

Health Savings Accounts



The Berry

Health savings accounts (HSAs) are special savings accounts specifically for medical expenses. To encourage people to save for medical expenses, lawmakers allow individuals to claim a tax deduction from their income when they contribute funds to an HSA, much like with an IRA. Each dollar contributed to the savings account reduces AGI and taxable income.

There are some important differences between an HSA and an IRA. First, money in an HSA can be withdrawn tax free at any time, as long as it is used for qualified medical expenses. This is significant, because it means that the money contributed to an HSA is *never* taxed—not when it is contributed (because of the deduction) and not when it is withdrawn. The tax code treats *no other arrangement* so favorably. Additionally, the unique set of rules that govern HSAs provide a rare “double berry” opportunity in the tax code.



The Hiding Spot

Generally, medical expenses can be deducted from your taxable income only if you itemize deductions. If you claim the standard deduction, you receive no tax benefit from those expenses. Even if you itemize, you can deduct only those medical expenses that exceed 7.5% of your AGI (or 10% if you are subject to the Alternative Minimum Tax [AMT]).



Example: James is a professional fisherman in Louisiana. This year he had an AGI of \$80,000 and \$6,500 in medical expenses. He can deduct only \$500 of those expenses ($7.5\% \times \$80,000 \text{ AGI} = \$6,000$ nondeductible expense \rightarrow $\$6,500$ expenses $- \$6,000$ nondeductible = $\$500$ deductible). If James were subject to the AMT, he would get no deduction because his expenses would not exceed the nondeductible amount ($10\% \times \$80,000 = \$8,000$ nondeductible).

With an HSA, however, you can circumvent these limitations and deduct many of these “nondeductible” expenses. You must first have a qualifying high-deductible health insurance plan. With such an insurance policy in place, you can contribute up to \$3,050 (\$6,150 for families) to an HSA. When you do this, every dollar contributed is deductible. Then you can

use those funds tax free to pay for medical expenses. In this way you can circumvent the itemization requirement and avoid having to exceed 7.5 or 10% of AGI in your medical expenses.



Tip: An additional benefit to HSA contributions is that the AMT has no effect on your ability to claim the deduction, as it does when you're itemizing. In fact, the AMT is reduced when you claim this deduction.



Tip: If you are over the age of 55, you can contribute an additional \$1,000 over the \$3,050 and \$6,150 limits as a “catch-up” contribution.

While the money is in the HSA, it can be invested and grow tax free. When you need the money, you can withdraw it tax free, as long as you use it for medical expenses.



Tip: The term “medical expenses” is broadly defined to include all kinds of expenses, including things your insurance plan might not cover. The money can be used for dentists, chiropractors, acupuncture, laser eye surgery, and so on. Nearly everything that is deductible as an itemized deduction for medical expenses is allowable for HSA expenditures.

If you don't use the money in the savings account for medical expenses, you can use it for any expenses once you reach retirement age, which for this purpose is considered age 59½. If you use the money for nonmedical expenses after age 59½, the amount withdrawn will be subject to income taxes, in the same way all non-Roth retirement accounts are taxed.



Tip: Contributions to an IRA or 401(k) do not limit your ability to contribute to an HSA. If you have made the maximum contribution to an IRA, an HSA could be a great way to significantly increase the contribution you can make to an IRA-like account. Additionally, HSA contributions have no high-income cap. High-income earners, who might not be allowed to make contributions to an IRA, can contribute to HSAs.



The Cultivation

To take advantage of this strategy, you must first ensure that you have a qualifying high-deductible health insurance plan. The best way to find that out is to contact your insurance company or your human resources department. Once you have the right plan, you must set

up an HSA with a provider. Many large banks offer HSAs. They usually give you a special debit card for the account, which makes it very easy to access the funds when you need to pay a bill. Once you have the right plan and the account, contribute all you can to the account, up to the maximum allowed.



Tip: If you need to switch insurance plans to qualify for an HSA, there is a very good chance that the money you save in premiums will add up to a large portion of the maximum HSA contribution. Contribute at least the amount you save in premiums each month.

If your budget is really tight, contribute to the HSA at least as you have medical expenses. If a doctor bills you for \$150, send the \$150 to your HSA first, and then pay the doctor from the account. Doing so will usually bring a greater tax benefit than paying the doctor from funds outside the HSA.



Tip: In the preceding scenario, you ensure that each dollar you pay in medical expenses becomes a deduction. If you pay out of pocket, not through the HSA, your medical expenses will be limited by the itemization thresholds.



The Double Berry

Although this strategy is not truly “double dipping,” it comes very close. There is a way to have your cake and eat it too, when it comes to HSAs and itemized medical deductions. Here is what to do:

- Contribute the full amount allowable to your HSA in order to get the maximum deduction.
- Withdraw no money from the HSA for medical expenses you incur—just leave all of the funds in the HSA.
- Allow the contributions to grow tax free for the future.
- Pay all of your current medical expenses out of pocket. Included in those expenses is the cost of your health insurance premiums (which cannot be paid from the HSA).

By following these steps you will get a deduction for the HSA contribution, another deduction for expenses over 7.5% of AGI (including premiums), and tax-free growth on your HSA. Is that not beautiful?



The Thorns

Here are the things you need to know to get the full benefit of this strategy and avoid the painful thorns:

- You can make HSA contributions up to April 15th of the following year.
- Contribute no more than the maximum allowable for an HSA—you'll pay fairly steep penalties if you do.
- Don't use HSA funds for unqualified medical expenses. If you do you will pay taxes on the amounts used, as well as a 10% penalty if you are younger than 59½. In 2011 the penalty increases to 20%.
- Beginning in 2011 you cannot use HSA funds to purchase over-the-counter medications, unless they are prescribed by a doctor.
- Keep records of the medical expenses you cover with HSA funds.
- You could be ineligible for an HSA because of an employer-sponsored health plan, unless it is an HSA plan.
- Ensure that your insurance plan meets all of the necessary qualifications.



The Lists, the Charts, and the Numbers

The following chart shows the maximum contributions allowed to HSAs in 2010.

	Under 55	55 or Older
Individual	\$3,050	\$4,050
Family	\$6,150	\$7,150