What is a health savings account (HSA) and how is it taxed?

A health savings account (HSA) is a trust created exclusively for the purpose of paying the qualified medical expenses of an account beneficiary.[[1]](#footnote-1)

An HSA must be created by a written governing instrument that states:

(1) except in the case of certain rollover contributions, no contribution will be accepted:

a. unless it is in cash;

b. to the extent that the contribution, when added to previous contributions for the calendar year, exceeds the contribution limit for the calendar year;

(2) the trustee is a bank, an insurance company, or a person who satisfies IRS requirements for administering the trust;

(3) no part of trust assets will be invested in life insurance contracts;

(4) trust assets will not be commingled with other property, with certain limited exceptions; and

(5) the interest of an individual in the balance of his or her account is non-forfeitable.[[2]](#footnote-2)

HSAs are available to any employer or individual for an account beneficiary who participates in a high deductible health insurance plan. An eligible individual or an employer may establish an HSA with a qualified HSA custodian or trustee without IRS permission or authorization. As mentioned above, any insurance company or bank can act as a trustee and, additionally, any person already approved by the IRS to act as an individual retirement arrangement (“IRA”) trustee or custodian automatically is approved to act in the same capacity for HSAs.[[3]](#footnote-3)

HSAs are similar to IRAs in some respects although a taxpayer cannot use an IRA as an HSA, nor can a taxpayer combine an IRA with an HSA.[[4]](#footnote-4)

Contributions to an HSA generally may be made either by an individual, by an individual’s employer, or by both. If contributions are made by an individual taxpayer, they are deductible from income.[[5]](#footnote-5) Contributions made by an employer are excluded from the employee’s income.[[6]](#footnote-6) The HSA itself is also exempt from income tax as long as it remains an HSA.[[7]](#footnote-7) HSA contributions may be made through a cafeteria plan under IRC Section 125.[[8]](#footnote-8)

HSA distributions used exclusively to pay qualified medical expenses are not includable in gross income. Distributions used for other purposes are includable in gross income and may be subject to a penalty, with some exceptions.[[9]](#footnote-9)

An employer’s contributions to an HSA are not treated as part of a group health plan subject to COBRA continuation coverage requirements.[[10]](#footnote-10) Therefore, a plan is not required to make COBRA continuation coverage available with respect to an HSA.[[11]](#footnote-11)

According to IRS guidance, a levy to satisfy a tax liability under IRC Section 6331 extends to a taxpayer’s interest in an HSA. A taxpayer is liable for the additional 10 percent tax (20 percent after December 31, 2010, under PPACA 2010) on the amount of the levy unless the taxpayer has attained age sixty-five or is disabled at the time of the levy.[[12]](#footnote-12)

1. IRC Sec. 223(d)(1). [↑](#footnote-ref-1)
2. IRC Sec. 223(d)(1). [↑](#footnote-ref-2)
3. Notice 2004-50, 2004-2 CB 196, A-72; Notice 2004-2, 2004-1 CB 269, A-9, A-10. [↑](#footnote-ref-3)
4. See Notice 2004-2, above. [↑](#footnote-ref-4)
5. IRC Sec. 223(a). [↑](#footnote-ref-5)
6. See IRC Sec. 106(d)(1). [↑](#footnote-ref-6)
7. IRC Sec. 223(e)(1). [↑](#footnote-ref-7)
8. IRC Sec. 125(d)(2)(D). [↑](#footnote-ref-8)
9. IRC Sec. 223(f). [↑](#footnote-ref-9)
10. See IRC Secs. 106(b)(5), 106(d)(2). [↑](#footnote-ref-10)
11. See Treas. Reg. §54.4980B-2, A-1 regarding Archer MSAs. [↑](#footnote-ref-11)
12. CCA 200927019. [↑](#footnote-ref-12)