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HSAs: A best kept secret?

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HSAs are somewhat of a hidden gem in the investment world. In many of my own client interactions, I find that people may have a decent understanding of an HSA, but they may not fully be aware of all the advantages that go along with using one.

HSA stands for Health Savings Account and one can be used in conjunction with a high-deductible health insurance plan to pay for medical expenses. To be eligible for an HSA, you must have a minimum “self-only” deductible of $1,350 or a family deductible of $2,700 (both limits as of 2018).

Why use an HSA?

There are three main tax benefits of using an HSA. First, when money is contributed, is goes into the account on a pre-tax/tax-deductible basis (similar to IRA or 401k contributions). This results in the lowering of your taxable income in the year you make the contribution, which lowers your income taxes.

Next, the money that is inside an HSA can grow year after year on a tax-free basis (similar to a Roth IRA). In other words, you can avoid taxes on dividends and capital gains year over year with however much is in the HSA.

Lastly, qualified withdrawals can be taken from an HSA on a tax-free basis as well. Qualified withdrawals are withdrawals used for qualified medical and dental expenses. You can learn more about what exactly consists of a qualified expense by reviewing IRS Publication 969 or IRS Publication 502.

Investment options

While everyone who contributes to and takes qualified withdrawals from an HSA will receive tax benefits, not everyone takes full advantage of the potential for tax-free growth. The reason is that not all HSAs allow for investing in mutual funds, but some do. I've seen some cases that an individual or couple had contributed to an HSA, but never actually logged in to their account or looked up the potential investment options inside the plan. Therefore, the balance of the HSA was simply in a cash-like position, earning hardly any interest. This could be an area of opportunity for those who might be using HSAs today.

If you are not currently using an HSA, but would like to invest in one, it's important to evaluate the different features of each plan provider. You should weigh the fees of each plan, and of course, make sure that the plan offers investment options that you can take advantage of for the long-term. (You can click here for a list of HSA providers and a comparison of their benefits)

What are the contribution limits for HSAs?

For someone on a high-deductible health plan that has "self-only" coverage, the contribution limit for an HSA is $3,450 in 2018. For those that have family coverage, the limit is $6,850 in 2018. But, HSAs also have a catch-up provision that allows individuals over the age of 55 to contribute up to $1,000 more to their account per year. Therefore, for a couple over 55 and on a high-deductible health insurance plan, their contribution limit would be increased to $7,850 in 2018.

What if I need the money for reasons other than healthcare expenses?

Everything about HSAs so far sounds great, but what if you needed to withdraw money from your HSA for reasons other than for qualified medical expenses? The answer is that you would have to pay income tax plus an additional tax of 20% on the portion of the distribution not used for qualified medical expenses, which is a steep price to pay.

However, there are exceptions to this rule. If you take distributions after you reach age 65, become disabled, or die, there is no additional tax on distributions. Therefore, if you are 65 or older, your HSA can almost serve as an additional IRA for you at that time, as withdrawals would trigger income tax, but no additional penalty.

Record-keeping and reporting

As with anything that deals with the IRS, it’s good to keep accurate records regarding your HSA. As stated in Publication 969, you must have records to show that your distributions were used to pay or reimburse qualified medical expenses. Those expenses also cannot have been previously paid or reimbursed from another source or taken as an itemized deduction in any year.

There are also nuances in how you report HSA distributions on your tax return. It’s important to speak with a qualified tax professional to ensure you are properly reporting your distributions.

What about FSAs?

FSAs, or Flexible Spending Accounts provide an alternative to HSAs for a medical expense savings account. One of the few pros for FSAs is that anyone with a traditional health plan is eligible to participate. However, contribution limits are lower than for HSAs, there are no investment options offered, you can only carry-over a maximum of $500 of any unused balance year-to-year, there is no catch-up provision, FSAs are not portable to another employer, and changes to contributions can only be made at a qualifying event such as a marriage, divorce, birth, or during open enrollment.

Bottom Line

It’s clear to see why a Health Savings Account could be such an attractive option for those who qualify to use one. It’s not clear why these types of accounts don’t seem to be emphasized or talked about as much as IRAs, 401(k)s, etc. But, now that you’re educated about HSAs, speak with a qualified investment adviser or a CERTIFIED FINANCIAL PLANNER™ professional to see if an HSA is a prudent option for you.

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