

Health Savings Accounts (HSAs)

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The dramatic rise in health care expenses in recent years has prompted some individuals to combine a high deductible health insurance policy with a federal Health Savings Account (HSA) to control these costs. This MontGuide provides basic information about HSAs. Additional information sources are listed on page 4.



MontGuide

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What is an HSA?

HSAs are special savings accounts that were established by federal law to allow eligible individuals to make deposits that can be used to pay for future *qualifying medical expenses*. Deposits to HSAs reduce an individual's state and federal taxes. Any funds remaining in the HSA at the end of the year may be used to pay for *qualifying medical expenses* in future years for the individual, his or her spouse or dependent children.

What are qualifying medical expenses?

Qualifying medical expenses include health insurance deductibles and co-payments, long-term care costs, prescription and over-the-counter drug costs, dental expenses, eyeglasses and contact lenses, and many other medical expenses. The IRS publishes a list (Publication 502) of common medical expenses that are qualified and those that are not. Search for "Publication 502" at www.irs.gov.

Special rules apply to medical insurance premiums. Generally, expenses for medical insurance premiums are not *qualifying medical expenses*, although there are some exceptions. HSA funds may be used for Medicare Part A, B, C and D premiums. The premium for a Medicare supplemental insurance policy (often referred to as a Medigap policy), however, does not meet the definition of a *qualifying medical expense*.

Can an HSA be used to pay for qualifying medical expenses incurred before the HSA was established?

No. Funds in an HSA can only be used to pay for *qualifying medical expenses* that were incurred after the HSA was established. Any expenses that were incurred before the HSA was established are not allowed.

Who is eligible to have an HSA?

To be eligible for an HSA an adult must meet **all** of the following **four** requirements:

- A person must have a qualifying *high deductible health plan*. A qualified *high deductible health plan* (HDHP) is one with a minimum deductible of \$1,150 for an individual (\$2,300 for a family). A qualified HDHP also must limit out-of-pocket expenses (not including premiums) to \$5,800 annually per individual (\$11,600 for a family). These limits are for the year 2009 and are adjusted annually for inflation.
- A person cannot have any other non-HDHP coverage, although exceptions are allowed for accident, disability, dental, vision, and long-term care insurance. If a person has received Veteran's benefits in the past three months, he or she is not eligible to contribute to an HSA.
- A person cannot be enrolled in Medicare.
- A person cannot be claimed as a dependent on another person's tax return.

Where can an HSA be opened?

HSAs can be established at banks, credit unions, insurance companies, and other financial institutions (such as a mutual fund company) that have decided to offer HSAs. Because an HSA is a designated account, an individual cannot use an established savings account as his or her HSA. The types of investments (CDs, stocks, bonds, mutual funds and so on) that are available to account holders are determined by the financial providers that offer HSAs.

Many insurance companies that offer *high deductible health plans* (HDHP) also offer HSAs. However, companies that offer HDHPs are not required to offer HSAs nor must individuals use the same company for their HDHPs and their HSAs. HSA providers can be compared at www.hsainsider.com.

How much can be contributed to an HSA?

The maximum amount that an individual can contribute to an HSA for 2009 is \$3,000 (\$5,950 for a family). Maximum contribution limits are adjusted annually for

inflation. Individuals who are age 55 or older and eligible for an HSA are allowed an additional *catch-up contribution*. The maximum allowable *catch-up contribution* for 2009 is \$1,000.

Do HSA contributions need to be made all at one time?

No. Contributions can be made to an HSA on a regular or irregular basis. Some individuals contribute to their HSA each month. Others may choose to make a single contribution yearly and still others may choose to deposit funds on an “as needed basis.”

Contributions to an HSA can be made at any time during the year or as late as April 15 of the following year to qualify for a state and federal tax deduction for the prior year.

A financial institution may impose minimum balance and deposit requirements on HSA accounts. Some institutions also charge a variety of fees for setting up an account, closing an account, making excess contributions, monthly maintenance, and for making debit card transactions.

Example 1: Frank decided to open an HSA at the same bank where he has his checking and savings accounts. Frank’s bank requires a minimum \$100 deposit to open an HSA. The bank also requires that all future HSA deposits be at least \$50. A \$1.50 monthly maintenance fee is charged to Frank’s HSA if his average account balance for the month is less than \$500.

Does contributing to an HSA reduce taxes?

Yes. An individual will save on both state and federal taxes by contributing to an HSA. The total savings depends on the amount contributed and the individual’s state and federal tax brackets. The greatest tax savings are for individuals in higher income tax brackets who contribute the maximum allowable amount (\$3,000 individual; \$5,950 family).

