Your Finances: Health savings accounts show rise in popularity

By Laura Medigovich
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In an effort to combat the rising cost of health care, high-deductible health-care plans (HDHP) with a health savings account (HSA) are becoming ever more common. And as health savings accounts are increasing in popularity, I thought I would dedicate this week's column to exploring strategies to best utilize the saving account's tax benefits.

Withdrawls are tax-free

As the name suggests, an HSA is a savings account that helps you shoulder medical costs. With an HSA, you can make before-tax contributions that grow tax-free and can be withdrawn tax-free if used to pay qualified medical expenses, including potential costs that aren't covered by your HDHP.

HSAs can be especially beneficial for individuals who are nearing retirement, have extra discretionary money, want to reduce their taxable income, and are concerned about how to pay for the rising cost of health care in retirement.

Here are three tax-saving tips to help you optimize your HSA opportunities:

1. Maximize your contributions

Maximizing your contributions to your HSA will reduce your taxable income, as all contributions are tax-deductible. If you have an individual HDHP coverage plan, you can contribute up to $3,300 annually. If you have a family HDHP, you can contribute up to $6,550 annually.

2. Don't pay for medical expenses from your HSA

The idea here is to let your HSA continue to build and grow tax-free until retirement, if at all possible. Bear in mind HSAs do not have a use-it-or-lose-it provision. Any money not used at the end of the plan year rolls over to the next year. Thus, you can allow your HSA to grow by paying for health-care expenses from your regular operating cash flow.

Keep in mind that this strategy is not for everyone. You need to determine how much you want and can comfortably contribute to your HSA. (Remember: Nonqualified withdrawals will be subject to tax and a 20 percent penalty.)

3. HSAs in retirement

As mentioned above, HSAs can really shine in retirement. When you turn 65 and are enrolled in Medicare, you can make tax-free withdrawals to pay for qualified health-care costs. Nonqualified withdrawals are treated similar to 401(k) and IRA withdrawals in retirement, as they are subject to income tax but no penalty.

For individuals who are getting closer to retirement, this can be advantageous, as it acts almost like a secondary 401(k) that helps to pay health-care costs. For high-income earners who have maxed out their regular retirement accounts, this can be especially beneficial.

As always, you should discuss your specific situation with your tax adviser to determine your contribution to a HSA.

For more information on health savings accounts and their tax-deductibility, see IRS publication 969 at IRS.gov.

-- Laura Medigovich is a certified financial planner and vice president for M&T Bank's Hudson Valley region. The views expressed by the author are her own and are not endorsed by M&T Bank, M&T Securities or their affiliates.