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Wealth Management

Health Savings Accounts 101

What Is a Health Savings Account (HSA)?

First introduced in 2003, HSAs are special, tax-advantaged savings accounts designed to offset the higher costs associated with high-deductible health plans, or HDHPs (which we discuss on the next page). They are only available to people enrolled in health insurance plans that meet the government's definition of an HDHP. Money contributed to an HSA can stay in the account indefinitely, earning income, until you need it for a qualified health care expense.

In short, because HSAs offer a triple play of tax benefits plus other extraordinary options that we will discuss more fully, anyone who has access to one should take full advantage of it and, subject to budget considerations, make the maximum contributions permissible. The following table illustrates the triple benefit of an HSA and compares it to other tax-deferred savings vehicles, as well as to taxable accounts.

HSA Tax Benefits

1. Contributions are tax-deductible and FICA-exempt.[1]
2. Investment growth is tax-deferred.
3. Qualified withdrawals are tax-free.

Savings account	Contributions	Investment growth	Withdrawals	Other considerations
Health savings account	Pre-tax	Tax-deferred	Tax-free*	Receives favorable treatment from most states. Exempt from FICA taxes if contributions are made through payroll deductions.
Roth IRA or employer plan	Taxable	Tax-deferred	Tax-free	Most states follow federal rules for income taxes, though there are exceptions.
Traditional IRA or employer plan	Pre-tax	Tax-deferred	Taxable	Most states follow federal rules for income taxes, though there are exceptions.
529 plan	Taxable	Tax-deferred	Tax-free*	Contributions are deductible from state income tax in most cases.
Taxable investment accounts	Taxable	Taxable	Taxable gains	

**Distributions must be offset by qualified expenses.*

Note: When taking withdrawals from a tax-deferred plan before age 59½, you may have to pay ordinary income tax plus a 10% federal penalty tax. This table does not address nondeductible contributions made to a traditional IRA or employer plan.

Table source: Vanguard, "HSAs: An Off-Label Prescription for Retirement Saving," 2017

[1] *FICA refers to payroll deductions that go to fund Social Security and Medicare under the Federal Insurance Contributions Act. If you take advantage of this exemption by contributing to an HSA through payroll deductions, your eventual Social Security benefits may be lower.*

High-Deductible Health Plans

Picking a health insurance plan can be complicated. Often, you have many options to choose from, and there are multiple factors to consider, including coverage, expected health care needs, premiums, deductibles, out-of-pocket limits, tax effects, and your budget.

High-deductible health plans, or HDHPs, offer lower premiums than traditional health insurance plans, but the tradeoff is, as the name implies, higher deductibles. They also tend to have higher out-of-pocket maximums. However, the option to fund a health savings account in conjunction with an HDHP offers a unique retirement savings opportunity—one that uses pre-tax dollars, earns tax-deferred income, and allows for tax-free qualified withdrawals.

Why Use an HSA?

There are many ways to save on taxes when investing your money for the future. Let's look at how HSAs stack up to some of the most popular savings options.

- In a traditional IRA or employer retirement plan, contributions are made with pre-tax dollars, the investment growth is tax-deferred, but withdrawals are taxable.
- In a Roth IRA, contributions are made with post-tax dollars, but the investment growth and withdrawals are tax-free.
- In a 529 college savings plan, contributions are not deductible for federal tax purposes, but most states permit you to deduct your contributions from your state income. Investment growth is tax-deferred, and distributions are tax-free provided that they are used for qualified expenses. Otherwise, they are taxable.

The triple play of the HSA is that: (i) contributions are made pre-tax, (ii) investment growth is tax-deferred, and (iii) withdrawals are tax-free providing they are used for qualified expenses. Because there is no time limit for using the funds, and since even Medicare enrollees must pay certain expenses out of pocket, the practical reality is that many HSA participants will never pay taxes on their contributions.

(Note: IRS rules say that you **can't contribute to an HSA if** you're enrolled in **Medicare**. You can, however, draw on funds already in the account but you can't add to them.)

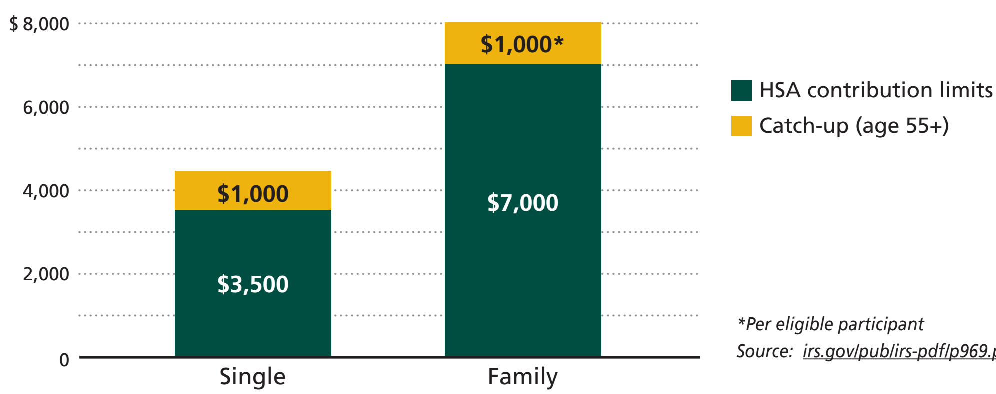
Contribution Limits

For 2019 provided you are enrolled in an HDHP, the annual HSA contribution limits are:

