What are some advantages of an HSA?

With HSAs, employees own their account—even if they leave their job—and earnings in the account grow tax free. With flexible spending accounts, the other popular health care account, the employer owns the account and no earnings are paid.

With HSAs, funds roll over at year's end. With FSAs, funds don't roll over or, as we've seen recently, there's a limit to how much is allowed to roll over. And with HSAs, no employer involvement is necessary, unlike FSAs, where employers must review claims.

To be eligible for an HSA, an employee must be covered under a high-deductible health plan. However, just because someone is covered under an HDHP doesn't mean they have to open an HSA.

It's been estimated that nearly half of Americans who are eligible to open an HSA, haven't—usually because they can't afford to. Unfortunately, they are missing out on potential tax benefits.

What's the down side to HSAs?

Well, besides having to come up with money to fund it if your employer doesn't put some in, the rules around them can get complex. The employee who owns an HSA will need to take more responsibility for learning about these rules.

Some are also concerned about the so-called Cadillac tax kicking in in the future. This is the Patient Protection and Affordable Care Act law that places a tax on high-priced health plans starting in 2018. The IRS said that both employer and employee payroll deferral HSA contributions count toward the tax cap. This is something employers and the insurance industry are watching closely.

Now that that's covered, let's look at these 10 FAQs about HSAs.

#1: Why is having an HDHP a requirement for having an HSA?

Opponents of the HSA legislation were concerned that HSAs would become just another tax break for the wealthy. To partially counter that concern, the HSA laws require that in order to be eligible for an HSA you must be covered by an HDHP and no other health plan.

This is to avoid the situation where a taxpayer could get a large deduction for an HSA contribution and then not really need the HSA to pay for day-to-day medical expenses because the person either had traditional, low-deductible insurance, or was double covered and had both traditional and HDHP coverage.

People with HDHP coverage and no other health plan coverage (other than permitted coverage or coverage by another HDHP) need the benefits of an HSA because they face a high deductible.

The idea behind HSAs is that HSA owners would pay day-to-day medical expenses with the HSA. Their HDHP insurance is only accessed for catastrophic events or very large medical expenses.

#2: Are HDHP-covered individuals that are also covered by their spouse's traditional insurance eligible for an HSA?

No. The individual would have "other health coverage" that disqualifies the individual for an HSA.

This type of double coverage represents the typical example of someone that is not eligible for an HSA due to the "other health coverage" rule.

#3: Are counseling, disease management, and wellness EAP programs considered to "provide significant benefits in the nature of medical care and treatment" and be a health plan and disqualify one from an HSA?

No. The three types of EAP programs below are generally not considered to be a health plan and would not disqualify you for an HSA.

Counseling EAP Program. EAPs designed to provide short-term counseling to identify problems that may impact work performance are generally allowed with an HSA. Issues addressed in this type of EAP program often include substance abuse, mental health or emotional disorders, financial or legal difficulties, and dependent care needs.

Disease Management EAP Program. EAPs designed for disease management are generally allowed with an HSA. This type of EAP identifies employees and their family members who have, or are at risk for, certain chronic conditions. The program provides evidence-based information, disease specific support, case monitoring, and coordination of care (not the actual care).

Wellness EAP Program. EAPs designed for employee wellness are generally allowed with an HSA. A wellness program provides a wide range of education and fitness services designed to improve the overall health of the employees and prevent illness. (IRS Notice 2004-50)

#4: When can an HSA be opened?

An HSA can be opened at any time of year, as long as the individual is already enrolled in a qualified HDHP and is otherwise HSA-eligible. If enrolling through an employer, generally people enroll during the employer's open enrollment period.

#5: Can an HSA owner "establish" an HSA with a zero balance?

Pursuant to many state laws, the HSA must be funded to be considered "established."

Without researching state laws, a conservative approach is for HSA owners to fund the HSA with a small amount to get it "established."

#6: What are the ramifications when someone loses eligibility for an HSA?

Common reasons that people lose HSA eligibility include changing jobs, becoming eligible for Medicare, or just switching insurance plans. Some items for HSA owners to consider are listed below:

The money belongs to the HSA owner. The HSA belongs to the HSA owner regardless of whether the HSA owner or the employer made the contribution to the HSA.

