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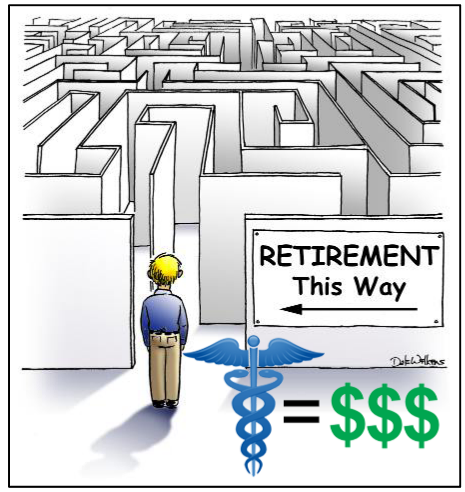
Health Savings Accounts: Win the "Tax trifecta"

Navigating the Retirement Maze



"I'm proud to be paying taxes in the United States. The only thing is, I could be just as proud for half the money."

– Arthur Godfrey, American radio and TV personality (1903 - 1983)

A maxim in the financial planning profession is that what's important is not what you earn, but what you keep, better known as "after-tax returns." Uncle Sam and most states want to get a piece of your income, profits, and whatever else is allowed in the tax code. So part of the financial planning process is minimizing taxes wherever possible. Thus the preference for long-term capital gains, tax free bonds, using all legitimate deductions on tax returns, and tax-deferred growth in retirement accounts.

So what if there was an investment vehicle where contributions resulted in reduced income taxes, allowed your assets to grow tax-free, and was tax-free when eventually withdrawn? I call it the "tax trifecta," where you get a tax benefit at every stage of the process. Sounds too good to be true? Health Savings Accounts (HSAs) can accomplish this feat. HSAs are special savings accounts that are an excellent way to save and grow funds to be used later for qualified health care expenses. Let's look at the particulars of HSAs, including who qualifies for them and which expenses are eligible to be paid for with them.

Who is eligible?

There are strict requirements to be able to invest in HSAs, and in different years you may or may not be eligible depending upon your current health plan. The main criteria for eligibility are enrollment in a high-deductible health plan (HDHP), not being able to be claimed as a dependent on another's tax return, and no coverage under any other health insurance plans. The IRS defines HDHPs for 2016 as plans with minimum annual deductibles (the amount paid out of pocket, not including premiums, before plan benefits kick in) of $1,300 and $2,600 for individual and family coverage, respectively, and maximum total out-of-pocket limits of $6,550 and $13,100, respectively. Medicare is not an HDHP, so contributing to an HSA isn't an option once an individual goes on Medicare.

HSAs are individual plans, and cannot be held jointly. However, plans can be established either for an individual's health care expenses, or for those of a family. Plus, if you die before using all of the funds in an HSA, the remainder roll over to your surviving spouse or as an inheritance to your beneficiaries, though the tax-free withdrawals disappear in the latter instance.

Plans that qualify as HDHPs are usually designated as such in their names. This is also typically true for health plans available through state health care exchanges. Company-sponsored HDHPs often have an HSA option paired with them. If your employer does not offer an HSA or you use a state health care exchange, plans are available through many banks and independent HSA providers. There are some exceptions and special situations for eligibility, and these along with the rest of the rules for HSAs are described in IRS Publication 969, which can be found at IRS.gov.

How much can you contribute?

For individuals enrolled in an HDHP for the entire calendar year, the 2016 HSA contribution limit is $3,350 for individuals and $6,750 for families. Those 55 and older can add $1,000 to these amounts. An individual eligible for an HSA can contribute on their own, or other family members can contribute on their behalf. There are rules for partial year HDHP coverage, which can reduce the amount of your maximum annual contribution. HSAs can be funded for a particular tax year up until April 15th of the following year.

One important caveat is that if you enroll in a Flexible Savings Account (FSA) at your employer, you cannot contribute to an HSA at the same time unless the FSA is a "limited purpose" one, which is only for dental and vision care expenses. If you are eligible for both an HSA and a full FSA, which one should you choose? FSAs are "use it or lose it" plans, whereas HSAs do not have annual withdrawal requirements and can be taken with you when you leave your employer. HSAs also have higher contribution limits, so in most cases you are probably better off with an HSA.

Where can you spend it?

Funds in an HSA can be used for a broad range of medically related expenses, which are listed in IRS Publication 969. In addition to paying for health care deductibles and co-payments, other HSA-qualified expenses include Medicare premiums, dental, long term care insurance premiums, and even over-the-counter medications if accompanied by a doctor's prescription. Withdrawals for non-qualified expenses incur a 20 percent tax penalty, in addition to being counted as taxable income. The 20 percent tax is waived for individuals over 65, but the withdrawal still counts as taxable income if not used for qualified expenses.

Use it as an extra IRA

Many users of HSAs with whom I have spoken often complain that they wind up depleting most of their annual contributions with medical expenses in the same year. Unfortunately, that deprives you of the third tax benefit of HSAs: tax-free compounding. Most HSAs allow you to invest the funds in a number of investment mutual funds similar to your other investments. So if you are eligible to fund an HSA, consider using after-tax funds to pay your medical expenses in any given year and let your HSA account grow, to be tapped many years later in your retirement to pay for your medical expenses. So treat it as though you are getting the benefit of a bonus IRA, and let the assets grow over time. It may seem counterintuitive to not use an HSA for current health care expenses, but the numbers show that the tax-free compounding of an invested HSA over many years will increase your retirement assets compared to depleting them earlier for health care expenses.

Health savings accounts are like a tax loophole for the not-so-rich. So take advantage of this gift from the IRS and use it to improve your overall financial picture.

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