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Health Savings Accounts: Are They Just What the Doctor Ordered?

Most HSAs allow you to contribute through automatic transfers from a bank account or, if you're employed, through an automatic payroll deduction plan.

Are health insurance premiums taking too big of a bite out of your budget? Do you wish you had better control over how you spend your health-care dollars? If so, you may be interested in an alternative to traditional health insurance called a health savings account (HSA).

How does this health-care option work?

An HSA is a tax-advantaged account that's paired with a high-deductible health plan (HDHP). Let's look at how an HSA works with an HDHP to enable you to cover your current health-care costs and also save for your future needs.

Before opening an HSA, you must first enroll in an HDHP, either on your own or through your employer. An HDHP is "catastrophic" health coverage that pays benefits only after you've satisfied a high annual deductible. (Some preventative care, such as routine physicals, may be covered without being subject to the deductible.) For 2010 and 2011, the annual deductible for an HSA-qualified HDHP must be at least $1,200 for individual coverage and $2,400 for family coverage. However, your deductible may be higher, depending on the plan.

Once you've satisfied your deductible, the HDHP will provide comprehensive coverage for your medical expenses (though you may continue to owe co-payments or coinsurance costs until you reach your plan's annual out-of-pocket limit). A qualifying HDHP must limit annual out-of-pocket expenses (including the deductible) to no more than $5,950 for individual coverage and $11,900 for family coverage for 2010 and 2011. Once this limit is reached, the HDHP will cover 100% of your costs, as outlined in your policy.

Because you're shouldering a greater portion of your health-care costs, you'll usually pay a much lower premium for an HDHP than for traditional health insurance, allowing you to contribute the premium dollars you're saving to your HSA. Your employer may also contribute to your HSA, or pay part of your HDHP premium. Then, when you need medical care, you can withdraw HSA funds to cover your expenses, or opt to pay your costs out-of-pocket if you want to save your account funds.

An HSA can be a powerful savings tool. Because there's no "use it or lose it" provision, funds roll over from year to year. And the account is yours, so you can keep it even if you change employers or lose your job. If your health expenses are relatively low, you may be able to build up a significant balance in your HSA over time. You can even let your money grow until retirement, when your health expenses are likely to be substantial. However, HSAs aren't foolproof. If you have relatively high health expenses (especially within the first year or two of opening your account, before you've built up a balance), you could deplete your HSA or even face a shortfall.

How can an HSA help you save on taxes?

HSAs offer several valuable tax benefits:

- You may be able to make pretax contributions via payroll deduction through your employer, reducing your current income tax.
- If you make contributions on your own using after-tax dollars, they're deductible from your federal income tax (and perhaps from your state income tax) whether you itemize or not. You can also deduct contributions made on your behalf by family members.
- Contributions to your HSA, and any interest or earnings, grow tax deferred.
- Contributions and any earnings you withdraw will be tax free if they're used to pay qualified medical expenses.

Consult a tax professional if you have questions about the tax advantages offered by an HSA.

Can anyone open an HSA?

Any individual with qualifying HDHP coverage can open an HSA. However, you won't be eligible to open an HSA if you're already covered by another health plan (although some specialized health plans are exempt from this provision). You're also out of luck if you're 65 and enrolled in Medicare or if you can be claimed as a dependent on someone else's tax return.

How much can you contribute to an HSA?

For 2010 and 2011, you can contribute up to $3,050 for individual coverage and $6,150 for family coverage. This annual limit applies to all contributions, whether they're made by you, your employer, or your family members. You can make contributions up to April 15th of the following year (i.e., you can make 2010 contributions up to April 15, 2011). If you're 55 or older, you may also be eligible to make "catch-up contributions" to your HSA, but you can't contribute anything once you reach age 65 and enroll in Medicare.

Note: *You may be able to make a one-time tax-free rollover of funds to your HSA from a health flexible spending account (FSA), a health reimbursement arrangement (HRA), or a traditional IRA (certain limits apply).*

Can you invest your HSA funds?

HSAs typically offer several savings and investment options. These may include interest-earning savings, checking, and money market accounts, or investments such as stocks, bonds, and mutual funds that offer the potential to earn higher returns but carry more risk (including the risk of loss of principal). Make sure that you carefully consider the investment objectives, risks, charges, and expenses associated with each option before investing. A financial professional can help you decide which savings or investment options are appropriate.

How can you use your HSA funds?

You can use your HSA funds for many types of health-care expenses, including prescription drugs, eyeglasses, deductibles, and co-payments. Although you can't use funds to pay regular health insurance premiums, you can withdraw money to pay for specialized types of insurance such as long-term care or disability insurance. IRS Publication 502 contains a list of allowable expenses.

There's no rule against using your HSA funds for expenses that aren't health-care related, but watch out--you'll pay a 10% penalty if you withdraw money and use it for nonqualified expenses, and you'll owe income taxes as well (in 2011, the penalty increases to 20%). Once you reach age 65, however, this penalty no longer applies, though you'll owe income taxes on any money you withdraw that isn't used for qualified medical expenses.

Questions to consider when weighing your options

- *How much will you save on your health insurance premium by enrolling in an HDHP? If you're currently paying a high premium for individual health insurance (perhaps because you're self-employed), your savings will be greater than if you currently have group coverage and your employer is paying a substantial portion of the premium.*
- *What will your annual out-of-pocket costs be under the HDHP you're considering? Estimate these based on your current health expenses. The lower your costs, the easier it may be to accumulate HSA funds.*
- *How much can you afford to contribute to your HSA every year? Contributing as much as you can on a regular basis is key to building up a cushion against future expenses.*
- *Will your employer contribute to your HSA? Employer contributions can help offset the increased financial risk that you're assuming by enrolling in an HDHP rather than traditional employer-sponsored health insurance.*
- *Are you willing to take on more responsibility for your own health care? For example, to achieve the maximum cost savings, you may need to research costs and negotiate fees with health providers when paying out-of-pocket.*
- *How does the coverage provided by the HDHP compare with your current health plan? Don't sacrifice coverage to save money. Read all plan materials to make sure you understand benefits, exclusions, and all costs.*
- *What tax savings might you expect? Tax savings will be greatest for individuals in higher income tax brackets. Ask your tax advisor or financial professional for help in determining how HSA contributions will impact your taxes.*