/her HSA on an ongoing basis. The maximum annual contribution is $3,550 for individual coverage or $7,100 for family coverage for calendar year 2020. Individuals who are 55 or older are permitted to contribute an additional $1,000.[2] Employer contributions to an HSA may be excluded from your gross income. Contributions made by someone other than employers are tax deductible.
- HSA payments for health care are called "distributions." When an individual needs to pay for health-care expenses that are not reimbursed by his high deductible insurance plan, he asks the trustee of the HSA to send a distribution.
- The individual will need to keep records that are sufficient to show that distributions received from his HSA were exclusively used to pay or reimburse a qualified medical expense, that this qualified medical expense had not been previously paid or reimbursed by another source, and that the medical expense was not taken as an itemized deduction.[3]
- This information is to be maintained for the individual's tax records. It does not need to be sent in with tax forms. (See section on taxes for more information.)

1 https://www.healthcare.gov/glossary/high-deductible-health-plan/

2 https://www.healthcare.gov/glossary/health-savings-account-hsa/

3 https://www.irs.gov/pub/irs-pdf/p969.pdf

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Health Savings Accounts

Qualifying expenses

Legitimate expenses that may be paid for with HSA funds include (these may change with changes in tax law and rules):

- Expenses included in the IRS Publication 502, Medical and Dental Expenses. It can be viewed here https://www.irs.gov/pub/irs-pdf/p502.pdf
- Some examples include ambulance service, eye exams and hearing aids, hospital services, chiropractor care, laboratory fees, premiums you pay for certain health insurance (specifically long-term-care insurance), continuation coverage such as COBRA and health insurance while receiving unemployment benefits, amounts paid for qualified long-term care, and much more.
- Upon enrolling in Medicare, consumers can no longer contribute to their HSA. If they had an HSA before they enrolled in Medicare, they may use remaining HSA funds to pay premiums for Medicare Part B and Part D, but not premiums for supplements like a Medigap policy.[4]
- For a medicine to qualify as a legitimate expense it requires a prescription. This applies to over-the-counter medicines as well. Insulin is a qualified medical expense.[5]

Some of the tax implications

- Employer contributions may be excluded from your gross income.
- Employee contributions are also considered pre-tax income if the employer takes them out of the employee's paycheck. If the employee contributes to the HSA separately outside of work, these contributions may be deducted from income on tax returns. This is true even if the taxpayer is not itemizing deductions.
- Funds can be invested. All income grows tax-free and no tax is paid as long as distributions are for qualified expenses.[6]
- There are penalties if funds are distributed for non-qualified health care expenses.
    a. the amount of the funds will be subject to income tax AND
    b. may be subject to an additional 20% tax.[7]
- The exceptions to the penalties:
    - after age 65 or upon disability, the consumer may withdraw funds for living expenses. At that time, the amount withdrawn will be considered income and taxed as such. However, there will be no penalty for using these funds for non-health-care purposes.
- Since it is a tax-favored account, use of the account needs to be reported to the IRS annually. IRS Form 8889 needs to be included with a consumer's tax return if any distributions have been made.[8] The consumer will need to follow the instructions on Form 8889 to report all distributions from an HSA, both qualified and non-qualified.

Special circumstances

Some individuals who have other coverage in addition to high deductible coverage may still be eligible to maintain an HSA. Those coverage exceptions are:

- liability coverage such as those under workers compensation,
- coverage for a specific illness or disease, and
- coverage that involves a fixed amount and timeframe of hospitalization care. Additionally,
- coverage for accidents, disability, vision care, dental care, and long-term care do not disqualify an individual from opening an HSA. Likewise,
- an individual remains eligible if their spouse has health coverage other than a high-deductible health plan as long as the individual with the HSA is not covered under that plan.

4 https://www.irs.gov/pub/irs-pdf/p969.pdf
5 https://www.irs.gov/pub/irs-pdf/p969.pdf
6 https://www.irs.gov/pub/irs-pdf/p969.pdf
7 https://www.irs.gov/pub/irs-pdf/p969.pdf
8 https://www.irs.gov/pub/irs-pdf/f8889.pdf

Health Savings Accounts

HSAs are becoming more common

Depending on one's actual annual health-care expenses, a high deductible health plan combined with HSAs may yield significant savings. The money contributed to a HSA can be used to help meet the High Deductible Health Plan (HDHP) deductible and reduce taxable income. The money in the HSA rolls over each year, which can benefit individuals in several ways. This savings can be used to pay for health insurance premiums when a person is between jobs and to pay for qualified long-term care premiums. Additionally, it can be used to pay Medicare Part B and Part D premiums, deductibles and copayments for medical expenses, out-of-pocket costs for prescription drugs, vision, and dental care.

In contrast, many consider high deductible plans as problematic since consumers may be afraid to spend the money. The high-deductible health plans that are paired with HSAs often feature low premiums so they appear enticing. However, consumers need to have enough money in their HSAs to feel comfortable using them. Some can't save enough or are afraid to use their HSA funds for relatively minor health-care needs. This may encourage delaying needed care. Consumers that have lower deductible plans are more likely to use care that they think they need without having a financial constraint.

Further, one of the significant benefits of a HSA is the reduction in taxable income it permits while offering a way to set aside money. Should a consumer need to make use of this savings for a non-qualified reason, that withdrawal would be subject to income tax and possibly additional tax. Therefore, an HSA may not be an ideal savings account if the consumer is not able to also set aside money in an account that does not have these restraints.

Health Savings Accounts (HSAs) are special accounts that consumers set up to put money aside to be used for future health-care expenses. Health-care needs are unpredictable and anticipating health-care expenses can be challenging. Depending on individual circumstances, HSAs may provide a way for a consumer to experience savings through lower health insurance premiums and income tax reduction.

More information can be found at https://www.irs.gov/pub/irs-pdf/p969.pdf and http://www.hsacenter.com

http://www.treasury.gov/resource-center/faqs/Taxes/Pages/Health-Savings-Accounts.aspx

Health Savings Accounts

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Kansas State University Agricultural Experiment Station and Cooperative Extension Service
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