HSA: A versatile financial solution

Key findings

- Health care costs in retirement are steadily rising.
- Health savings accounts (HSAs) are designed to address those costs.
- HSAs offer triple tax advantages, making them a powerful tool for savvy financial planning.

By one estimate, an average 65-year-old couple could spend up to **$315,000 in health care costs** in retirement.[3]

For any job, using the right tool can make all the difference. But when it comes to financial planning, one of the most versatile and beneficial financial tools — the health savings account (HSA) — is often overlooked.

Think of an HSA like a multitool. An HSA is a tax-advantaged savings account designed for paying medical expenses, but its usefulness doesn't stop there. It's also a powerful tool for long-term savings and tax-savvy financial planning.

Your clients can use HSAs to stash away pretax dollars, avoid taxes on earnings and withdraw funds tax-free for qualified medical expenses. This guide dives into the uses of HSAs, how they work, what their benefits are, and strategies to maximize their value.

Help your clients prepare for the rising costs of health care

With the health care landscape constantly evolving and costs steadily rising, helping your clients plan for future medical expenses isn't just wise — it's essential. In 2023, for example, the annual cost of health care for the average person covered by an employer-sponsored PPO plan was estimated at $7,221.[1]

Health care costs for the average person during retirement could be significantly higher. Medical and prescription drug costs are continuing to rise. Increases in the cost of care are being exacerbated by the worsening shortage of nurses and physicians.[2] In fact, by one estimate, an average 65-year-old couple could spend up to $315,000 on health care costs in retirement.[3]

HSAs were designed to help individuals save for these costs. Let's review how the plans work.

How do HSAs work

Although they're incredibly flexible, HSAs do still come with some restrictions. It's important that your clients understand those rules.

HSA contribution eligibility
In order to contribute to an HSA, an individual must:

- Be covered under a health plan that has a high deductible
- For 2024, the health plan must have a minimum deductible of $1,600 for individual coverage or $3,200 for family coverage
- Have no other disqualifying coverage
- Not be enrolled in Medicare
- Not be claimed as a dependent on someone else's tax return

Contribution limits
Tax-free contributions are a big benefit of HSAs. Those who are eligible for HSAs can contribute up to $4,150 for individuals or $8,300 for families tax-free in 2024. Individuals age 55 and older can also make an extra catch-up contribution of $1,000 in 2024. These limits are adjusted annually for inflation.

Employers can also contribute to HSAs on behalf of their employees. Keep in mind, however, that any employer contribution counts toward the overall limits, reducing the amount the employee can contribute.

Individuals don't have to use their HSA savings during the year the contribution was made. Unused HSA funds automatically roll over into the next year, allowing invested assets to potentially grow year after year until withdrawn.

Qualified medical expenses
In addition to tax-free contributions, HSAs allow for tax-free withdrawals — if the withdrawals are used for qualified medical expenses. Fortunately, the list of qualified medical expenses is lengthy.

For example, HSA funds can be used to pay for:

- Copays and deductibles for doctor and hospital visits
- Dental expenses
- Vision expenses (including eyeglasses and contact lenses)
- Prescriptions
- Hearing aids
- Lab fees
- Long-term care
- Medical equipment, such as wheelchairs and crutches
- Medicare premiums
- Mental health care

Examples of nonqualified medical expenses include cosmetic surgery and procedures, health club dues, nonprescription drugs and supplements, and funeral costs.

Individuals younger than age 65 who make HSA withdrawals for nonqualified expenses incur a 20% penalty on the withdrawal amount, along with income taxes. Those age 65 and older, however, can withdraw from their HSA for any reason without a penalty, and if the purpose is a qualified medical expense, the withdrawal is tax-free. If it's for any other purpose, the withdrawal is taxable as income.

Benefits of an HSA

Like a multitool, HSAs offer a lot of benefits. They include:

- Triple tax advantages: HSAs are among the (very) few financial tools that deliver triple tax benefits — tax-deductible contributions, tax-free growth and tax-free withdrawals for qualified medical expenses.
- Flexibility: In addition to common medical, dental and vision expenses, HSAs can also be used to pay for things such as Medicare premiums, long-term care costs and an array of other medically necessary services and products.
- Long-term investment potential: Many HSA providers offer investment options within the accounts, allowing the funds to potentially grow over time.

Help clients make the most of HSAs

HSAs offer tremendous benefits, so it's smart to make the most of them. You can help your clients do that by encouraging them to:

- Contribute the maximum during their working years. Given the triple tax benefits of HSAs, clients may benefit from maxing out their annual HSA contributions while they're still working before deciding how much they can afford to contribute to a traditional retirement plan, such as a 401(k) and IRA.

- Invest for short- and long-term needs. Investing within an HSA can help those assets potentially grow over time. But clients should balance their goals for growth with their tolerance for risk and their need to keep some HSA funds in more liquid assets to cover short-term medical expenses.
- Avoid non-qualified withdrawals. Making sure all HSA withdrawals are for qualified expenses only will help avoid ordinary taxes and, for those under age 65, potential penalties.

Navigating Medicare and HSAs

As you explain HSAs to clients who are in or nearing retirement, make sure they understand how the accounts work with Medicare. Anyone enrolled in Medicare can no longer contribute to an HSA — and they must stop contributing to their HSA 6 months before applying for Medicare to avoid an IRS penalty. However, they can still withdraw HSA funds for:

- Qualified medical expenses (tax-free)
- Other financial needs or wants (taxed at ordinary income tax rates)

Withdrawal strategies in retirement

Efficiently using HSA funds in retirement involves careful withdrawal planning. Because withdrawals for qualified medical expenses remain tax-free, some retirees may want to use HSA funds for those costs instead of withdrawing from other accounts that may trigger taxable income.

How to open an HSA

Many employers who offer health plans with high deductibles offer HSAs in conjunction with those plans. When available, these are convenient options, as contributions can be taken automatically from each paycheck. Some employers also make their own contributions to employees' HSA accounts.

Those who are not able to fund their HSA through pretax payroll deduction, however, aren't necessarily out of luck. Anyone can open an HSA through an independent financial institution as long as they meet the contribution eligibility requirements.

Conclusion

HSAs are powerful financial tools offering tax advantages, flexibility and the potential for long-term growth. As a financial professional, you can help your clients maximize the benefits of HSAs not only to prepare for future health care costs but also to strengthen their financial position throughout retirement.

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[1] 2023 Milliman Medical Index (May 2023).

[2] "Healthcare's next chapter: What's ahead for the US healthcare industry," McKinsey & Company (Dec. 19, 2023).

[3] "Projected Savings Medicare Beneficiaries Need for Health Expenses Remained High in 2022," EBRI Issue Brief, no. 549 (Feb. 9, 2023).

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