Why Health Savings Accounts Matter More Than Ever

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Many experts expect healthcare costs will continue to rise, making it important that advisors help their clients plan ahead.

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According to the Kaiser Family Foundation, health care has become somewhat less affordable, *even among those with health insurance*. Since 2015, larger shares of people with health insurance say they have a difficult time affording their **healthcare costs**: from 27% to 37% for premiums; 34% to 43% for deductibles; and from 24% to 31% for copays and prescription drugs.

Some experts estimate that a 65-year-old couple who retired in 2016 will need $260,000 to cover just healthcare costs in their golden years—6% more than the previous year's estimate of $245,000. That's the highest estimate since such projections started in 2002, and chances are repealing and replacing the **Affordable Care Act**, not to mention the high cost of **pharmaceuticals**, could push retiree healthcare costs even higher. All of which highlights the need for advisors to discuss with clients the flexibility and power of Health Savings Accounts (HSAs).

HSAs were created with the passage of the Medicare Modernization Act in 2003. Although available more than a decade, HSAs are growing in popularity with both employers and employees. Why? An HSA offers an opportunity to pay medical expenses in retirement tax free. Distributions can be made at any time (unlike flexible spending accounts, which follow "use it or lose it" distribution rules), which, with smart planning, offers a younger individual to fund his or her HSA today and let the account grow without distributing any proceeds until later in life, potentially as late as retirement.

Of course, clients (and their spouses and dependents) have medical costs throughout their lives. So, if at all possible, it's advisable to encourage them to tap other funds, while their HSA grows. Note that tax-free distributions are allowed for a spouse even if he/she has medical coverage that is not HSA eligible.

In fact, HSAs are triple tax-advantaged, which means that contributions are tax deductible, distributions (of contributions) are tax free, and earnings are distributed tax free so long as the proceeds are used to cover qualified medical expenses. HSAs also can enable employers to lower premiums by creating higher deductibles and increase "cost sharing" with employees.

HSA eligibility requires an employee to be enrolled in a high deductible health plan (HDHP).

However, once an individual reaches age 65, and enrolls in Medicare, he or she forgoes their HSA eligibility. In other words, once enrolled in Medicare, you are no longer allowed to fund an HSA. Turning 65 does, however, provide benefits. While a distribution from an HSA is generally subject to a 20% penalty if the proceeds are not used for qualified medical expenses, the penalty is waived for those individuals age 65 and older who used their HSA for nonqualified medical expenses. But such a distribution is subject to income taxes.

In 2017, the maximum funding limit for an HSA is $3,400 for an individual ($4,400 for those employees age 55-plus) and $6,750 for a family ($7,750 for those age 55-plus). The contribution deadline is the employee's tax-filing deadline, not including extensions. So, you still have time to make a 2016 HSA contribution.

HSAs also offer a little known benefit—in coordination with your IRA. An individual once (in their lifetime) can transfer IRA proceeds to their HSA—up to the contribution amount allowed for the year. This transfer is known as qualified HSA distribution or QHFD. However, an individual must meet a number requirements, including:

- The transfer can only occur once per lifetime.
- The transfer amount is determined by the contribution limit for the individual in the year of transfer.
- IRA proceeds must be moved as a direct transfer. A 60-day rollover is not permitted.
- Eligible IRAs include traditional, Roth, SEP, or SIMPLE. However, the SEP or SIMPLE must be inactive.
- Distributions are not subject to the "pro-rata" rule. In other words, an individual is not permitted to move aftertax dollars; only pretax dollars are allowed to transfer.
- A QHFD also applies to inherited IRAs.
- Be sure to engage a tax professional, as there is no special 1099-R coding to report the transfer as a QHFD.
- An individual must remain HSA eligible for a one-year period after a QHFD to avoid taxes and penalties.

Has an HSA helped you offset rising healthcare costs? Do you have any specific questions to add? Join the conversation here.

HDHPs: Minimum Deductibles and Maximum Out-of-Pocket Expenses*

Year	Self-Only HDHP Minimum Deductible	Self-Only HDHP Maximum Out-of-Pocket Expenses	Family HDHP Minimum Deductible	Family HDHP Maximum Out-of-Pocket Expenses
2016	$1,300	$6,500	$2,600	$13,100
2017	$1,300	$6,500	$2,600	$13,100

*Clients should confirm with the health insurance company that their plan is an HDHP.

HSA Tax Benefits & Advantages	
Control	Owned and controlled by the individual, not the employer.
Death of HSA Owner	Spouse beneficiary automatically treated as new HSA owner. Non-spouse beneficiary must include HSA value at death as taxable income, but no 20% penalty.
Distributions	Tax-free for qualified medical expenses of the individual, spouse or dependents. Distributions not used for qualified medical expenses are taxable as ordinary income plus a 20% penalty unless due to death, disability, or age 65+.
Employee/Individual Contributions	Tax deductible as an above-the-line deduction (reduces AGI), regardless of individual's tax-filing status or income.
Employer Contributions	Tax deductible to employer and must be "comparable." Employees do not include employer HSA contributions in income.
Investment Gains	Tax-free, if used for qualified medical expenses.
Portability between HSAs	HSA funds can be rolled over or transferred to another HSA (once-per-year rule and 60 day rule applies to rollovers).
Portability from an IRA	IRA funds cannot be rolled over or transferred to an HSA. There is a one-time exception for a qualified HSA funding distribution.
Qualified HSA Funding Distribution (QHFD) from an IRA	QHFD is a tax-free direct transfer from an IRA to an HSA. It is a one-time only transfer that is limited to individual's maximum HSA contribution for the year. Only pre-tax IRA funds can be transferred (exception to the IRA pro-rata rule). Does not apply to ongoing SIMPLE or SEP IRAs. After a QHFD, individual must remain HSA eligible for a 1-year testing period to avoid taxes and penalties.
Use-It-Or-Lose-It Rule	N/A - Unused HSA funds continue to belong to the owner.

Source: Ed Slott & Company

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Traditional IRA contributions plus earnings, interest, dividends, and capital gains may compound tax-deferred until you withdraw them as retirement income. Amounts withdrawn from traditional IRA plans are generally included as taxable income in the year received and may be subject to 10% federal tax penalties if withdrawn prior to age 59½, unless an exception applies.

A **Roth IRA** is a tax-deferred and potentially tax-free savings plan available to all working individuals and their spouses who meet the IRS income requirements. Distributions, including accumulated earnings, may be made tax-free if the account has been held at least five years and the individual is at least 59½, or if any of the IRS exceptions apply. Contributions to a Roth IRA are not tax deductible, but withdrawals during retirement are generally tax-free.

SEP IRA—A Simplified Employee Pension Plan is a retirement plan specifically designed for self-employed people and small-business owners. When establishing a SEP IRA plan for your business, you and any eligible employees establish your own separate SEP IRA; employer contributions are then made into each eligible employee's SEP IRA.

SIMPLE IRA—A Savings Incentive Match Plan for Employees' IRA is an IRA-based plan that gives small-business employers a simplified method to make contributions toward their employees' retirement and their own retirement. Under a SIMPLE IRA plan, employees may choose to make salary reduction contributions and the employer makes matching or non-elective contributions. All contributions are made directly to an individual retirement account (IRA) set up for each employee (a SIMPLE IRA). SIMPLE IRA plans are maintained on a calendar-year basis.
