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Stretch your financial muscles: The unique flexibility of HSAs

The continued growth of high-deductible health plans (HDHPs) and health savings accounts (HSAs) offers a unique opportunity to save for retirement, prepare for long-term goals, and help support financial wellness. We explore this underappreciated but extremely flexible savings opportunity by reviewing HSAs, their nearly unrivaled tax benefits, and a few potential ways to take advantage of the flexibility they offer.

Understanding HSAs and HDHPs

HSAs are tax-sheltered savings accounts available to those enrolled in an eligible HDHP. HDHPs generally charge lower premiums than traditional insurance plans but typically come with higher deductibles and out-of-pocket maximums. HSAs provide tax benefits that can help defray these potential higher costs.

The unique tax benefits of HSAs

In tax-advantaged accounts such as IRAs, 401(k) plans, and 529 education savings plans, you pay taxes either now (as with Roth contributions) or later (as with traditional contributions). With an HSA, the "now" or "later" can become "never." The tax savings offered by HSAs can compound to produce higher after-tax returns compared with other account types.

Putting HSAs' flexibility into practice

How to use an HSA depends on how much you can afford to save based on your budget. For those with the means to do so, the best strategy may be to treat an HSA as a long-term investment account by paying for current medical expenses out of pocket rather than withdrawing funds from the HSA. For those with less capacity to save, the decision may entail more investment and lifestyle considerations.

Understanding HSAs and HDHPs

HSAs are an increasingly popular tax-advantaged savings vehicle that can be paired with an eligible HDHP. Introduced in 2003, HSAs held over $100 billion in assets at the end of 2022, up from $3.4 billion in 2007.[1] Their growth is likely to continue, driven by the accelerating use of HDHPs.

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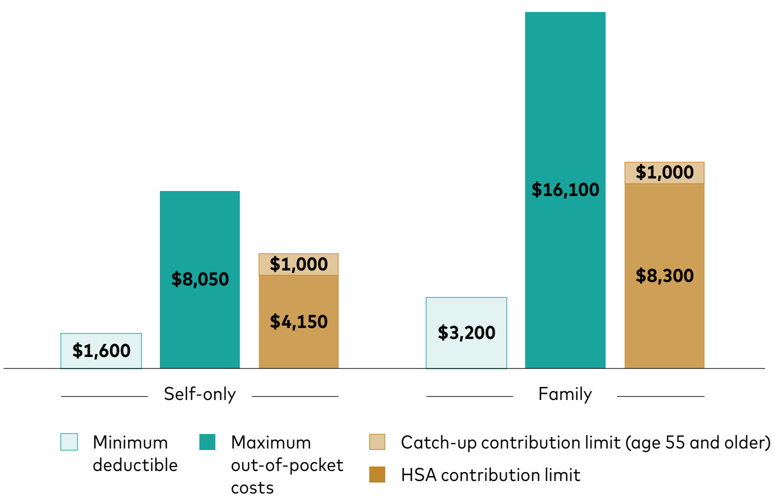
In 2022, 24% of covered workers were enrolled in an HSA-eligible HDHP—twice as many as a decade earlier, according to the Kaiser Family Foundation.[2] The percentage of workers covered by more common plan types, such as a Preferred Provider Organization (PPO), is higher, 49% in 2022, but has been declining steadily, down from 56% in 2012.

An HDHP generally charges lower premiums than an equivalent PPO option but typically has higher deductibles and out-of-pocket maximums. **Figure 1** shows the minimum deductibles and maximum out-of-pocket costs for HSA-eligible insurance plans in 2024. Health insurers can offer HDHPs with out-of-pocket maximums lower, but not higher, than those shown.

FIGURE 1

HDHPs must meet certain criteria while HSAs have contribution limits by type of coverage



Notes: Self-only plans cover only an individual while family plans cover an individual and at least one other qualifying person. All values presented are for the 2024 tax year. The catch-up contribution limit is $1,000 per owner after reaching age 55.

Source: IRS Revenue Procedure 2023-23: www.irs.gov/pub/irs-drop/rp-23-23.pdf.

