

HSA. However, the expense for coverage under any of the following will be an HSA-qualified medical expense:

- continuation coverage under federal law (e.g., COBRA or USERRA);
- a qualified long-term care insurance contract;
- any health plan maintained while the individual is receiving unemployment compensation under federal or state law; or
- for account holders age 65 or over (whether or not they are entitled to Medicare), any deductible health insurance (e.g., retiree medical coverage) other than a Medicare supplemental policy.

c. Timing Issues for Tax-Free HSA Distributions

In order for an HSA distribution to be tax-free, qualified medical expenses must be incurred after the HSA is established in order to be reimbursable on a tax-free basis.

Because there is no time limit on when an HSA distribution must occur, an HSA account holder can choose to delay taking an HSA distribution to pay or reimburse qualified medical expenses incurred in the current year and can use a current-year HSA distribution to pay or reimburse qualified medical expenses incurred in any prior year, so long as the expenses were incurred after the HSA was established. This “shoebox rule” gives HSA account holders an opportunity to maximize the tax-free growth of their HSA funds. If the HSA distribution is being taken on a tax-free basis (i.e., to pay or reimburse qualified medical expenses incurred after the HSA was established), the account holder is required to keep records sufficient to prove that the expense was a qualified medical expense, that it was not previously paid or reimbursed from another source, and that it was not taken as an itemized deduction in any prior taxable year.

Example of Shoebox Rule: Expense Reimbursed in Following Year. Pamela, an HSA-eligible individual, establishes an HSA in 2007 and contributes \$1,000. On December 1, 2007, Pamela incurs a qualified medical expense of \$1,500, while her HSA balance is \$1,025. On January 3, 2008, she contributes another \$1,000 to the HSA, bringing the balance in the HSA to \$2,025. In June of 2008, Pamela receives a distribution of \$1,500 to reimburse her for the \$1,500 medical expense incurred in 2007. Pamela can show that the \$1,500 HSA distribution in 2008 is a reimbursement for a qualified medical expense that has not been previously paid or otherwise reimbursed and has not been taken as an itemized deduction. The distribution is excludable from Pamela’s gross income.

An HSA account holder may withdraw funds for qualified medical expenses on a tax-free basis even if he or she, at the time of the distribution, is no longer an eligible individual (i.e., is no longer eligible to make HSA contributions or to have them made on his or her behalf).

d. HSA Distributions for Nonmedical Expenses

HSAs are different from other arrangements that are established to reimburse medical expenses (for example, HRAs and health FSAs), because amounts in an HSA can be withdrawn on a taxable basis even though no medical expense has been incurred. But, if an HSA distribution is not used for qualified medical expenses, the distribution is included in the account holder's gross income and generally is subject to an additional 10% tax.

HSA distributions that are made by mistake can be returned to the HSA if there is clear and convincing evidence that the distribution was made because of a mistake of fact due to reasonable cause (e.g., an HSA account holder reasonably, but mistakenly, believes that an expense was a qualified medical expense when he or she requested and received reimbursement for that expense from his or her HSA). So long as the mistaken distribution is returned to the HSA no later than April 15th following the first year in which the HSA account holder knew or should have known that the distribution was a mistake, the distribution will not be taxable nor subject to the additional 10% excise tax.

The additional 10% excise tax does not apply to certain otherwise-taxable distributions, specifically: Payments made after the HSA account holder dies, attains age 65, or becomes disabled; excess contributions returned to the account holder; and rollover contributions paid into an HSA within statutory time frames.

e. HSA Rollover Distributions and Trustee-to-Trustee Transfers

Rollovers or direct transfers from one HSA to another HSA are not includible in gross income and are not subject to the additional 10% excise tax, if certain requirements are met. Rollover contributions and direct transfers may be made in cash or in kind (e.g., stock certificates). An HSA account holder who receives an HSA distribution and who intends to make a rollover contribution of that distribution to another HSA must do so within 60 days after he or she receives the distribution. And, the account holder must wait one full year before he or she can make another rollover contribution to an HSA. By contrast, direct trustee-to-trustee transfers from one HSA to another are not subject to the 60-day or one-year restrictions that apply to rollovers.

f. Treatment of HSAs Upon Divorce or Death

If an HSA account holder gets divorced, some or all of the funds in his or her HSA can be transferred, tax-free, into his or her spouse's (or ex-spouse's) HSA. After the transfer, the spouse (or ex-spouse), like any other HSA account holder, may designate a beneficiary to receive any amounts remaining in the HSA account upon his or her own death, may roll over (or directly transfer) some or all of the HSA account balance into another HSA or an Archer MSA, and may add to the HSA through regular contributions (if the spouse or ex-spouse is an HSA-eligible individual), rollover contributions, or direct transfers.