Health Savings Accounts: Raising the Cap on Tax-Deferred Savings

Properly utilizing HSAs can provide tax advantages and supplement retirement income.

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As a Senior Financial Advisor with HBKS® Wealth Advisors, Brittany Taylor guides her clients in achieving their overall financial goals, by establishing and overseeing a plan of action that is specific to their unique economic and life situation.

Ms. Taylor started with the firm in 2001 and has helped many families and individuals through major life changing events, including the loss or disability of a loved one. Although these are unhappy occasions, Ms. Taylor stresses the importance of proper planning both preceding and following these inevitable events, in order for her clients' wishes to be carried out. She is passionate about providing her clients with the highest level of coordinated service in a detailed and personal manner.

Ms. Taylor earned her Bachelor of Arts Degree in Business Management and Finance from Mercyhurst University.

Given their current and future tax benefits, health savings accounts (HSAs), a product of The Medicare Prescription Drug, Improvement and Modernization Act of 2003, are being viewed increasingly as supplemental retirement plans. HSAs offer a triple tax advantage: reduced taxable income on current contributions, tax-free growth on earnings and tax-free distributions for qualified medical expenses.

Tax savings on contributions to an HSA come in several forms. Generally contributions to HSAs are not taxed at the federal level, much like 401(k) s and IRAs. They are also immune to state (in all but a few states), FICA and FUTA taxes as part of an employer plan where contributions are made on a pre-tax basis. They also retain their tax-free status when they are used to pay for qualified medical expenses.

These tax benefits are broadly known and understood. But what more and more people are now becoming aware of is the increased benefits of an HSA over the long term. Assets in an HSA grow tax-deferred over time and can be used tax-free in the owner's retirement years for medical expenses and healthcare premiums, with the exception of Medigap coverage – an especially valuable benefit, given a typical retiree's medical expenses of as much as $500 per month, or $1,000 per month for a married couple. Fidelity's 2016 "Health Care Cost Estimate" study estimates a 65-year-old couple will need $245,000 to cover healthcare expenses through their retirement. And the Centers for Medicare and Medicaid Services estimate an average annual growth rate of 5.8 percent in healthcare spending between 2015 and 2025, which translates to roughly $430,000 a retired couple will need to cover their healthcare expenses in just 10 years.

Eligibility, Limitations and Penalties

To be eligible to contribute to an HSA you must be covered under a High-Deductible Health Plan (HDHP) and not enrolled in Medicare or have other health coverage. Nor can you be claimed as a dependent on someone else's tax return.

As with any tax advantaged account there are various maximums and limits. The maximum contribution limits for 2016 are $3,350 for individuals and $6,750 for family coverage. The provisions also allow for a $1,000 per year "catch-up" contribution starting at age 55. Keep in mind, contributions can be made only until you are enrolled in or become entitled to Medicare Part A benefits at age 65. These limits differ from 401(k)s and IRAs; they do not require a minimum distribution at a certain age as do those plans.

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Penalties come into play when HSA dollars are used for something other than qualified medical expenses. Account owners pay ordinary income taxes on the money, plus a 20 percent penalty. After age 65, the 20 percent penalty no longer applies, though the non-qualifying distributions are still subject to ordinary income taxes.

A valued supplement

An HSA can be a valuable supplement to your retirement income, in particular when the dollars are used for qualified medical expenses. HSAs can be employed to raise the cap on tax-deferred savings above and beyond the maximum 401(k) and IRA contribution limits. The benefits grow in tandem with the number of years to retirement or to age 65, whichever comes first. Once you have accumulated an adequate balance available for short-term healthcare costs, you might consider investing the excess dollars in the plan's investment options, if available, which could serve to protect you against the impact of ever-increasing healthcare costs.

Each individual and every family have different needs. So too, HSAs differ in many ways. Consult your financial advisor to determine if an HSA account would benefit you and if so how to best include an HSA in your financial plan.□