Example 2: Gary, a 42-year old Montana resident, expects to earn \$45,000 in 2009. He plans to contribute the maximum allowed \$3,000 to his HSA. Assume his 2009 federal tax rate is 25 percent and his Montana tax rate is 6.9 percent. Gary will reduce his federal income tax by approximately \$750 ($\$3,000 \times 25\%$) and his Montana income tax by approximately \$207 ($\$3,000 \times 6.9\%$). His total tax savings from contributing \$2,850 to his HSA in 2009 is approximately \$957.

How is an HSA reported on federal and Montana tax returns?

IRS Form 8889 (Health Savings Accounts) is used to calculate contributions to an HSA for both state and federal tax returns. Part 1 of Form 8889 focuses on contributions and deductions. Part 2 examines distributions and penalties

for non-qualified withdrawals from HSAs. The HSA deduction can be claimed regardless of whether an individual itemizes deductions or claims the standard deduction.

The Montana HSA tax deduction (calculated on Form 8889) is reported on Form 2 (Montana Individual Income Tax Return, Long Form). The federal HSA deduction is reported on IRS Form 1040.

How are HSA withdrawals taxed?

HSA withdrawals are not taxed at the state or federal levels as long as they are used for *qualifying medical expenses* of the account holder, his or her spouse or dependents.

Withdrawals from HSAs that are not used for *qualifying medical expenses* are subject to state and federal income taxation and a 10 percent penalty. Instructions for reporting a *non-qualifying withdrawal* from an HSA are provided in “Instructions for Form 8889.”

Example 3: In January, Casey was faced with an unexpected car repair bill. He did not have enough money in his checking account to pay for the repairs, so he decided to withdraw \$500 from his HSA. Because car repairs are not *qualifying medical expenses*, Casey is required to report the \$500 withdrawal as income on both his state and federal tax returns. He is also responsible for a 10 percent penalty of \$50 on the amount of withdrawal ($\$500 \times 10\%$).

How is an HSA different from a flexible spending account (FSA)?

Some employers offer their employees flexible spending accounts (FSAs). Each year employees are allowed to contribute on a pretax basis to their FSAs for the upcoming year. One of the major drawbacks of FSAs is that any funds remaining in the FSA at the end of the year are forfeited because of the “use it or lose it” requirement. In an HSA, any unused funds may be carried over and used for *qualifying medical expenses* during future years.

HSAs are portable and FSAs are not. Because FSAs are company sponsored, individuals who change employers are no longer eligible to participate in their former employer’s FSA. HSAs, unlike FSAs, are not company sponsored.

How is an HSA different from a Montana Medical Care Savings Account (MSA)?

All Montana tax payers are eligible for a Montana Medical Care Savings Account (MSA) regardless of what type of health insurance plan they have purchased. HSAs are only available to individuals who have a qualifying HDHP, who are not enrolled in Medicare, who do not have another health insurance plan, and who cannot be claimed as a dependent on another person’s tax return. Establishing a Montana Medical Care Savings Account does not prohibit an individual from establishing an HSA. In other words Montanans can have both an HSA and a MSA.

Another difference between an HSA and a MSA is that a contribution to a Montana MSA is deductible on the Montana income tax return but not on the federal income tax return. A contribution to an HSA is tax deductible on both state and federal income tax returns.

For more information see MontGuide *Montana Medical Care Savings Accounts (MSAs)*, available online at <http://msuextension.org/publications/FamilyFinancialManagement/MT199817HR.pdf>, or request a copy without charge from your local MSU Extension county office.

What happens to an HSA when the account holder reaches age 65?

An individual who is age 65 or older may use the funds in his or her HSA to pay for *qualifying medical expenses*, just as they did before he or she reached age 65. An individual who is age 65 or older is no longer subject to the 10 percent penalty for withdrawals for non-qualifying expenses. However, withdrawals for non-qualifying expenses by an individual age 65 or older are still subject to state and federal income taxation.

Can individuals keep their HSA if they change jobs or retire?

Eligibility for an HSA is not directly affected by an individual's employment. Individuals who still meet the four HSA eligibility requirements (see page 1) may continue to utilize their HSA just as they did prior to leaving their employer.

However, if an individual's HDHP is provided by an employer, he or she may lose HDHP coverage if he or she changes employers. In addition, an individual who loses his or her HDHP is ineligible to make future contributions to his or her HSA. However, the person may continue to use funds currently in the HSA.

What happens to an HSA upon the death of the account holder?

When an HSA is opened, one or more beneficiaries may be designated for the account. If beneficiaries are not designated the account passes by a person's will or by the Montana law of intestate succession. After the death of the account holder, his or her HSA will be transferred to the named beneficiary in one of two ways.

If the beneficiary is a spouse, then he or she will be able to use the funds in the account as his or her own HSA funds.

