A Health Savings Account (HSA) is a tax-advantaged account which allows an eligible individual to set aside funds to pay for future out-of-pocket medical expenses. In order to be considered an eligible individual and take advantage of an HSA, you must be covered under a High Deductible Health Plan (HDHP), which is a health plan that generally has a higher annual deductible than typical plans.

Why Establish an HSA?

HSAs have what is referred to as the triple tax benefit at the federal level:[1]

- Tax-Deductible Contributions
- Tax-Free Growth
- Tax-Free Distributions

These benefits are only retained if the distributions received from the HSA are for qualified medical expenses. [2] Additionally, withdrawals for any other purpose will lose the tax benefits mentioned above while also incurring a 20% penalty on the distribution. These taxes and penalties are included as part of the individual's tax return and will be due on April 15th of the following year of the distribution. However, after 65 years of age, you can withdraw the assets from an HSA for any purpose without incurring the 20% penalty, but will still be subject to income taxes.

Contribution Limits

In 2019, HSA contribution limits are $3,500 for an individual and $7,000 for family coverage. Any amount above the limit will not be tax deductible and will also be subject to a 6% excise tax. At age 55 or older, you can contribute an additional $1,000 per year.

Aside from the annual contribution limits, once you are enrolled in Medicare, you become ineligible to contribute to an HSA.

Passing Down an HSA

Upon the death of the account owner, HSAs are treated differently based on the beneficiary. Please see below:

Spousal Beneficiary: The HSA becomes the spouse's HSA as of the date of the account owner's death whether or not they are covered under an HDHP plan.

Non-Spousal Beneficiary: The HSA will be converted to an individual brokerage account for the beneficiary. The beneficiary will then be forced to include the fair market value (FMV) of the HSA as taxable income in the year of the account owner's death.

Estate Beneficiary: The FMV of the HSA will be added to the gross income of the owner's final income tax return.

Our Thoughts

There are numerous tax advantages of funding and utilizing an HSA and we believe eligible clients should consider it as part of their overall financial planning. However, given the potential unfavorable tax treatment of an HSA upon death, we recommend that clients aim to deplete these accounts as medical expenses arise rather than growing them indefinitely. While every client's situation is different, we believe that a good rule of thumb is to begin pulling distributions from these accounts around age 60-65 to fully take advantage of the tax free growth. Where a client has their spouse as the beneficiary of their HSA, the tax advantages of the account can be passed along at death and would allow for more flexibility in preserving the account's balance.

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[1]While most states follow some or all of the federal tax rules for HSAs, not all do. Certain states may tax contributions to an HSA and/or HSA account earnings. Clients should consult with a tax advisor on the applicability of any tax benefit referred to herein.

[2]A list of qualified medical expenses can be found in the IRS Publication 989 (2018): Health Savings Accounts & Other Tax-Favored Health Plans.