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Should You Open a Health Savings Account?

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At Artemis, we have long been fans of the Health Savings Account, or HSA. While these accounts have been around since 2004, many people still have misconceptions about them. This Brief aims to clear up these misconceptions and show how HSAs can be incorporated into a long-term financial plan.

What are HSAs?

A Health Savings Account (HSA) is a tax-advantaged account that enables the owner to contribute funds they can use to pay for certain *qualified medical expenses*. The main requirement with an HSA is that you must be covered by a high-deductible health plan (HDHP). You can use HSA funds to pay for qualified medical expenses each year (without any tax or penalty), but you can also invest HSA funds for future growth.

What counts as a qualified medical expense?

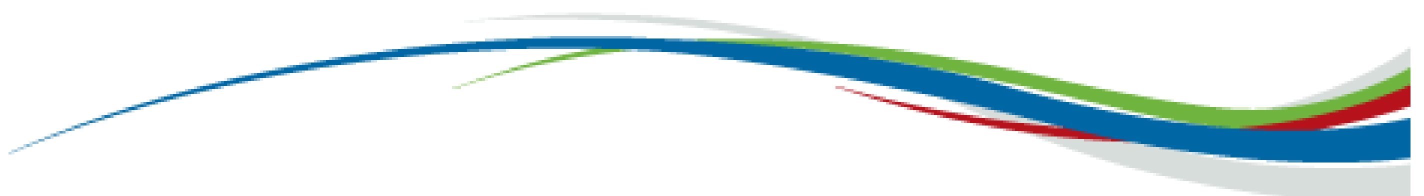
Generally, qualified medical expenses are those that would qualify for the medical and expense tax deduction as outlined in IRS Publication 502. I like to think of these expenses in a few broad categories:

- Any "cost-sharing" expense associated with the high-deductible health plan (HDHP), such as the deductible, coinsurance, or co-payments.
- Many expenses that may not be covered by health insurance, including dental, vision, and chiropractic care; eyeglasses, contact lenses, laser eye surgery, hearing aids, fertility treatment, weight-loss programs (overseen by a physician), and wheelchairs, to name but a few. Recently added, thanks to the CARES Act, are over-the counter drugs and menstrual care products.
- Medicare premiums for Parts B and D, long-term care services and long-term care premiums.

How do contributions and distributions to/from the HSA work?

You must be covered by a HDHP[1] to actively contribute funds into an HSA. If, however, you are no longer covered by a HDHP, you can still receive tax-free distributions to pay or reimburse for qualified medical expenses. Once you open up and contribute funds into an HSA, it is yours forever.

Like an IRA, HSA contributions are made pre-tax (i.e., *they reduce your taxable income for the year*) and come with annual limits. In 2022, that limit is $3,650 for self-only and $7,300 for families. Add an extra $1,000 if you are age 55+.



Distributions from the account to pay for qualified medical expenses are tax-free. Some HSAs come with a debit-type card to make paying for expenses even easier. Unqualified distributions (i.e., for non-medical expenses) are subject to income taxes and a 20% penalty if under the age of 65. If you are 65 or over, unqualified distributions are no longer penalized but still subject to income taxes.

To summarize, HSAs cover a variety of potential medical expenses while allowing you to save on taxes. Yet still less than 1 in 5 individuals is enrolled in an HDHP with an HSA. In fact, there are more people enrolled in HDHPs without an HSA! So, why don't more people use HSAs?

Misconception #1 – HSAs are "use it or lose it" accounts.

This misconception stems from confusion between HSAs and Flexible Spending Accounts (FSAs). Funds that you contribute into an FSA, which are most often for healthcare or dependent care, generally must be used within that calendar year. This is not the case with an HSA. HSA owners who do not incur healthcare expenses in a given year can simply let their funds continue to grow and use them in subsequent years.

Misconception #2 – The high-deductible health plan (HDHP) associated with an HSA provides worse health insurance coverage than a (traditional) PPO plan.