1 As of December 31, 2022. See Robb, Remjeske, and Jouwstra (2023).

2 See Claxton et al. (2022).

While the higher out-of-pocket costs of an HDHP may not be attractive, the ability to make tax-favored contributions to an HSA is. Figure 1 also displays the HSA contribution limits for 2024, which includes both individual and employer contributions.[3] Unlike most other tax-advantaged accounts, HSA contributions are not subject to income limitations or phaseouts. Plus, contributions can be invested in investment products like stock and bond funds, or kept in cash.[4] However, contributions are not allowed once an owner is enrolled in Medicare.[5]

While the higher out-of-pocket costs of an HDHP may not be attractive, the ability to make tax-favored contributions to an HSA is.

Flex even more with catch-up contributions
Did you know that if you and your spouse are both covered by an eligible HDHP and are at least 55 years old, you can each make a $1,000 catch-up HSA contribution? Since only the HSA owner can make a catch-up contribution, you should consider opening another HSA for your spouse if they don't already have one. That extra $1,000 may not seem like much for some, but it can prove to be especially valuable.

An HSA offers considerable tax benefits:

1. Contributions reduce taxable income.[6]
2. Investment growth is tax-deferred.
3. Qualified withdrawals are tax-free.

Although HSAs are designed to help people pay for health care, they have more in common with traditional savings vehicles such as IRAs than with health care accounts such as Flexible Spending Accounts (FSAs) and Health Reimbursement Arrangements (HRAs). As with an IRA, you can roll over all HSA savings from year to year, potentially accumulating a sizable long-term balance, whereas FSAs have limitations on rolling over funds.[7]

3 Contributions are subject to meeting additional requirements. See IRS Publication 969 for additional information: www.irs.gov/pub/irs-pdf/p969.pdf.

4 Investment options will vary by HSA provider. Most plans have a cash or spending account balance threshold that must be met before investing.

5 Individuals are generally eligible for Medicare at age 65. Since Medicare is retroactive for up to six months, back to age 65, for those working past age 65 it may be best to cease HSA contributions six months before enrolling to avoid potential tax penalties or having to take excess contribution withdrawals. Also, be aware that enrolling in Social Security also auto-enrolls an individual in Medicare Part A retroactively.

6 Contributions are also exempt from Federal Insurance Contributions Act (FICA) taxes for Social Security and Medicare if made through a salary reduction agreement with an employer, but this may lead to lower Social Security benefits. While the federal government and most states with income taxes do not tax HSA contributions, California and New Jersey do not recognize HSA contributions as tax-advantaged, or income or capital gains as deferred.

7 See IRS Publication 969 for additional information: www.irs.gov/pub/irs-pdf/p969.pdf.

The accounts are also portable. If you enroll in an eligible HDHP through work, you are not limited to the HSA custodian selected by your employer. You can open an account with, or transfer an existing account to, a custodian with lower fees or investment options that better suit your preferences.[8] And, because HSA employee and employer contributions are fully vested from the time the account is opened, you can take your HSA with you should you leave your employer.

HSA withdrawals must be used for qualified medical expenses, such as doctor visits, medications, and other expenses that may be deducted on a tax return.[9] Additionally, the CARES Act of 2020 expanded eligible expenses to include menstrual care products and over-the-counter medications without a prescription.

You can make a withdrawal at any point in the future for any qualifying expense incurred since you opened the account, as long as you've saved your receipt.

Rules for withdrawals are flexible provided the funds are used on qualified expenses. You can make a withdrawal at any point in the future for any qualifying expense incurred since you opened the account, as long as you've saved your receipt.

For example, let's say you pay $4,000 out of pocket today for your child's braces. If you save the receipt, you can reimburse yourself for that expense later by withdrawing that same $4,000—tax-free—to pay for a nonmedical expense like college tuition or retirement costs. Making the most of this flexibility requires careful record-keeping, but the flexibility also makes HSAs an attractive vehicle for a variety of long-term savings goals.

