HEALTH SAVINGS ACCOUNTS: AN OFTEN-OVERLOOKED TAX SAVINGS

For certain taxpayers, such as high-income employees, it is challenging to find ways to reduce federal tax liabilities proactively.

Since high-income employees often have sufficient cash to fund out-of-pocket medical expenses, the health savings account (HSA) could be an ideal opportunity to save money long-term in a tax-advantaged way.

Self-employed individuals can also benefit from a health savings account since they often can choose the type of health insurance plan they buy. Self-employed taxpayers get a tax deduction for the HSA-qualified plan premiums and any contributions to the HSA.

This article will review the general mechanism of the HSA, little-known rules that make the HSA a tax-savings powerhouse, and how these rules can build a taxpayer's tax-free wealth long-term.

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How the Health Savings Account and the High-Deductible Health Plan Work Together

A taxpayer enrolled in a high-deductible health plan (HDHP) is also eligible to potentially contribute funds to an HSA.

High-deductible health plans (HDHPs) are often labeled "HSA qualified" plans for easy identification. For health insurance to qualify as an HDHP, it must meet statutory requirements that cause the taxpayer to bear the initial costs of medical care before the insurance provides coverage. Those requirements for tax year 2022 are:[i]

- In the case of self-only coverage, a plan is an HDHP plan only if the annual deductible is at least $1,400 and the sum of the annual deductible and the other out-of-pocket expenses required to be paid (other than for premiums) for covered benefits is not greater than $7,050.
- In the case of family coverage, a plan is an HDHP plan only if the annual deductible is at least $2,800 and the sum of the annual deductible and the other out-of-pocket expenses required to be paid (other than for premiums) for covered benefits is not greater than $14,100.

HDHP Self-Employed Health Insurance Deduction

A sole proprietor can deduct health insurance premiums as an adjustment to income but not for self-employment tax purposes. This is much better than deducting the expense on Schedule A, as the 7.5 percent of adjusted gross income (AGI) threshold does not apply, and the taxpayer does not have to itemize deductions; in addition, reducing AGI may unlock other tax credits and deductions on the return.

There are three requirements to qualify for the deduction:

No eligibility for subsidized insurance. No deduction is allowed for any month in which the taxpayer is eligible to participate in a subsidized health plan sponsored by any employer of the taxpayer, the taxpayer's spouse, the taxpayer's dependent, or any child of the taxpayer under age 27.[ii]

Business establishes the plan. The insurance plan must be established with respect to the taxpayer's business. A sole proprietor who purchases health insurance in their individual name establishes a plan providing medical care coverage with respect to their trade or business.[iii]

Deduction cannot exceed earned income from the business. The deductible health insurance amount is limited to the taxpayer's earned income from the trade or business for which the medical plan is established. This is generally the net Schedule C income less the one-half of self-employment tax deduction.[iv]

There are three ways to optimize a sole proprietor's self-employed health insurance deduction:

Types of insurance allowed. Medical insurance, dental insurance, qualified long-term care, and Medicare premiums are allowed for the deduction.[v]

Types of insured persons allowed. Health insurance premiums eligible for the deduction can include the sole proprietor, their spouse, their dependents, and any child who is not age 27 or more at the end of the tax year.[vi] This also includes Medicare premiums in the name of a spouse, dependent, or eligible child.[vii]

Multiple businesses. A self-employed individual cannot add the net profits from all their trades and businesses to determine the deduction limitation. If a self-employed individual has more than one trade or business, the medical care insurance costs of the self-employed individual and the spouse and dependents are deductible under each specific health insurance plan established under each specific business up to the net earnings of that particular trade or business.[viii]

Two additional notes about the self-employed health insurance deduction:

No double deduction. Any premiums deducted above-the-line cannot be deducted again as an itemized deduction on Schedule A.[ix]

Deduction reduced by premium tax credit. The taxpayer must reduce the self-employed health insurance deduction by the amount of the premium tax credit allowed under §36B.[x] This is a circular calculation, so the Internal Revenue Service (IRS) issued guidance with optional calculation methods.[xi]

Of course, the self-employed health insurance deduction is also available to partners and more than 2 percent S corporation shareholders (directly or by attribution). To be eligible, S corporation shareholders must include the premiums paid or reimbursed by the S corporation as wages in box one on Form W-2.[xii]

HSA Contributions

To make a deductible contribution to an HSA for a particular month, a taxpayer must meet four requirements:[xiii]

1. The taxpayer is covered under an HDHP on the first day of such month.
2. The taxpayer is not also covered by any other health plan that is not an HDHP (with certain exceptions for plans providing certain limited types of coverage).
3. The taxpayer is not enrolled in Medicare (generally, has not yet reached age 65).
4. The taxpayer cannot be claimed as a dependent on another person's tax return.

