



With Planning You Can Cut Your Medical Costs Even Into Retirement

The Benefits of Health Savings Accounts

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Over the last decade we have seen significant upheaval with respect to health care in the United States. Fierce debates about health insurance, steeply rising costs of care and a global pandemic have only increased uncertainty about what care will cost and how we'll pay for it. One of the most powerful and underutilized tools available to help offset medical expenses is the health savings account.

At their core, health savings accounts, or HSAs, allow you to set aside money to pay for medical expenses. Their power lies in the fact that, if used properly, contributions are tax-deductible, growth is tax-free and withdrawals are tax-free, providing a triple tax benefit to the account holder.

HSAs can sometimes be confused with flexible spending accounts, or FSAs. While both can be used to pay out-of-pocket medical expenses, the HSA has some key advantages over the FSA that we will cover below.

Who Can Participate?

In order to qualify for an HSA, you must be enrolled in a high-deductible health insurance plan (HDHP). Each year the Internal Revenue Service determines the minimum deductible necessary for a plan to be considered an HDHP. If your plan is a high-deductible plan and is “HSA eligible,” then you are eligible to open an HSA account, as long as you are not also enrolled in Medicare or another health plan.

For 2021, a plan must have a minimum annual deductible of \$1,400 for self-coverage, or \$2,800 for family coverage, in order to be considered a high-deductible plan. HDHPs also have a maximum amount the plan holder can be required to spend out-of-pocket. For 2021, the self-only maximum is \$7,000, while the family maximum is \$14,000.

This one is one area where HSAs are more strict than FSAs. In order to contribute to an FSA, your employer simply has to offer the benefit. There are no deductible thresholds like those outlined above for an HSA.

Opening an HSA

Often, an employer that offers a high-deductible health plan will also offer an HSA as part of the employee benefits package. In this case you typically make contributions directly from your paycheck. Contributions are not subject to income tax, Social Security tax or Medicare tax.

If your employer does not offer an HSA associated with your plan, you may open one on your own through an HSA provider — typically a bank or broker. In this case

you can still deduct contributions on your income tax return, but they will be subject to Social Security and Medicare taxes.

Each account will have an annual maintenance fee, along with a different menu of investment options, so it is important to research the plans available and find the right fit. Each year, Morningstar evaluates HSA platforms and publishes a list of their “top providers.” While their criteria may not match yours, their research may be a good starting point for evaluating your options.

Contributions

Similar to an individual retirement account (IRA), health savings accounts have annual contribution limits. For 2021, the maximum contribution for a self-only plan is \$3,600 and for a family the max is \$7,200. Participants over age 55 are eligible to make an additional \$1,000 “catch-up” contribution.

Your employer may make contributions on your behalf, but combined contributions must not exceed the limits above.

Your contributions are either pretax, if made through your paycheck, or tax-deductible, if made on your own to a self-selected plan.

Lastly, HSAs typically allow you to change the amount you are contributing at any time, which offers greater flexibility than an FSA, where your contribution amount is typically locked in once per year.

Investment

In addition to tax-deductible contributions, health savings accounts also offer the opportunity for you to invest the balance. Typically a plan will offer a set menu of mutual funds or other investment options and any growth in your investments is tax-free. This differs from an FSA, where contributions are typically held in cash.

Most plans will require that you maintain a minimum cash balance before you can invest in longer-term options. Historically, that cash balance also earned interest, similar to a bank checking account. However, with interest rates near zero in the wake of the pandemic, these balances are earning little interest at the present.

Qualified Distributions for Qualified Medical Expenses

In order for distributions from an HSA to be considered tax-free, they must be made to cover qualified medical expenses, as defined by the IRS. These are generally your most common out-of-pocket health care, dental, vision and prescription costs, along with co-pays and deductibles. HSA money can also be used to pay COBRA



premiums should you be separated from your employer.

One notable quirk of HSAs is that withdrawals do not have to be made at the time of the qualified medical expense. In fact, an unlimited amount of time can pass between the expense and the actual withdrawal. This opens up significant planning opportunities, which we detail below.

Any withdrawals made for non-qualified expenses will be subject to both income tax and a 20% penalty, if the account holder is under age 65. For those over age 65, the non-qualified distributions are taxable, but the 20% penalty is waived.

Taxation of HSAs

As you can see from the provisions above, when used properly, HSAs have the ability to provide three tax benefits: tax-deductible contributions, tax-free growth and tax-free withdrawals for qualified medical expenses.

If there are unused funds in the HSA at the death of the account holder, the tax treatment will depend on the beneficiary. If the beneficiary is the account owner's spouse, the account is converted or rolled over into an account in the spouse's name and there is no tax due.

If the beneficiary is someone other than the account owner's spouse, the account ceases to become an HSA on the date of death and any remaining funds are considered to be distributed to the beneficiary on the date of death. This distribution is taxable to the beneficiary, unless the money is used to pay medical expenses of the deceased, within a year of their death.

HSA as a Long-Term Savings Vehicle

The most straightforward way to use an HSA is set aside money to pay for deductibles and other out-of-pocket medical expenses that you incur each year. But because there is no time limit on the use of the funds, there can be a benefit to contributing to an HSA and not using

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the funds immediately for medical expenses.

Under this strategy, you make an HSA contribution, receiving the tax deduction. You then pay medical expenses out of pocket from your bank or other savings, allowing the HSA contribution to continue to grow tax-free over the long-term, for use in retirement. The danger in this strategy is that you may not have enough medical expenses in retirement to make qualified, tax-free withdrawals in retirement. We think this risk is small and can be managed rather easily.

First, given the steady inflation in medical costs over the past few decades, it is likely that expenses will continue to rise for retirees.

Second, Medicare premiums are a qualified expense, so there is a built-in qualified expense on the horizon for anyone who qualifies for Medicare at age 65.

Third, as noted above, there is no time limit on when money is drawn to cover expenses. As long as you keep careful records and save receipts and documentation, you can draw money from an HSA at age 67 to cover out-of-pocket costs you paid 10 or 20 years prior!

Thus the HSA can produce greater long-term, tax-free growth, as the principal compounds on itself over time.

With careful record-keeping, that larger balance can then be drawn tax-free for qualified expenses. For this strategy to work, your household must have the means to pay expenses out of pocket and contribute to the HSA.

Conclusion

Health savings accounts offer a clear and immediate benefit in tax-deductible contributions along with the ability to pay for current expenses with tax-free withdrawals.

In addition, the potential for long-term, tax-free growth is particularly attractive for those that can afford it. A recent Fidelity study estimates that the average retired couple turning 65 this year will spend \$300,000 out-of-pocket on medical costs in retirement.

As we continue to live longer, and as medical costs increase, it is important to use all the tools at our disposal to meet these expenses. **R**

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