Use HSA for qualified medical expenses. The HSA owner can continue to use the HSA for qualified medical expenses even if no longer eligible for an HSA. The HSA owner just cannot add more money. The HSA works to pay co-pays, deductibles, dental, and other general medical expenses not covered by insurance, at least until the HSA is exhausted.

Use as retirement fund. HSA owners can simply let the account grow until they do need it. At age 65, an HSA owner can use the balance for any reason without penalty, but the HSA owner will have to pay income taxes on amounts withdrawn for nonmedical expenses.

Maximize contribution or remove an excess. In an HSA owner's final year of HSA eligibility, the HSA owner may want to maximize the HSA contribution. HSA owners can make an HSA contribution even if no longer eligible so long as the HSA owner is making the contribution for when the HSA owner was eligible (assuming the HSA owner makes the HSA contribution prior to the tax due date).

Protect the establishment date. HSA owners should consider keeping the HSA open to protect the "establishment date."

#7: Are there limitations on HSA investment options?

Yes. There are actually few limitations on investment choices, but HSAs may not be invested in collectibles. This includes works of art, antiques, metal (some exceptions involving platinum, gold and silver coins and bullion), gems, stamps, coins, alcoholic beverages, or other tangible personal property (specified by the IRS in guidance on IRC Sec. 408(m).)

HSAs may not be invested in life insurance contracts, and HSAs cannot be commingled with other property except in a common investment fund. You have to open your HSA with an approved HSA custodian, so finding one that allows for your investment choice is vital. (IRC Sec. 223 (d)(l)(C), IRC Sec. 408(m), IRS Notice 2004-50)

#8: Are there tax benefits to making an HSA contribution?

Yes. HSA owners making an HSA contribution enjoy a number of tax benefits.

Federal income tax deduction. HSA contributions reduce an HSA owner's income for federal income tax purposes.

State income tax deduction. Most states with income taxes allow HSA owners to reduce the state taxable income by the amount of the HSA contribution.

Payroll tax avoidance. HSA owners receiving HSA contributions pretax through an employer, either employer contributions or employee payroll deferral through a Section 125 plan also avoid Social Security taxes, Medicare taxes (together with Social Security referred to as FICA), federal unemployment taxes, Railroad Retirement Act taxes, and in most cases state unemployment taxes.

Tax deferred earnings growth. Any interest, dividends, or other appreciation of the assets in an HSA grow tax-deferred while in the HSA.

Tax-free distributions. HSA owners that use the HSA for qualified medical expenses enjoy tax-free distributions. This is a better deal than Traditional IRA or 401(k)s because those plans are only tax-deferred, not tax-free (although Roth IRAS/401(k)s are tax-free, contributions made to Roth accounts are not tax deductible).

#9: What types of records do HSA owners have to save?

The receipts show the amount paid, a description of the service/item purchases, the date, and the name of the service/item provider. HSA owners must keep records sufficient to show that:

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

#10: How much can an HSA owner contribute to an HSA?

The simple answer is $3,350 for 2016 ($3,350 for 2015) for HSA-eligible individuals covered by self-only HDHPs, and $6,750 for 2016 ($6,650 for 2015) for individuals with family HDHP coverage.

Additionally, there is a $1,000 catch-up contribution amount allowed for those over age 55.

The simple answer is inadequate because it ignores the issue of eligibility through the year. The amount an individual can contribute depends on the following factors:

HSA maximums for the year. The HSA maximum limits are adjusted each year for inflation.

Self-only or family HDHP coverage. The HSA maximum depends on whether the individual had self-only HDHP coverage or family HDHP coverage.

Age. Individuals over age 55 are entitled to take advantage of a catch-up contribution.

First day of eligibility – Eligibility on December 1. Individuals that become eligible before December 1 of the year and who remain eligible on December 1 can take advantage of the “full contribution rule.” December 1 is the key date for most taxpayers; if a taxpayer’s tax year does not end in December, then the first day of the last month of the tax year is the key date.

Last day of eligibility – Not eligible on December 1. If an individual's last day of eligibility falls in the calendar year and the individual is not eligible on December 1 (calendar year taxpayer), the individual will need to reduce the HSA contribution amount using the "sum-of-the months" rule.

First day of the month. Eligibility is tied to whether the person was eligible as of the first day of a month.