For tax year 2022, the annual contributions limits are $3,650 for an individual with self-only coverage and $7,300 for an individual with family coverage.[xiv] For taxpayers aged 55 and over not enrolled in Medicare, there is an additional $1,000 annual catch-up amount.[xv] If a taxpayer is enrolled in an HDHP for part of the year, then they can only contribute a pro-rata amount of the maximum amount based on the months of HDHP coverage (unless the last month exception applies, as indicated below).[xvi] There is no income limit to the

HSA deduction; therefore, higher-income taxpayers can get great value from opening and funding an HSA.

HSA Distributions

HSA distributions used to pay qualified medical expenses are tax-free and penalty-free.[xvii] Qualified medical expenses for HSA purposes are expenses paid by the account beneficiary, the spouse, or their dependents for medical care that would be allowed a medical expense deduction but only to the extent the expenses are not covered by insurance or otherwise.[xviii] The qualified medical expenses must be incurred only after the HSA has been established.[xix]

HSA distributions that do not reimburse qualified medical expenses are included in gross income and are subject to a 20 percent penalty.[xx] The 20 percent penalty does not apply to distributions made after the account beneficiary's death, disability, or attaining age 65.[xxi]

HSA Tax Planning

Six HSA rules allow for tax planning opportunities with HSAs:

Last month rule. To make the maximum annual contribution, the taxpayer does not need HDHP coverage for the entire tax year. Suppose the taxpayer has HDHP coverage on the first day of the last month of the tax year (December 1 for most taxpayers). In that case, the taxpayer is considered an eligible individual for the entire year and can make the maximum HSA contribution based on the type of HDHP (self-only or family plan). The participant must then maintain the HDHP coverage for the next 12 months, or else gross income increases by the amount of the extra contribution permitted plus a 10 percent penalty.[xxii]

Contribution by April 15. A taxpayer has until the unextended due date of the tax return for a calendar year to contribute to an HSA for that calendar year.[xxiii]

Once-in-a-lifetime rollover. A taxpayer can move money from an individual

EXAMPLE 1

On September 23, 2021, Paul, who is married, loses his job and his employer-provided health insurance. On November 1, 2021, Paul enrolled in an HDHP family plan through December 31, 2021, and opened an HSA.

Since Paul had a family HDHP plan on December 1, 2021, Paul contributes $7,200 to his HSA on April 1, 2022 (the due date of his 2021 tax return), applies it to his 2021 allowed contribution, and takes an above-the-line deduction on his 2021 Form 1040.

If his 2021 HDHP premiums are $700 per month, he can deduct $1,400 as self-employed health insurance (less any §36B premium tax credits) if he has sufficient earned income.

For tax year 2022, Paul maintains his HDHP, and the premiums increase to $750 per month. He can deduct $9,000 as self-employed health insurance (less any §36B premium tax credits) if he has sufficient earned income.

Instead of making a direct contribution, Paul decides to makeå a once-in-a-lifetime transfer from his IRA to his HSA on February 15, 2022, to fund the HSA. While he will not get a deduction on his 2022 Form 1040 return, he does not pay tax or penalty on the IRA transfer. The funds will now grow in the HSA tax-deferred and can be taken out tax-free and penalty-free if used to reimburse qualifying medical expenses.

Assume Paul on January 1, 2023, decides to sign up for a non-HDHP health insurance policy going forward; that does not affect his prior-year HSA contributions.

He saved $14,500 in the HSA and has three options:

1. Use the funds for current qualified medical expenses
2. Accumulate expenses and distribute funds when there is a cash need
3. Accumulate expenses and use the funds for tax-free retirement income.

EXAMPLE 2

On May 1, 2022, Jane had an HSA with a $34,000 balance she funded from contributions when she was younger. Jane needs $10,000 to capitalize a new corporation so she can start a business. In tax years 2019, 2020, and 2021, both she and her dependent child had $11,000 of non-insurance out-of-pocket qualified medical expenses that she did not reimburse from her HSA previously or claim as a medical deduction. She has proof of the expenses.