Example 4: In 2007, Kent established an HSA and designated his wife as beneficiary. In 2009 Kent passed away after a short illness. After all of Kent's medical expenses were paid, the balance in his HSA was \$730. Because he designated his spouse as beneficiary, the \$730 from Kent's HSA becomes an HSA for his wife. She may use funds in the HSA for her future *qualifying medical expenses*.

If the beneficiary *is not a spouse*, then the funds in the HSA are treated as taxable income to the beneficiary.

Example 5: In 2009, Wilma established an HSA and designated her daughter as beneficiary. After Wilma passed away in January of 2010, her HSA balance was \$1,320. Wilma's daughter is not allowed to use the \$1,320 as an HSA for herself because she is not the spouse of the decedent. Because Wilma's daughter is a non-spousal beneficiary, she must treat the \$1,320 as income on her state and federal tax returns.

Can funds be transferred from an individual retirement account (IRA) to an HSA?

A **one-time** only transfer from an IRA to an HSA is allowed--individuals cannot make multiple transfers from an IRA to an HSA. The one-time transfer from the IRA is limited to the annual HSA contribution limit (\$3,000 for an individual or \$5,950 for a family in 2009). The transfer amount is not included in the individual's income for the tax year and not subject to the 10 percent penalty for early withdrawals from IRAs. Search for "IRA to HSA transfer" at www.treas.gov.

What if an individual is eligible for an HSA for only part of a year?

Different rules apply to individuals who are eligible for an HSA for only a portion of a tax year. An individual who is eligible for an HSA on December 1st but not for the entire year is considered to be eligible for the entire year for contribution purposes (refer to Example 8 for an exception to this rule).

Example 6: On October 1, 2009, William enrolled in an HDHP offered by his employer. Prior to October 1st, William was enrolled in a traditional health care plan. Because William was eligible for an HSA on December 1st, he is allowed to contribute the maximum annual amount for a single individual (\$3,000 for 2009).

An individual who is eligible for part of the year but not on December 1st is subject to a prorated maximum annual contribution based on the number of months he or she was eligible.

Example 7: Jane became eligible for an HSA on January 1, 2009, because she met all four eligibility requirements. On July 1, 2009, Jane started a new job and enrolled in a traditional health care plan. Because her new employer did not offer a *high deductible health plan*, Jane is eligible to contribute to her HSA for only half of the year (6 of 12 months). The maximum Jane can contribute to her HSA for 2009 is \$1,500 ($\$3,000 \times \frac{1}{2} = \$1,500$).

Individuals who take advantage of the December 1st rule to can only contribute the maximum amount if they remain eligible for the entire following year. Individuals who become ineligible for an HSA during the following year lose their eligibility for the maximum contribution for the previous year. These individuals are limited to a prorated contribution limit based on the portion of the previous year that they were eligible. The December 1st eligibility rule should be used with caution if an individual's HSA eligibility for the following year is uncertain.

Example 8: Tim became eligible for an HSA on July 1, 2009.

Because Tim was eligible on December 1st, he elected to contribute the maximum contribution (\$3,000) to his HSA for 2009. On April 1, 2010 Tim became ineligible for an HSA because he accepted a new job that offered only traditional health insurance coverage. Tim's ineligible status in 2010 reduces his allowable contribution limit for 2009 from \$3,000 to \$1,500 (6 months ÷ 12 months x \$3,000 = \$1,500).

Summary

HSAs offer several benefits to account holders:

- A deduction can be claimed on both an individual's federal and Montana tax returns for contributions to an HSA, resulting in less federal and state income taxes.
- Any interest or other earnings on HSAs are federal and state income tax free.
- Any unused funds in an HSA account can be carried over from year to year, unlike the "use or lose it" flexible spending accounts offered by some employers. Individuals with few qualifying medical expenses could build up sizeable account balances that could be used for qualifying medical expenses during future years.
- Withdrawals from an HSA for qualifying medical expenses are federal and state income tax free.

- HSAs are portable. Changing employers, relocating to another state or changing health care insurance providers does not directly affect an individual's eligibility to contribute to an HSA.
- Savings may be achieved by switching from a traditional health insurance plan to a high deductible health plan that offers lower premium rates.
- There are no income limitations on HSA eligibility.

Additional Sources of Information

Federal Health Care Savings Accounts (HSA)

U.S. Department of the Treasury HSA Web site at: <http://www.treas.gov/offices/public-affairs/hsa>

Download the MSU Extension MontGuide *Montana Medical Care Savings Accounts (MSAs)*. <http://msuextension.org/publications/FamilyFinancialManagement/MT199817HR.pdf>, or request a copy without charge from your local MSU Extension County office.

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