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Tax Benefits of Health Savings Accounts (HSA)

This is the time of year when many face the intimidating task of choosing a health insurance plan for 2023. For those dealing with this, it pays to be aware of the tax benefits of Health Savings Accounts or HSAs.

HSAs have grown in popularity. According to one study, as of the middle of 2022, there were about 28 million HSAs compared to about 17 million as of the end of 2017. Total funds in them grew to $98 billion at year-end 2021 from $45 billion in 2017.
HSAs are now a key feature of many health-insurance plans, both for employees and individual buyers.

To be eligible for an HSA, a worker must also have high deductible health insurance. Many employees have deductibles of $5,000 for a family and $2,500 for an individual. The law allows up to $15,000 for a family and $7,500 for an individual for 2023. This insurance also has out of pocket maximums.

Other than being covered by an HSA-qualified, high-deductible health plan, the main requirements to be eligible to make contributions to an HSA are, not be enrolled in Medicare; not receiving other disqualifying coverage, such as through a spouse's non-HSA plan or Flexible Spending Account; and not be claimed as a dependent on someone else's tax return.

To reduce the pain of the high deductibles and out of pocket maximums, the insurance is coupled with a tax-advantaged savings account, the HSA.

Either the plan participant or the employer, or both, can put pretax dollars into this account to pay the cost of out of pocket health expenses.

For tax year 2023, the maximum HSA contribution is $7,750 for a family and $3,850 for an individual, plus $1,000 for participants age 55 and older. If one spouse carries the family coverage, the other (if 55 or older) can still get a $1,000 catch-up contribution. But this spouse must put the money into his or her own HSA, as accounts are individually owned.
Unused HSA dollars typically can be invested and grow tax free.

With respect to crucial deadlines for HSAs, as long as an HSA is set up by year-end, a participant has until the following tax-due date in April, or the date the return is filed, if earlier, to fund it. As a result, those who want to pay out-of-pocket expenses with HSA funds can wait to finish or begin funding their accounts until they know their eligible medical expenses for the prior year.
Similar to IRAs, HSAs are owned by individuals, not employers or insurers. If the fees offered by one sponsor are too high, the owner can move it to another.

Now comes the spectacular tax advantage. HSA owners who do not withdraw from their accounts, either due to low health costs or can afford or being able to pay current expenses out of pocket, get tax breaks even better than the ones for IRAs and 401(k)s. If properly managed, HSA funds are triple tax-free:

1. There is no tax on HSA dollars going into the HSA account,
2. Account assets grow tax-free, and
3. There is no tax on withdrawals used to pay eligible health expenses

HSA dollars can reimburse a wider variety of costs than insurance typically covers. Examples include contact lens solution or a wigs after chemotherapy treatments. IRS Publication 502 has a list of eligible healthcare expenses. As noted above, people enrolled in Medicare cannot contribute to an HSA, but they can take payouts from an existing one. As such, HSA reimbursements can be claimed for Medicare Part B and Part D premiums, and also for Medicare Advantage premiums. They cannot be claimed for Medigap supplemental coverage. HSA payouts can be claimed for Cobra premiums, which are amounts paid for health coverage through a prior employer.

Also, HSA funds left in the account can compound for years. Still, account owners who skip reimbursements as expenses are incurred can be reimbursed for them years later, as long as they keep receipts.

HSA payouts can also have an advantage over itemized deductions. Due to much higher standard deduction amounts, many filers no longer itemize deductions. Also, those who itemize can only deduct medical expenses exceeding 7.5% of their adjusted gross income. HSAs skirt both issues by allowing participants to make pretax contributions. Just be aware that if you get reimbursements for health expenses from an HSA, you cannot also take a medical expense deduction for those costs as an itemized deduction.

Another benefit is that HSAs can be a supplemental retirement account. At age 65 the owner can take withdrawals for **nonmedical** expenses and pay income tax on them, similar to traditional IRA payouts.

As a really great benefit, under current law, children such as recent graduates can fund their own HSA based on their parents' health coverage. For example, a 23 year old is employed but still has health insurance through a parents' high-deductible plan with an HSA. (Note: many children are covered by parental plans until age 26). If the 23 year old is not claimed as a dependent on the parent's income tax return, he can put up to $7,750, the family amount, into his own HSA, even if the parents have funded their own HSA. The 23 year old does not have to fund the HSA with his own earnings; someone else could give him the money for it.

The tax benefits of HSAs are impressive but there are some drawbacks.

Evaluating a high-deductible plan with an HSA can be a daunting number crunching project unless you expect to pay minimal health care costs during a given year. There are also plenty of shifting variables to consider. One variable is whether the employer subsidizes the insurance or HSA contribution. Another is drug prices or treatment for chronic conditions subject to deductibles.

Also, unlike traditional and Roth IRAs, HSAs cannot be inherited and used for medical expenses, except by a spouse. Otherwise, the assets become taxable at death. Still, the HSA owner's executor can use funds in the account within a year to pay unpaid medical bills at death and claim prior expenses that were paid out of pocket, as long as there is proof of them.

Since tax laws in this area can be confusing, it may be helpful to consult with a qualified tax specialist to gain an understanding of the tax laws and to determine the best approach to funding your medical expenses. If you have any questions regarding HSAs, please do not hesitate to contact one of our Traphagen tax professionals.

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