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Are You Using a Health Savings Account Effectively?

There has been a recent surge in the popularity of Health Savings Accounts correlating with the rise in number of high-deductible health plans. When talking to clients and colleagues, I often find that many are unaware of the extent of the features and benefits that Health Savings Accounts offer. I've often referred to it as one of the best "deals" in the current tax code but am surprised at how few people use Health Savings Accounts to their full capability.

What is a Health Savings Account?

A Health Savings Account (HSA) is a tax-advantaged account that is paired with a high-deductible health plan (HDHP). You cannot contribute to an HSA unless you are enrolled in a HDHP. For 2022, the IRS defines a HDHP as a plan with a deductible of at least \$1,400 for individuals and \$2,800 for families. You and your employer may contribute to an HSA. Then, when you need medical care, you can withdraw HSA funds to cover your expenses, or opt to pay your costs out-of-pocket if you want to save your account funds. Unlike "Flexible Spending Accounts," there is no "use it or lose it" provision, so funds roll over from year to year. Even if you leave your current employer, the account is yours to keep, and you could theoretically accumulate a significant balance over time. If you have high medical expenses, it's certainly possible to spend down all the money in your HSA every year (HSAs are very commonly used this way). However, if you don't have high medical expenses and are several years from retirement, I challenge you to view the HSA as a powerful retirement savings tool.

HSAs as a Retirement Savings Tool

- 1) **Tax deductible contributions regardless of income** - Contributions to HSAs can be made via payroll deductions and from your own personal funds. If you make contributions using after-tax dollars, they're deductible from your taxable income whether you itemize or not. Unlike retirement accounts, you do not have to have earned income to make deductible contributions. Contributions to HSAs are deductible until you sign up for Medicare.
- 2) **Ability to invest funds** - HSAs typically offer several savings and investment options. These may include interest-earning savings, checking, and money market accounts, or investments such as stocks, bonds, and mutual funds that offer the potential to earn higher returns but carry more risk (including the risk of loss of principal). Carefully consider your investment objectives, risk tolerance, expenses, and your time horizon before investing. A financial professional can help you decide which savings or investment options are appropriate.
- 3) **Potential for tax-free withdrawals** - Here's the kicker, contributions to your HSA, and any interest or earnings, grow tax deferred, UNLESS withdrawn for qualified medical expenses, in which case they could be withdrawn tax free. I recommend you consult a tax professional if you have questions about the tax advantages offered by an HSA.
- 4) **No Required Minimum Distributions** - Unlike a 401(k) or traditional IRA, HSAs do not require you to take funds out at a certain age. The account can remain untouched and invested as long as you like.
- 5) **Reimbursement for Medical Expenses in Retirement** - You are not required to take distributions for medical expenses in the year that you incur the expense. In fact, distributions for qualified medical expenses incurred after your HSA is opened could be deferred as long as you would like. If you pay medical expenses out of pocket instead of from your HSA, keep careful track of the expenses and save receipts to know how much you can distribute tax-free in retirement.



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HSA Limitations to Consider

- As mentioned above, you must be enrolled in a high deductible health plan to contribute to an HSA.
- For 2022, individuals can only contribute up to \$3,650 and families can contribute \$7,050. This annual limit applies to all contributions, whether they're made by you, your employer, or your family members. You can make contributions up to April 15th of the following year (i.e., you can make 2022 contributions up to April 15, 2023). There is also a "catch-up" contribution for individuals over age 55 that allows you to contribute an additional \$1,000.
- Distributions for expenses other than qualified medical expenses will be subject to income tax and a penalty of 20% if made before age 65. Individuals older than 65 can make distributions for any expenses without penalty, but those distributions will still be added to taxable income if not used for qualified medical expenses.
- Don't let the tax tail wag the dog. As with any retirement account, before making contributions, ensure you have an emergency fund set up and plenty of liquidity to cover your livings expenses. The last thing you want is to be forced into a situation where you have to make a distribution from your HSA to cover living expenses and incur a penalty.

Bottom Line

If you are enrolled in a high-deductible health plan, a Health Savings Account can be an extremely powerful retirement savings tool when you consider the triple tax advantage of tax-deductible contributions, potential tax-deferred growth, and potential tax-free withdrawals. If cash flow allows, consider paying health care costs out of pocket while you are working, keeping careful track of those expenses so you can reimburse yourself in retirement. An HSA may be a key part of a detailed, comprehensive financial plan. If you have any questions or would like to discuss the topic further, you can connect with us at www.sharrisfinancial.com.

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HSA's are never taxed at a federal income tax level when used appropriately for qualified medical expenses. Also, most states recognize HSA funds as tax-free with very few exceptions. Please consult a tax advisor regarding your state's specific rules. Investments available to HSA holders are subject to risk, including the possible loss of the principal invested and are not federally insured or guaranteed. HSA holders making investments should review the applicable fund's prospectus. Investment options and thresholds may vary and are subject to change. Consult your advisor or the IRS with any questions regarding investments or on filing your tax return. Before making any investments, review the fund's prospectus.

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