380. How are amounts distributed from a Health Savings Account (HSA) taxed?

A distribution from an HSA used exclusively to pay qualified medical expenses of an account holder is not includable in gross income.[[1]](#footnote-1) Any distribution from an HSA that is not used exclusively to pay qualified medical expenses of an account holder must be included in the account holder’s gross income.[[2]](#footnote-2)

Any distribution that is includable in income because it was not used to pay qualified medical expenses is also subject to a penalty tax.[[3]](#footnote-3) The penalty tax is 10 percent of includable income for a distribution from an HSA.[[4]](#footnote-4) For distributions made after December 31, 2010, the additional tax on nonqualified distributions from HSAs is increased to 20 percent of includable income.[[5]](#footnote-5)

Includable distributions received after an HSA holder becomes disabled within the meaning of IRC Section 72(m)(7), dies, or reaches the age of Medicare eligibility are not subject to the penalty tax.[[6]](#footnote-6)

Qualified medical expenses are amounts paid by the account holder for medical care[[7]](#footnote-7) for the individual, his or her spouse, and any dependent to the extent that expenses are not compensated by insurance or otherwise.[[8]](#footnote-8) For tax years beginning after December 31, 2010, medicines constituting qualified medical expenses will be limited to doctor-prescribed drugs and insulin. Consequently, over-the counter medicines will no longer be qualified expenses unlessprescribed by a doctor after 2010.[[9]](#footnote-9) Interestingly, over-the counter non-drug medical expenses (bandages, contact lenses cleaner, blood pressure monitors, etc.) are still qualified without a prescription.( see Q380)

**Planning Point:** Perhaps the most commonly question asked of HSA professionals is whether or not a particular expense in a particular set of circumstances is qualified or not. Even though there is an abundance of interpretative material, the question is sometimes difficult to answer. The IRS definition below provides a helpful summary interpretation of the law.

“Medical expenses are the costs of diagnosis, cure, mitigation, treatment, or prevention of disease, and the costs for treatments affecting any part or function of the body. These expenses include payments for legal medical services rendered by physicians, surgeons, dentists, and other medical practitioners. They include the costs of equipment, supplies, and diagnostic devices needed for these purposes.

Medical care expenses must be primarily to alleviate or prevent a physical or mental defect or illness. They do not include expenses that are merely beneficial to general health, such as vitamins or a vacation.”

This definition is helpful after you have exhausted the research for specific items where the IRS has already ruled, or in cases where items can have dual purposes (a massage given in a hospital to revive an atrophied muscle is different than a massage given on vacation for pleasure).

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With a number of exceptions, the payment of insurance premiums is not a qualified medical expense. The exceptions include any expense for coverage under a health plan during a period of COBRA continuation coverage, a qualified long-term care insurance contract ([Q 424](http://pro.moss.nuco.com/taxfacts2015/tfins/p5-ltcins/Pages/0424-00-TF1.aspx)),[[10]](#footnote-10) a health plan paid for during a period in which the individual is receiving unemployment compensation,[[11]](#footnote-11) or the payment of Medicare premiums (other than Medigap) after the age 65 and in some cases the employee portion of employer provided health insurance premiums after the age 65.

An account holder may pay qualified long-term care insurance premiums with distributions from an HSA even if contributions to the HSA were made by salary reduction through an IRC Section 125 cafeteria plan. Amounts of qualified long-term care insurance premiums that constitute qualified medical expenses are limited to the age-based limits found in IRC Section 213(d)(10) as adjusted annually ([Q 430](http://pro.moss.nuco.com/taxfacts2015/tfins/p5-ltcins/premiums/Pages/0430-00-TF1.aspx)).

An HSA account holder may make tax-free distributions to reimburse qualified medical expenses from prior tax years as long as the expenses were incurred after the HSA was established.. There is no time limit on when a distribution must occur.[[12]](#footnote-12)

HSA trustees, custodians, and employers need not determine whether a distribution is used for qualified medical expenses. This responsibility falls on individual account holders.[[13]](#footnote-13)

1. . IRC Sec. 223(f)(1). [↑](#footnote-ref-1)
2. . IRC Sec. 223(f)(2). [↑](#footnote-ref-2)
3. . IRC Sec. 223(f)(4)(A). [↑](#footnote-ref-3)
4. . IRC Sec. 223(f)(4)(A). [↑](#footnote-ref-4)
5. . IRC Sec. 223(f)(4)(A), as amended by PPACA 2010, as further amended by HCERA 2010. [↑](#footnote-ref-5)
6. . IRC Secs. 223(f)(4)(B), 223(f)(4)(C). [↑](#footnote-ref-6)
7. . As defined in IRC Section 213(d). [↑](#footnote-ref-7)
8. . IRC Sec. 223(d)(2). [↑](#footnote-ref-8)
9. . IRC Sec. 106(f), as added by PPACA 2010. [↑](#footnote-ref-9)
10. IRC Sec. 223(d)(2). [↑](#footnote-ref-10)
11. . Notice 2004-50, 2004-2 CB 196, A-40 [↑](#footnote-ref-11)
12. . Notice 2004-50, 2004-2 CB 196, A-39. [↑](#footnote-ref-12)
13. . Notice 2004-2, 2004-1 CB 269, A-29, A-30. [↑](#footnote-ref-13)