Improving Your Finances

3 Tricks for Getting the Most Out of Your HSA

By Christine Benz | 06-15-17 | 10:00 AM | Email Article

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Anytime you read about health-savings accounts (HSAs), there's the obligatory windup about how quickly they're growing. And the uptake has been notable, mainly due to the growth in high-deductible health plans (HDHPs), which workers must be covered by in order to contribute to an HSA. A survey by America's Health Insurance Plans showed that the number of Americans covered by HDHPs--and who are, in turn, eligible for HSAs--rose by two million between 2014 and 2015, a more than 10% growth rate.

But plenty of workers who are eligible to contribute to HSAs don't take full advantage of them. Even though HSAs offer the best tax treatment of any savings vehicle--pretax contributions, tax-free compounding, and tax-free withdrawals for qualified healthcare expenses--only 4% of HSA holders choose to invest their funds, according to research from HelloWallet.

Of course, not everyone has the wherewithal to use an HSA as an investing vehicle; most people need to spend the amounts they've accumulated in their HSAs to cover out-of-pocket healthcare costs. But even those where workers who use a "spend as you go" approach probably aren't saving enough: The HelloWallet study found that the average HSA deferral was $1,600; the median deferral was $700. Families, especially, are apt to blow through that amount in a hurry in a given year.

In my anecdotal experience, HSA-eligible investors are also mixed up about the difference between a flexible spending account (FSA) and an HSA; the former is "use it or lose it," while HSA balances roll over from one year to the next. That confusion may deter them from putting more into their HSAs.

Other would-be HSA investors are rightfully deterred by the layers of fees and low opacity that mark the HSA landscape. Holders of health-savings accounts can face a number of fees just to go about their regular healthcare business, ranging from debit-card charges to account-maintenance fees. In addition, HSA holders who wish to invest their funds can confront transaction fees to purchase fund or ETF shares; they'll also pay mutual fund and ETF expense ratios on an ongoing basis, just as all other investors do. Those expenses can stack up, eroding the tax benefits of HSAs.

If you're considering using your HSA as an investment vehicle, here are three strategies to help get the most mileage out of this valuable account type.

Trick 1: Obtain a payroll deduction while also getting away from a lousy employer-provided HSA.
High-deductible healthcare-plan participants are free to use any HSA custodian they choose, not just the one their employers have chosen. To do so, they would simply steer their contributions into their own HSA, then deduct the contribution on their tax return. (Note that HSA contributions don't fall under the heading of qualified medical expenses, the latter of which can only be deducted to the extent they exceed 10% of adjusted gross income. Rather, HSA contributions are an "above-the-line" deduction,

so they help reduce your adjusted gross income directly, thereby reducing your income to enable Roth contributions and the like.)

But from a practical standpoint, that can be cumbersome and won't likely yield exactly the same tax benefits as having your contribution extracted from your payroll. For one thing, using the payroll deduction enables you to get the tax break right away versus waiting to reap the benefit of the deduction on your tax return. Additionally, HSA dollars extracted via payroll deduction are not subject to Social Security and Medicare taxes, provided the plan is a Section 125 or cafeteria plan.

A workaround is to contribute to your employer's chosen HSA for convenience and tax benefits, then annually roll over or transfer that money to the HSA of your choice. (A rollover, which is allowed once a year, means that you get a check from the first HSA custodian and must get it over to the second HSA custodian within 60 days. A transfer means the two custodians deal with one another on the transaction; you don't receive a check. You can complete multiple transfers per year.) That strategy lets you enjoy the best of both worlds: You get the tax benefit of payroll deductions as well as the long-term benefits of steering your HSA investments to a custodian with better and/or lower-cost options.

A couple of caveats: You can have more than one HSA going at one time, but like IRAs, your combined HSA contribution for a given year cannot exceed the limits--in 2017, that's $3,400 for individuals and $6,750 for families. And if you're employing the two-part strategy I outlined above, it's worth thinking through your investment approach to the employer-provided HSA. Because it's essentially a short-term parking place under the two-part strategy, you'd either want to keep your money liquid while you hold it there or make sure that your hand-chosen HSA includes analogous investment products that you hold in your employer-provided HSA. That way, if one of the investment choices in your employer-provided HSA happens to be in the dumps at the time you plan to transfer your money, you can swap into a similar investment option to maintain like-minded market exposure.

Trick 2: Take a hybrid 'spend/invest' approach.
HSAs offer prodigious tax features--tax-free contributions, tax-free compounding, and tax-free withdrawals for qualified healthcare expenditures. That explains why HSA-eligible investors are often advised to let their HSA assets ride while using non-HSA assets to defray their healthcare costs as they arise. (Doing so has the salutary effect of not triggering point-of-purchase fees that some HSA debit cards carry.)

Yet, even as that makes all the sense in the world by the numbers, from a practical standpoint, paying healthcare expenses with non-HSA assets can be disruptive to a household's budget. For employees who have spent most of their careers covered by traditional healthcare plans like PPOs, it's disconcerting to be suddenly on the hook for hundreds or even thousands of dollars of out-of-pocket healthcare costs.

In that instance, it can be comforting to split the difference: Contribute the maximum to your HSA if you can swing it, park enough in the savings-account option to cover your expected healthcare outlays and pay for them from that account, and invest the rest in long-term investments. If you have had an HDHP for the past few years, your previous out-of-pocket outlays can help you figure out how much to hold in cash.

Trick 3: Use your HSA to cover emergency non-healthcare costs later on.
Despite the very good case to be made for paying healthcare expenses with aftertax

assets and letting the assets build inside an HSA, some investors might demur. The HSA is, after all, a single-purpose vehicle--that is, you only enjoy the full range of tax benefits if you earmark your withdrawals for healthcare expenditures.

That's mostly true, but there's actually a workaround in case you need to crack into your HSA for non-healthcare expenses later on. Even if you paid out of pocket (using non-HSA assets) for healthcare expenses in previous years, you can still make a tax-free withdrawal later on for non-healthcare expenses, provided you hung on to receipts for the earlier healthcare costs. An unlimited amount of time can elapse between when you actually incurred the healthcare cost and when you reimburse yourself; the withdrawal will be tax-free as long as you have the proper documentation of the prior expense.

To use a simple example, let's say a person paid $5,000 out of her taxable monies to cover healthcare expenses incurred at the end of 2016. Throughout 2016, she racked up the maximum family contribution of $6,750 in her HSA, letting the money build up rather than spending from it. If she needed a new roof in 2017, she could pull $5,000 from her HSA to steer toward that expense, and that withdrawal would be tax-free provided she could document the 2016 out-of-pocket healthcare costs.

That's not ideal, of course, because she's better off letting the money grow. But a tax-free HSA withdrawal beats other forms of emergency funding, such as credit cards, HELOCs, or 401(k) loans.

The key to preserving this escape hatch, as noted above, is to maintain scrupulous documentation of healthcare expenditures. It's also worth noting that the HSA participant must have established the HSA and made the contribution before she incurred the healthcare cost.

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