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Why You Should be Using an HSA

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Health Savings Accounts, or HSAs, were introduced in 2003 as part of the Medicare Prescription Drug, Improvement, and Modernization Act. Although they have been in existence for decades, they remain a financial planning tool that many people overlook.

To open an HSA account, an individual must be covered by a High-Deductible Health Plan or HDHP for short. In 2024, this means having a deductible greater than $1,600 for an individual and an out-of-pocket maximum of no more than $8,050, or a $3,200 for family coverage and an out-of-pocket maximum of no more than $16,100. While these limits may be confusing, in general, the health plans that do qualify as HSA eligible will make clear that they do in the title, allowing consumers to quickly identify the eligible choices. If you are covered by an HDHP, individuals can contribute $4,150 per year to the HSA while those with family coverage can contribute $8,300. For participants over age 55, there is an additional $1,000 catch up contribution than can be made each year.

So, what makes HSA accounts so attractive? They are one of the few accounts to enjoy what's often called a triple tax benefit. The first benefit comes when a contribution to the account is made, resulting in a tax deduction for the year the contribution is made. From there, funds in the account can be invested and allowed to grow tax-deferred, meaning no taxes are owed on investment income or gains generated in the account. While these benefits are nice, they are the same tax benefits offered by traditional IRA and 401(k) plans. The HSA differentiates itself from these accounts by offering a third tax benefit that neither traditional IRA nor 401(k) plans can: the ability to withdraw funds without incurring any additional tax. In order for those withdrawals to qualify for the tax-free treatment, they must be made for qualified medical expenses, but meeting that standard may be easier than many people think.

The definition of qualified medical expenses is quite broad and won't be the focus of this article, but many common healthcare expenses will fall into this category. A key aspect of the HSA strategy involves the timing of those expenses and their reimbursements. While qualified withdrawals must be made for medical expenses, the law does not specify ***the year*** in which the withdrawals must take place. This flexibility allows an individual to build up a backlog of prior medical expenses that remain unreimbursed by the HSA. Then, at a date of their choosing, they could withdraw any amount up to the total of those prior medical expenses without triggering any additional tax. This unique feature of HSAs can provide a valuable tool for long-term financial planning. Let's walk through an example

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with Sally, our fictitious HSA saver.

Say in Year One, Sally opens an HSA account and contributes $2,000. She invests the money at a 5% rate of return and continues making the same $2,000 contribution for the next 10 years. During these 10 years, Sally accumulates various qualifying medical expenses of $1,000/year. Therefore, in year 10, Sally has $26,413 in her HSA (thanks to compounding interest) and $10,000 in prior medical expenses. Those past medical expenses of $10,000 allow Sally to withdraw up to $10,000 from her HSA in year 10 without incurring ***any tax*** on the distributions. Sally has no limits on what she can spend this $10,000 on as the distribution was made for medical expenses that already took place. Sally could decide to take a trip, all while having a remaining balance of $16,413 in her HSA for any future medical expenses!

It is not hard to see how an individual who saved the maximum amount to an HSA every year ($4,150/year for an individual or $8,300/family) could accumulate a large balance in the account if they invested the funds and allowed them to grow. Then, by carefully tracking medical expenses over the years, access these funds without needing to spend them on medical bills. Given a long enough time horizon, it’s likely that a large HSA balance will remain even with periodic withdrawals. These remaining funds can help pay for medical expenses through retirement, alleviating pressure on other retirement funds like 401(k)s and IRAs or even the need for long-term care insurance.

This example was a fairly simple illustration, and like many tax-advantaged accounts, there are numerous considerations not discussed in this article, so we recommend speaking with your financial advisor first. When used properly, an HSA can be an incredibly flexible and powerful financial planning tool that the astute saver shouldn’t overlook.

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