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HSAs as a Tax-Efficient Savings Vehicle

You likely know that HSAs, or Health Savings Accounts, can be used to pay for medical expenses, but did you know that covering current expenses is likely not the most efficient way to utilize them? HSAs offer unique advantages that are useful for both medical expenses and accumulating wealth. This article will explore these accounts that are often misunderstood, which can result in missed opportunities.

WHAT IS AN HSA?

This relatively new, tax-advantaged savings account was introduced in 2003 as part of the Medicare Prescription Drug, Improvement and Modernization Act. It is a type of savings account that allows you to set aside pre-tax dollars if you are enrolled in a high-deductible health plan.[1] The funds can be used for qualified medical expenses, which generally include doctor's visits, medications, medical equipment and dental and vision care for you and your family. You can pay for long-term care insurance premiums and Medicare Parts B and D and Medicare Advantage plans, though Medigap premiums are not considered qualified. There are no AGI phaseouts, so as long as your insurance is high-deductible, you can contribute. The 2023 contribution limit for those under the age of 55 is $3,850 per individual or $7,750 per family. If you are over the age of 55, you can contribute an additional $1,000 per year. In 2024, the limits increase to $4,150 for individuals and $8,300 for families, while the over-55 age group catch-up remains the same at $1,000.

THE ADVANTAGES OF AN HSA

Contributions to your HSA are tax-deductible in the year of the contribution, growth is tax-free and withdrawals are tax-free when used for qualified medical expenses. This provides a triple tax benefit! Additionally, unlike Flexible Spending Accounts, or FSAs, your HSA funds roll over each year and are completely portable if you change employers or health plans.

[1] In 2023 high-deductible plans have a minimum individual deductible of $1,500 or a family deductible of $3,000 with maximum out-of-pocket expenses of $7,500 per individual or $15,000 per family. In 2024, the minimum individual deductible is $1,600 and $3,200 for families, while the out-of-pocket maximums increase to $8,050 and $16,100, respectively.

LONG-TERM SAVINGS

Most HSAs have an option to invest a portion of the account, which you should do if you are able to cover your current medical expenses out-of-pocket. After age 65, withdrawals for non-qualified expenses are penalty-free, though income taxes apply. In this way, HSAs function similarly to an IRA, however, they have the added benefit of tax-free withdrawals for qualified medical expenses.

Expenses are not required to be reimbursed in the same year they are incurred. As long as you keep your receipts and the expenses occur after the HSA is established, you can take distributions in the future after letting your investments continue to grow.

WHAT HAPPENS TO AN UNUSED HSA?

In case you are unable to use all of your HSA funds before you pass, it's important to verify that you have named a beneficiary of the account. Like IRAs, HSAs pass via beneficiary designation. If the designated beneficiary is a spouse, the spouse becomes the new HSA owner, and the transfer is not taxable. The HSA continues its tax-free status when used for qualified medical expenses. If the designated beneficiary is a non-spouse, the HSA ceases to be an HSA, and the fair market value of the HSA on the date of death is taxable to the beneficiary in the year of death. The non-spouse beneficiary may reduce the taxable amount by any payments made from the HSA for qualified medical expenses incurred by the deceased account holder before death, but only if the payments are made within one year after death.

While it may be tempting to cover current medical expenses with funds you have already contributed to an HSA, consider allowing the funds to grow to maximize their value. The unique combination of tax advantages and long-term savings potential make them a worthy addition to your portfolio.

FOR MORE INFORMATION, PLEASE REACH OUT TO:

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