

TAX BENEFITS OF HEALTH SAVINGS ACCOUNTS

Health savings accounts (HSAs) are tax-advantaged vehicles designed to pay current medical bills or be invested long-term for future health care and retirement.

AM I ELIGIBLE AND WHAT ARE THE LIMITS?

The prerequisite for an HSA is the enrollment in a qualified high deductible health plan (HDHP). In 2020, the IRS requires a deductible to be at least \$1,400 for an individual or \$2,800 for a family and max out-of-pocket expenses (including deductibles, copayments, and coinsurance) to be no more than \$6,900 for an individual or \$13,800 for a family.

The HSA contribution limit in 2020 is \$3,550 for self-coverage and \$7,100 for family, plus an optional \$1,000 catchup contribution for those ages 55 or older.

HOW DOES IT DIFFER FROM A FLEXIBLE SPENDING ACCOUNT (FSA)?

HSA is not subject to the use-it-or-lose-it rule, unlike the flexible savings account (FSA). FSA has its own merits and can complement an HSA.

An FSA can be used to cover dental and vision care, but not medical items until you have used the HSA (or other money) to meet the HDHP deductible. HSA can pay for vision, dental care, hearing aids, and nursing services, too. The idea is to use FSA, in addition to HSA, to enjoy a significantly greater savings capacity, tax free. That is, estimate expenses to be covered by FSA, use it all up during the year, and then use HSA to cover whatever remains or invest the money otherwise. However, the use-it-or-lose-it FSA rule makes it very tricky for anyone to foresee the forthcoming health care needs and figure out a precise amount to be saved in an FSA during the annual enrollment period.

WHAT ARE THE TAX ADVANTAGES?

Traditional retirement plans such as 401(k) and individual retirement accounts (IRAs) allow participants to make pre-income-tax contributions, defer taxes on investment earnings, and then pay ordinary income taxes on all withdrawals. A Roth plan

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reverses the order whereby participants pay income taxes on contributions up front and then accrue returns and make withdrawals without tax obligations. These contributions are subject to the Federal Insurance Contributions Act (FICA) taxes for Social Security and Medicare.

Through an HSA, the worker can

- make contributions, without income or FICA taxes,
- accrue tax-free investment returns, and
- pay no tax on withdrawals for qualified healthcare expenses.

For many workers, the mandatory FICA deductions from their paychecks, also referred to as “payroll taxes”, are 7.65% of earnings – 6.2% for Social Security on earnings up to the taxable maximum (\$137,700 in 2020) and 1.45% for Medicare on all earnings. For higher earners, there is an additional 0.9% Medicare tax on wages over the statutory thresholds (\$200,000 for singles, \$250,000 for married couples filing jointly, not indexed).

HOW CAN I USE AN HSA?

An HSA is meant to pay for qualified medical expenses, tax and penalty free.

In general, an HSA cannot be used to pay the premium for private health insurance, with limited exceptions for those between jobs.

An HSA can pay certain Medicare expenses, including premiums for Parts B (outpatient coverage) and D (prescription drug coverage) but excluding supplemental MediGap (Plan F). An HSA can be used to pay “tax qualified” long term care (LTC) insurance premiums, with certain limitations.

An HSA could be used for general consumption, subject to income taxes upon withdrawals, like 401(k)s and IRAs. At age 65 or later, such withdrawals have no penalty. Before 65, however, HSA withdrawals for non-medical expenses are required to pay a 20% penalty to the IRS. In comparison, 401(k) and IRA withdrawals earlier than age 59 ½ have to pay a 10% penalty.

HSAs can be invested, just like 401(k)s and IRAs.

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