

## When is an HSA Established and Why Does It Matter?

In what may be a surprise to employers and employees, the IRS has released guidance (included in IRS Notice 2007-22) about when an HSA is deemed to be established. This guidance states that the establishment date is based on state law, which may create difficulties for employers that operate plans intended to work in tandem with HSAs. There is no effective date attached to the IRS' announcement; presumably, it applies from the effective date of the legislation authorizing HSAs (January 1, 2004).

### Background

Health Savings Accounts (HSAs) are tax-advantaged trusts or custodial accounts that are available to certain individuals covered by high deductible health plans (HDHPs). While both the employer and employee may contribute pre-tax funds to the HSA, the employee is the account owner and is responsible for authorizing distributions from the account. The employee is also responsible for correctly reporting, when filing his or her individual tax return, whether any distributions did not meet the requirements for pre-tax advantages.

Distributions from an HSA are tax-free if they are made for qualifying medical expenses *and* if the expenses were incurred after the HSA establishment date. While there were several possibilities for an HSA's establishment date (e.g., the date of application; the date paperwork was fully executed; the date funds were deposited; the date an account number was provided), the IRS provided little written or formal guidance regarding when, exactly, an HSA was deemed established. The limited written guidance that was available indicated that an HSA was established when the forms establishing the trust or custodial account were fully executed by the account owner and the HSA trustee/custodian.

### Establishing an HSA

Before this recent IRS Notice, an employee and trustee/custodian could complete the HSA paperwork in advance with an effective date of the first day of the plan year. That first day of the plan

year arguably would be the HSA establishment date and, if it were, then all qualifying expenses incurred during the plan year could be reimbursed from the HSA on a tax-free basis. Now, however, it is clear that state law determines the establishment date and, under most states' trust laws, a trust is not deemed established until it is funded (i.e., money is deposited into the trust account).

Note: HSAs may be held in *custodial* accounts instead of *trust* accounts and different state laws may apply to the two types of accounts.

A minimal amount of funding, even one dollar, will be sufficient to establish the HSA in many states. However, the timing is somewhat of a catch-22, because an HSA cannot be funded until the individual is covered by an HDHP. If the employee first becomes covered by an HDHP on January 1, contributions cannot be deposited to the HSA prior to that date. Since January 1 is a holiday, the earliest date that funds could be deposited would be January 2. The downside of not having the HSA established as of the first day of the plan year is that expenses incurred prior to the establishment date are not qualifying expenses that can be reimbursed tax free.

In many cases, initial HSA funding takes place after the first payroll in January. If the state requires funding for the trust to be established and the funds are sent after the first payroll, the trust may not be established until sometime in mid-January. For example, if the initial deposit occurs on January 18, claims incurred from January 1 through January 17 cannot be reimbursed from the HSA on a tax-free

basis. If any expenses incurred during this period were reimbursed from the HSA, the penalties that apply when funds are withdrawn for non-qualifying expenses would apply to the reimbursement. That is, the reimbursement would be included in taxable income and subject to an additional ten percent tax. The employee is responsible for reporting this information to the IRS.

### **Why This is Important for Employers**

The HSA generally is not an employer-sponsored plan, and the employer cannot prevent an employee from making a taxable withdrawal of HSA funds. In addition, HSA trustees and custodians are not responsible for adjudicating claims, so there is no oversight process in place to prevent taxable withdrawals. However, if the account owner (i.e., the employee) ends up having a taxable distribution when he or she expected a nontaxable distribution, the employee might raise the issue with the employer. In some cases, the employee might assert that the employer is responsible for the adverse tax consequences.

### **Conclusion**

It is important for the employer to understand which laws apply in the state in which the trust or custodial account is established (the trustee or custodian should be able to provide this information) and to make sure that the impact of this information is communicated to employees. Armed with the knowledge of the specific state requirements for HSA establishment, employers may choose to speed up initial deposits or may advise employees to independently deposit funds in their HSAs so as to establish the HSA as quickly as possible. Once the HSA is established, tax-free reimbursements for qualifying expenses can be made from that date forward. To avoid unintended tax consequences, employees need to understand the date that the HSA is deemed established and the effect of that date.

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