PNC CENTER FOR FINANCIAL INSIGHT

The PNC Center for Financial Insight[SM] builds bridges from thought to action, creating practical, applicable strategies to help benefit you and your family.

Health Savings Accounts

Health Savings Accounts (HSAs) provide a tax-advantaged way to pay for current medical expenses. They can also be used as part of long-term retirement planning.

A Health Savings Account (HSA) is a tax-exempt account set up to pay certain health care expenses. Both while you are working and during retirement, HSAs can help you manage qualified out-of-pocket expenses, the amount you pay directly to providers beyond what you pay in insurance premiums. They can also be used to build a tax-advantaged account to cover medical-related expenses, such as Medicare premiums, in retirement.

Ever-rising health care costs are creating financial insecurity. Employee out-of-pocket costs for health care increased 5.1% between 2016 and 2017[1] and are projected to rise an average of 4.8% per year from 2016-2025.[2] Additionally, couples may need as much as $350,000 to cover medical expenses in retirement.[3] HSAs, which are only available to individuals in High Deductible Health Plans (HDHPs),[4] can help provide a layer of financial security.

HDHPs paired with HSAs are offered by some employers. They tend to be popular with consumers because of their investment flexibility and ease of use. The funds often are accessible via a debit card and can be used for prescriptions, deductibles, and co-pays.

Similar to traditional retirement accounts, you can contribute money pre-tax and allocate to investments.[5] Also, your earnings are not taxed while in the account. Unlike traditional 401(k) and IRA plan withdrawals, which require you to pay taxes on contributions and earnings, the money withdrawn from HSAs to pay for qualified medical expenses is tax free. Most people contribute to HSAs by having money deducted from their paychecks, but you can also make a contribution directly to your HSA.

Qualified Expenses

Expenses qualifying for tax-free withdrawal include those incurred

[1] Chris Girod, Sue Hart, Scott Weltz. 2017. 2017 *Medical Index.* Milliman Research Report, Milliman, 10, Fig. 9. Accessed July 3, 2017. http://careers.milliman.com/uploadedFiles/insight/Periodicals/mmi/2017-milliman-medical-index.pdf.

[2] *National Health Expenditure Projections 2016-2025,* Centers for Medicare and Medicaid Services Office of the Actuary. Retrieved from https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/proj2016.pdf

[3] For those with drug expenses at the 90th percentile throughout retirement and who want a 90 percent chance of having enough money saved for healthcare expenses in retirement by age 65. Source: Savings Medicare Beneficiaries Need for Health Expenses: Some Couples Could Need as Much as $350,000, EBRI Notes, Employee Benefit Research Institute, January 31, 2017, Vol. 38, No. 1.

[4] Deductibles under an HDHP for 2017 are at least $1,300 for Single, $2,600 for Married and the out of pocket maximum is no more than $6,550 for Single, $13,100 for Married. From IRS Rev. Proc. 2016-28.

[5] Once your balance reaches a minimum specified by the trustee/custodian.

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HSA vs. FSA

An HSA is different from a Flexible Spending Account (FSA), but the similar acronyms often lead to confusion. An FSA is a benefit your employer might offer to help you pay for medical expenses or dependent daycare expenses with pre-tax money. There would be a separate FSA for each of these. With an FSA, you contribute pretax money to your account and can then pay for qualified expenses from that account. Unlike an HSA, you cannot invest the money, so there is no growth opportunity. And there is a time limit on when you can use the funds, after which you forfeit the money back to your employer.

HSA Tax and Withdrawal Treatment

	Included in Adjustable Gross Income	20% Penalty
Used for qualified medical expenses	No	No
Not used for qualified medical expenses		
Before age 65	Yes	Yes
Age 65 and over	Yes	No

by you, your spouse, and dependent children who would qualify for the medical and dental expenses deduction.

Insurance premiums are considered qualified expenses if they are for the following:

- long-term care insurance;[6]
- health care continuation coverage such as COBRA;
- health care coverage while receiving unemployment compensation; and
- Medicare and other health care coverage if you are age 65 or older (however, premiums for a supplemental medical policy, such as Medigap, are not qualified).

Withdrawal Tax Treatment

Money withdrawn from an HSA is tax free if used for qualified medical expenses. If you use the money for something other than qualified medical expenses, how it's treated depends on your age.

Eligibility

To become eligible to contribute to an HSA, you must

- be enrolled in a high deductible health plan; and
- not be enrolled in Medicare, claimed by anyone as a dependent, or have any other health coverage.[7]

HSA Contributions

In 2017, contributions to your HSA can be made up to:[8]

- $3,400 if you are single;
- $6,750 for a family; and
- $1,000 catch-up contribution if you will reach age 55 by the end of the year.

If you become eligible for an HSA part way through the current year, you can still contribute the full annual amount

[6] Subject to limits based on age and adjusted annually.

[7] With some exceptions. More details are available in IRS Publication 969, *Health Savings Accounts (HSAs), Qualifying for an HSA, Other health coverage*.

[8] These are the limits for contributions from all sources, including you, your employer, and family members.

as long as you remain eligible for all of the following year. If not, your current year contribution amount is prorated.[9]

If you contribute more than the limit to your HSA, you will be assessed a 6% excise tax on the excess contribution. You can avoid that penalty, however, by withdrawing the extra contributions—and any earnings on them—before the due date of that year's tax return, usually April 15 of the following year.

Not All Beneficiaries are Created Equal

Spousal beneficiaries can use the HSA to take tax-free withdrawals to cover their qualified medical expenses. If the beneficiary is someone other than your spouse, however, the account stops being considered an HSA. The balance immediately becomes classified as taxable income to your beneficiary and must be reported by them as income for that year.

[9] For example, if you were to become eligible on July 1, 2017, you can contribute the full $3,400 (if you're single) even though it's half-way through the year. But then you also have to be eligible for all of 2018. If you're not, then the amount you were allowed to contribute for 2017 is prorated (so your allowable contribution amount is changed to $1,700) and everything above that is an excess contribution.

For more information, please contact your Hawthorn advisor.

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