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10 HSA Rules Every Advisor Needs to Know

Health Savings Accounts (HSAs) are rapidly growing in both size and number. These accounts can be a valuable tool when planning for your clients' financial futures. Here are 10 HSA rules every advisor needs to know.

1. **No income limits.** There are many situations where higher-income clients may be ineligible for tax breaks. There are income limits on Roth IRA contributions and IRA deductibility for those who also participate in retirement plans at work. This is not the case with HSAs. There are currently no income limits for HSA contributions. Your client will never make too much money to be eligible for this tax break.

2. **Contributions are always deductible.** When an HSA owner makes an HSA contribution, they may deduct that contribution regardless of how high their income is. There are no limits. For higher-income clients looking for new and overlooked strategies to reduce their taxable income, an HSA deduction may fit the bill. The deduction is an above-the-line deduction rather than an itemized deduction. The deduction is taken by filing IRS Form 8889, with the total contributions also reported on IRS Form 1040.

3. **Tax-free distributions from your HSA for qualified medical expenses.** Not only are HSA contributions deductible, but distributions from an HSA used to pay qualified medical expenses are tax-free. For your clients, this means that both their contributions to their HSA and the earnings on those contributions will never be taxed if used for eligible medical expenses. This also includes the expenses of a spouse or dependent, even if they are not covered under the HSA compatible high-deductible health insurance.

   HSAs offer a lot of flexibility when it comes to tax-free distributions. A client can take a tax-free distribution from an HSA to reimburse themselves for qualified medical expenses in prior years as long as the expenses were incurred after they established their HSA and they have proof of those expenses.

4. **Funding an HSA with an IRA.** Clients can use an IRA to fund an HSA by doing a transaction called a Qualified HSA Funding Distribution (QHFD). A QHFD is done by direct transfer from the IRA to the HSA. The transaction is neither taxable nor subject to the 10% early distribution penalty. The amount allowed to be transferred cannot exceed the amount the individual is eligible to contribute to their HSA for the year.

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A client may only do one QHFD in their lifetime. Once a client does a QHFD, they must remain eligible for the HSA for the testing period. The testing period begins the month of the HSA contribution and ends on the last day of the month twelve months later. There are exceptions to the testing period for death and disability.

This strategy can be a great way to jump start an HSA. A QHFD can also provide a unique opportunity to move taxable funds from an IRA and leave the IRA basis behind. How is this possible? Only the taxable portion of an IRA can be moved as a QHFD. Basis is not eligible for a QHFD. This is a win-win result for a client. It includes tax-free distributions from their HSA for qualified medical expenses and more of their IRA distributions being tax free.

5. **Funding can be done by an employer or an individual.** An employer or an individual may contribute to an HSA. As a reminder, combined contributions cannot exceed the maximum contribution limit for the year. The individual cannot take a deduction for employer contributions.

6. **High deductible health plan required.** Under the current rules, to be eligible to make an HSA contribution, a client must be covered by a high-deductible health plan (HDHP). The rules are very specific about which plans qualify as HDHPs. The plan must have a minimum deductible and a maximum out-of-pocket expense. These amounts are indexed for inflation. Except for preventative care, an HDHP may not provide benefits until the deductible for the year is met. The easiest way to determine if the client's health insurance qualifies as an HDHP is to ask the insurance company.

7. **Contribution limits.** Contribution limits depend on the client's age and type of health insurance. The HSA contribution limits are indexed for inflation. Contributions are generally prorated for the number of months the individual is enrolled in an HDHP. Contributions can be made by the individual, the employer, or anyone, but the annual contribution limit applies. The contribution deadline is the client's tax-filing deadline, not including extensions (i.e. April 15).

2017 HSA Contribution Limits

Self-only HDHP under age 55	Self-only HDHP age 55+	Family HDHP under age 55	Family HDHP age 55+
$3,400	$4,400	$6,750	$7,750

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8. **Understanding qualified medical expenses.** Qualified medical expenses include those that would generally qualify for the medical and dental expense deduction. This includes most medical, dental, vision and chiropractic expenses.

9. **Saving for medical expenses in retirement.** A critical part of saving for retirement is saving for medical expenses. Many experts estimate that a large percentage of many retirees' savings will go toward healthcare costs. If a client begins funding an HSA annually and does not use the funds for current medical expenses, it can accumulate to a significant amount that can help defray these costs in retirement.

   Individuals cannot contribute to an HSA once they are enrolled in Medicare. However, they can keep their existing HSA and still take tax-free distributions for qualified medical expenses. They can even take tax- and penalty-free distributions for Medicare premiums and out-of-pocket expenses. When they reach age 65, if they do not use the funds in their HSA for medical expenses, they may use them for any other purpose without penalty. Any distributions not used for medical expenses will be taxable.

10. **Naming a beneficiary.** Clients can name a beneficiary for their HSA. If the HSA beneficiary is their spouse, at the time of the client's death, the HSA will become their spouse's. The HSA can continue to be used tax-free for qualified medical expenses.

    Nonspouse beneficiaries do not fare so well. The account value of the HSA becomes taxable to them in the year of the HSA owner's death. Clients may want to consider being more open to taking tax-free distributions from their HSA during their own lifetime whenever possible to pay for medical expenses. Remember, clients can even reimburse themselves for qualified medical expenses that they paid out of pocket in previous years, as long as those expenses occurred after they established the HSA and they have proof of those expenses. This may be the most tax-efficient way to distribute the remaining balance in the HSA. By using their HSA during their lifetime, they can preserve other assets for their heirs.

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