

Health Savings Account Update

Take-Away: The Health Savings Accounts (HSAs) rules were recently changed to expand the number of individuals who can open an HSA and thus enjoy its 'triple' tax benefits.

Background: A health savings account, or HSA, is a tax-advantaged savings and investment account that is used in conjunction with an HSA-eligible high-deductible health plan (HDHP) to pay for qualified medical expenses. As a generalization, there are three tax advantages associated with an HSA.

- Contributions to the HSA are made with pre-tax dollars, thus lowering taxable income.
- The earnings from the investments held in the HSA grow without being taxed, much like a traditional IRA.
- Distributions from the HSA are tax-free when they are used for qualified medical expenses, much like a Roth IRA.

HSA Flexibility: Unlike a flexible spending account (FSA), there is no 'use-it-or-lose-it' rule with an HSA. Accordingly, an unused HSA account balance simply rolls over from year-to-year. In addition, an HSA can be transferred, i.e., portability, from one employer to another employer, or from one HSA plan to another HSA plan, without any negative tax consequences.

HSA Contributions: Starting in 2026 the maximum contribution to an HSA depends on the type of coverage. For individual coverage, contributions up to \$4,400 are permitted. For a family's coverage, the maximum contribution amount is \$8,750. Catch-up contributions can also be made by individuals who are age 55 and older, of up to another \$1,000 (or \$2,000 if married filing jointly, if each spouse has their own HSA.)

HSA Investments: Many HSA providers permit a portion of the HSA balance to be invested in various financial assets like mutual funds, stocks, and bonds, so that the account functions much like a retirement investment account.

Qualified Medical Expenses: The scope of *qualified* medical expenses defined by the IRS is fairly broad. These expenses cover deductibles; copayments, and coinsurance; prescription drugs; over-the-counter medications; dental and vision care, e.g., glasses, contacts, braces; some insurance premiums such as Medicare Parts B and D premiums; COBRA coverage; and qualified long-term care insurance premiums (but with some limits.) [See IRS Publication 969 for more details on what is covered as a *qualified* medical expense.]

HSA Eligibility: However, for an individual to be able to open an HSA, he/she must meet several eligibility criteria. The individual must: (i) be covered by a qualifying HSA-eligible HDHP; (ii) not have other disqualifying coverage, like a general purpose-FSA or a spouse's non-HDHP plan; (iii) not be enrolled in Medicare; and (iv) not be claimed as a dependent on another individual's income tax return.

HDHP: A high-deductible-health-plan means that the HSA owner is responsible for paying all medical costs out-of-pocket until he/she meets a high deductible, which can be \$1,500 for individuals or \$3,000 for families (in 2025.) Many HDHP plans impose even higher deductible amounts that must be met.

HSA Drawbacks: The HDHP is one of the main disadvantages of an HSA due to the potential of high out-of-pocket costs that must be paid first until the high deductible amount is met. This then leads to struggles in accurately budgeting for unpredictable medical expenses while requiring accurate recordkeeping, along with the 20% penalty and ordinary income taxes associated with HSA funds that are withdrawn for non-*qualified* medical expenses before attaining age 65. Accordingly, individuals with chronic conditions or high expected medical expenses are not good candidates for an HSA who would have to pay for those large expenses out-of-pocket. Penalties can also be imposed if contributions continue to be made to an HSA within six months of the owner applying for Social Security.

Retirement Savings: In recent years many have looked to HSAs not so much to cover their current *qualified* medical expenses but for their retirement years, when healthcare costs for seniors are usually the largest expense that a senior faces in retirement. If HSA contributions are made each year but are not drawn down, the growth in that HSA

investment will grow with compounded earnings, and possibly never be taxed, much like a Roth IRA, yet the HSA contributions are made on a pre-tax basis.

Example: Katie is age 35 in 2025. Katie has individual health insurance coverage. Katie contributes \$4,300 pre-tax dollars to her HSA this year. Assume that Katie continues to contribute the inflation-adjusted maximum amount to her HSA each year for the next 30 years. Assume further that Katie's HSA investments grow at a rate of 6% (not guaranteed.) Katie's account could grow to about \$340,000 when she is age 65. The tax savings on Katie's HSA contributions would be another \$42,570 [$\$4,300 \text{ contribution} \times 30 \text{ years} \times 33\% \text{ combined federal and state income tax rate} = \$42,570$.] This simple example assumes both Katie's continued good health and that she has enough income or access to other financial resources to pay for her health care expenses over the next three decades.

To put this example into a real-life context, a recent Fidelity study indicated that a 65-year-old couple can expect to spend between \$315,000 to \$350,000 just on healthcare over their remaining lifetimes.

Deductible Medical Expenses: Distributions from an HSA are *not* deductible for income tax purposes. However, currently an individual can deduct his/her medical expenses only above 7.5% of their adjusted gross income (AGI.) Moreover, the OB3 just curtailed the 'value' of an itemized deduction to 35/37th of each deductible dollar. And most retirees take the standard deduction which means that most do not claim an itemized deduction on Schedule A for their medical and dental expenses.

Recent Changes: The scope, or reach, of health savings accounts (HSA) was expanded by the One Big Beautiful Bill Act (OB3) this year. As a generalization, the OB3 expanded the scope of HSA participation as it: (i) allows high deductible health plans (HDHPs) to offer pre-deductible telehealth and remote services without a deductible, thus preserving HSA eligibility; (ii) classifies Affordable Care Act bronze and catastrophic plans as HDHPs which extends HSA access to a broader population base; and (iii) permits participation in direct primary care arrangements, aka *concierge plans*, which were previously disqualified under HSA rules.

Telehealth: HDHPs can now include telehealth and remote services without a deductible, which thus preserve's HSA eligibility. The coverage is on a 'first-dollar' basis (before the deductible is met) without jeopardizing the individual's HSA eligibility. This 'telehealth' rule is effective starting in 2025.

ACA Exchange a HDHP: The bronze and catastrophic Affordable Care Act Exchange plans are reclassified as HDHPs, which is intended to extend HSA access to a much broader population, including young adults and hardship-exempt enrollees. It is projected by Congress that up to 7.3 million additional Americans will thus become eligible to open and contribute to an HSA if they are enrolled in one of these plans and they meet the other HSA criteria, e.g., not enrolled in Medicare or claimed as a tax dependent by another. This rule change is effective in 2026.

Direct Primary Care: Under the OB3 a HDHP participant can engaged in direct primary care (DPC) arrangements, which were previously disqualified, and pay for those services using HSA funds, i.e., those distributions will be treated as *qualified* medical expenses, up to \$150 per month for an individual and \$300 a month for family, (which dollar amounts are indexed to inflation.) The intent behind this change is to expand access and promote affordability in consumer-driven healthcare. This OB3 change is effective starting in 2026.

[IRC 223(c)(1)(2), (d)(2)(C).] [OB3 Sections 71306-71308]

Conclusion: Health Savings Accounts are much more than just a checking account to pay for copays and medical deductibles. They can also function as a *quiet* retirement savings vehicle with unmatched tax advantages using consistent annual contributions, investing the HSA balance wisely, and delaying, if possible, HSA distributions until the owner's retirement years. For many individuals who can afford to contribute to a HSA but not take distributions from it, a fully funded HSA is the equivalent to a Roth IRA that can be used to pay for healthcare expenses in the owner's retirement years.

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