- $3,500 for people with individual health insurance coverage
- $7,000 for families

These amounts are adjusted annually for inflation. In addition, those who are 55 years and older can contribute an additional $1,000 per year. This means that older adults who have self-only coverage can contribute up to $4,500, and those who have family coverage can contribute a maximum of $8,000 in 2019.

Maximum HSA Contributions for 2019



**Per eligible participant*
Source: irs.gov/pub/irs-pdf/p969.pdf

The Optionality of HSAs

One of the unique aspects of HSAs is that you have the option to save the money rather than spending it. Smart use of these plans can increase your total saving capacity.

Many families, particularly those with children, spend more than $7,000 out of pocket annually on health care costs. In this situation, the HSA is simply an efficient way to use pre-tax dollars to cover these costs.

If you spend less than the annual contribution limit, you can keep the unspent funds invested until they are needed. You can also choose to pay all your current medical expenses out of pocket and treat the entire contribution amount as a long-term investment.

How Do I Save Through an HSA?

HSAs are typically set up through your employer. Once the account is active, you can start making pre-tax contributions from your paycheck, similar to a 401(k) contribution payroll deduction. However, if you're covered on a spouse's plan, you can't sign up for an additional HDHP just to qualify for an HSA.

There are HSA options for people who are self-employed and for those who own small businesses as well, but the process for making contributions and deducting them from your taxable income is different. A tax professional can advise you on the best way to do this.

Qualified Expenses

Typically, an HSA participant receives a debit card linked to the HSA account. The card can then be used to pay directly for qualified medical, dental and vision expenses, and there's generally no need to submit receipts for reimbursement. Moreover, there's no deadline on when you have to spend the money.

Health Care Costs Are Inevitable

Unfortunately, health care costs have historically risen at nearly double the long-term inflation rate of 3%. And with increases in longevity come increases in lifetime health care costs. Fortunately, HSAs can be used to pay Medicare premiums (with the exception of Medigap premiums) or to buy long-term care insurance.

Can an HSA Be Used for Nonmedical Expenses?

HSAs are only completely tax-free when used for qualified health care expenses. When used for nonqualified expenses, the withdrawals are taxable, with a significantly higher tax penalty for a pre-age-65 HSA withdrawal (outside of death or disability) compared to a pre-age-65 retirement plan withdrawal.

In addition to being taxed as ordinary income, early withdrawals from a traditional IRA or 401(k) typically incur an extra 10% penalty,[2] while an early disbursement from an HSA for nonqualified expenses incurs an extra 20% penalty.[3]

Save Now, Pay Later —Tax-Free

Suppose a new pair of prescription eyeglasses with all the trimmings costs you $1,000. If you decide to pay for them out of pocket this year and leave the money in your HSA to grow, you can use the receipt 10 years from now to withdraw those funds—tax-free—to help pay for a vacation. Or you can save all the money until you retire. The longer you leave the funds invested, the more you will have to help pay for your expenses in retirement.

[2] irs.gov/retirement-plans/hardships-early-withdrawals-and-loans

[3] irs.gov/publications/p969

Other, Similar Types of Health Accounts

There are other types of health accounts that have similar sounding abbreviations, but which have important differences compared to HSAs, and which include the following:

- **Flexible Spending Account (FSA):** Tax-free spending account for certain out of pocket health care costs that you must spend each year ("use it or lose it")
- **Health Reimbursement Account (HRA):** Employer-funded plan that helps employees pay for qualifies medical expenses not covered by their health plans

After age 65, you'll pay ordinary taxes on such withdrawals, but you can spend them however you like. This would also apply to your beneficiaries, should they use funds from the account to pay nonmedical expenses after you die.

How to Invest Your HSA Savings

Each HSA has its own investment options. Contributions can be kept in cash or invested in longer-term assets such as stock and bond funds. If you are using your HSA to pay your current medical expenses, keep all the funds in cash or in a short-term bond fund. On the other hand, if you are paying all of your medical expenses out of pocket and using the HSA primarily as a long-term investment vehicle, allocate your savings 100% to stocks. (See our **"Asset Allocation Made Easy"** briefing for a detailed explanation.)

Other Considerations

HSAs are portable. If you leave your employer, you can take your HSA with you.

When a married person dies, the surviving spouse receives the account balance tax-free and can continue to use it to pay his or her own medical expenses. However, if your HSA beneficiary is not your spouse, that person will have to pay taxes on any funds that remain after paying your outstanding medical expenses.

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