HDHPs provide strikingly similar coverage to PPOs, minus the deductible amount of course. There can be differences in the coinsurance amount for certain services, but there are generally no differences in what is considered a *covered service*. This means the plan participant does not have to compromise on *healthcare access* when signing up for a HDHP.

Misconception #3 – HSAs are administratively burdensome.

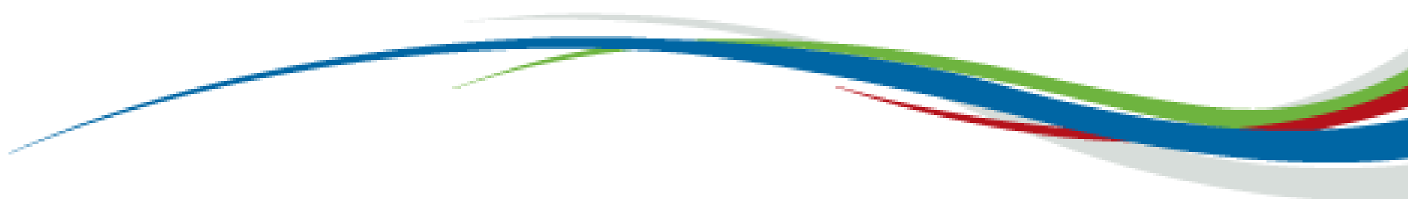
Any time you pay for a qualified medical expense using funds from your HSA, you should save the receipt in case of an IRS audit. This sounds like a lot of work but filing receipts has gotten much easier with the ability to snap a picture from your phone and securely store it in the cloud. And, unlike certain Flexible Spending Accounts (FSAs) that require you to show a receipt to claim a reimbursement each year, HSAs only require you to produce receipts in the event of an IRS audit.[2]

Misconception #4 – HSAs are like "Roth IRAs" for healthcare expenses.

In fact, from a tax standpoint, HSAs are better than Roth IRAs! HSAs are "triple tax free." The first tax benefit is via the pre-tax contribution. Second, the growth of your funds, including any interest or dividends, within the HSA is not taxed each year. And third, the withdrawals for qualified medical expenses are tax-free as well. Plus, not only are the HSA contributions not subject to income tax, but they also escape Social Security and Medicare tax (unlike Roth IRA contributions!).

What else do you need to know?

There is a lot to know about HSAs, and this Brief can't cover everything, but here are a few more important points to consider:



- Since HSAs are not “use it or lose it” accounts, you can invest your HSA funds for long-term growth, thereby maximizing the tax-free return. This means selecting one or more stock index funds and having the account value grow over years or even decades. If you incur medical expenses along the way, you can pay for them using other funds and then reimburse yourself out of the HSA later (just be sure you saved the receipt).
- What happens upon death of the HSA owner? This depends on whom the owner has designated as the beneficiary of the account. If it’s a spouse, then the HSA is treated as the spouse’s HSA. If it is *anyone other than the spouse*, then the fair market value of the HSA becomes taxable to the beneficiary in the year in which the HSA owner died.
- As the owner of an HSA, not only can you claim a qualified medical expense for yourself, but you can also claim one if incurred by your spouse and all dependents on your tax return.
- Many employers provide matching contributions when you sign up for a HDHP and HSA. This is free money!

The Bottom Line

Do the math. High-deductible health plans (that complement an HSA) have lower monthly premiums than PPOs. Combined with the triple-tax savings and an employer matching contribution, this pairing of HDHP plus HSA can be better financially than a traditional PPO. It is not always the case—I have seen it go both ways—so you really do need to run the numbers and look at a variety of scenarios of potential medical expenses.

Footnotes

[1] A HDHP is defined by the amount of the deductible and the out-of-pocket maximum. The IRS increases these amounts in most years, so it is a good idea to check with the insurance company to see if the plan qualifies. Medicare is not considered a HDHP.

[2] One finer point to note: in any year that you contribute to or withdrawal funds from an HSA, you are required to document this on Form 8889 when you file your taxes. Today’s tax software (or your accountant) makes this very easy.

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