Jane can distribute $10,000 from her HSA to reimburse prior qualified medical expenses and use the funds to capitalize her corporation. The HSA distribution is both tax-free and penalty-free to Jane.

retirement account (IRA) to an HSA once in the taxpayer's lifetime to fund the HSA. The maximum IRA-to-HSA rollover amount is the annual maximum contribution amount in the rollover year.[xxiv] The rollover must be done during the calendar year of eligibility; it cannot be done by the unextended due date and credited to the prior tax year.[xxv]

Delayed reimbursement rule. An account beneficiary may defer to later tax years distributions from HSAs to pay or reimburse qualified medical expenses incurred in the current year as long as the taxpayer incurred the expenses after the HSA was established. A distribution from an HSA in the current year could be used to pay or reimburse expenses incurred in any prior year if the expenses were incurred after the HSA was established. There is no time limit on when the distribution must occur.xxvi

However, to be excludable from the account beneficiary's gross income, the taxpayer must keep records sufficient to show later that the distributions were exclusively to pay or reimburse qualified medical expenses, and that the qualified medical expenses have not been previously paid or reimbursed from another source and that the medical expenses have not been taken as an itemized deduction in any prior taxable year.xxvii

Qualified medical expenses. This includes any expense ordinarily deductible to an individual under §213, including those of a spouse or a dependent. A distribution from an HSA for a medicine or drug is a qualified medical expense only if the medicine or drug is a prescribed drug (including those available without a prescription) or is insulin.xxviii

Certain insurance premiums are allowed as expenses. Qualified long-term care insurance, Consolidated Omnibus Budget Reconciliation Act (COBRA) healthcare continuation coverage, and healthcare coverage while an individual receives unemployment compensation are qualified medical expenses.xxix

For individuals over age 65, Medicare Part A, B, or D, Medicare HMO, and the employee share of premiums for employer-sponsored health insurance, including premiums for employer-sponsored retiree health insurance, are qualified medical expenses.xxx Medigap policies are not qualified medical expenses.xxxi

Summary

The HSA provides a unique upfront deduction not limited by income, tax-deferred growth of funds in the HSA, with tax-free and penalty-free distributions available at any time during the taxpayer's life if he or she reimburses qualified medical expenses.

When discussing tax-advantaged savings opportunities for retirement with a taxpayer, do not forget there are options other than traditional retirement plans. Having funds in different vehicles with different tax profiles can increase income planning options in retirement.

Consider that each taxpayer should ideally have funds available in each of these four types of accounts to maximize tax planning in retirement:

1. Capital gain investments (such as stock) since long-term capital gains and qualified dividends are taxed at preferred rates (and possibly).
2. Traditional retirement accounts (such as a traditional IRA) can be distributed tax-free to the extent of the standard deduction and low tax above that amount without triggering Social Security taxation.
3. Roth retirement accounts (such as a Roth IRA) can be distributed tax-free and penalty-free if the distribution is a qualified distribution and pass assets to beneficiaries tax-free and penalty-free.
4. Health savings accounts can be distributed tax-free and penalty-free to the extent of current and prior unreimbursed qualified medical expenses, including Medicare premiums.

[i] *Rev. Proc. 2021-25*
[ii] *§162(l)(2)(B)*
[iii] *Chief Counsel Advice 200524001*
[iv] *§162(l)(2)(A); §401(c)*
[v] *§162(l)(2)(C); Chief Counsel Advice 201228037*
[vi] *§162(l)(1)*
[vii] *Chief Counsel Advice 201228037*
[viii] *Chief Counsel Advice 200524001*
[ix] *§162(l)(3)*
[x] *§280C(g)*
[xi] *Rev. Proc. 2014-41*
[xii] *Notice 2008-1*
[xiii] *Notice 2004-02, Q&A 2*
[xiv] *Rev. Proc. 2021-25*
[xv] *Notice 2004-02, Q&A 14*
[xvi] *§223(b)(2)*
[xvii] *§223(f)(1)*
[xviii] *§223(d)(2)(A)*
[xix] *Notice 2004-02, Q&A 26*
[xx] *§223(f)(4)*
[xxi] *Notice 2004-02, Q&A 26*
[xxii] *§223(b)(8)*
[xxiii] *Notice 2004-02, Q&A 21*
[xxiv] *§408(d)(9)*
[xxv] *Notice 2008-51*
[xxvi] *Notice 2004-50, Q&A 39*
[xxvii] *Notice 2004-50, Q&A 39*
[xxviii] *§223(d)(2)(A)*
[xxix] *§223(d)(2)(B)*
[xxx] *§223(d)(2)(C)(iv); Notice 2004-50, Q&A-45; Notice 2008-59, Q&A-29*
[xxxi] *§223(d)(2)(C)(iv); Notice 2004-2, Q&A-27*

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