If withdrawals prior to age 65 are not used for qualified medical expenses, they are subject to income taxes and a 20% penalty. For those 65 or older, there is no tax penalty for nonqualified withdrawals, but income taxes are still due. In this sense, HSA taxation is similar to how traditional IRA assets are treated. One notable difference is that HSA balances are not subject to required minimum distributions (RMDs), allowing for additional control on when and how you use your HSA balance.

In any case, the risk of incurring a penalty or tax is low. Health care costs are all but inevitable. And, in addition to typical out-of-pocket costs, an HSA can be used to pay Medicare premiums (except for Medigap premiums) or to buy long-term-care insurance.[10]

8 Rollovers to another custodian are limited to once every 12 months. There are no limits on trustee-to-trustee transfers.

9 See IRS Publication 969 for more information: www.irs.gov/pub/irs-pdf/p969.pdf.

10 See IRS Publication 502 for more information: www.irs.gov/pub/irs-pdf/p502.pdf.

As always, costs matter

An HSA's power, as either a short-term spending or long-term investing account, depends on its costs. Account maintenance fees at some of the largest HSA custodians range from $0 to $45 per year, according to a 2022 Morningstar report.[11] Some custodians also charge an investment fee for account owners who invest in mutual funds or a custodial fee for holding investments. The funds themselves also have underlying expenses, which average 0.31% for a typical investor, according to Morningstar.[12]

The lower your costs, the harder your HSA can work for you. Costs are one factor, and there may be other material differences between investment products that must also be considered prior to investing.

HSA balances are not subject to required minimum distributions (RMDs), allowing for additional control on when and how you use your HSA balance.

If an account owner dies with funds still in their HSA, a spouse who inherits the account can use it as their own with no taxes or penalties due. A nonspouse beneficiary would not owe any penalties but would owe income taxes on the fair market value of the account on the date of death, less any qualified medical expenses paid by the beneficiary that were incurred by the deceased before the date of death and were paid within one year after the date of death.[13] Given this tax treatment, an HSA is likely better used as a lifetime spending vehicle rather than an estate planning tool.

11 Fees based on HSA accounts available to individuals. See Nations, Pacholok, and Rohr (2022).

12 Morningstar defines a typical HSA investor as someone having $2,000 in their spending balance and $14,000 in their investing balance.

13 See IRS Form 8889 for more information: www.irs.gov/instructions/i8889.

The unique tax benefits of HSAs

The advantages of an HSA are most obvious when compared with other long-term savings accounts. **Figure 2** compares the tax treatment of HSA contributions, investment growth, and withdrawals with those of other tax-advantaged and taxable account types.

FIGURE 2

Taxes now, taxes later, taxes never

	HSAs	Roth IRA or employer plans	Traditional IRA or employer plans	529 education savings plans	Taxable investment accounts
Contributions	Pre-tax*	After-tax	Pre-tax	After-tax†	After-tax
Investment growth	Tax-deferred	Tax-deferred	Tax-deferred	Tax-deferred	Taxable
Withdrawals	**Tax-free****	**Tax-free*****	Taxable***	**Tax-free††**	Taxable gains
Other considerations	CA and NJ levy state taxes on contributions, investment income, and capital gains distributions, as well as realized investment gains.	Most states follow federal rules for income taxes, though there are exceptions.	Most states follow federal rules for income taxes, though there are exceptions.	Qualified-use rules may vary at the state level.	Capital gains realized for holdings held more than 1 year receive preferred taxation treatment.

* FICA tax exemption may be available for salary reduction agreements made through an eligible employer plan.

** Distributions must be offset by qualified expenses. See IRS Publication 969 for additional information: www.irs.gov/pub/irs-pdf/p969.pdf.

*** See IRS Publication 590-A for additional information: www.irs.gov/pub/irs-pdf/p590a.pdf.

† State tax deductions may be available for contributions.

†† Distributions must be offset by qualified expenses. Qualified expense definitions may vary by state law. See IRS Publication 970 for additional information: www.irs.gov/pub/irs-pdf/p970.pdf.

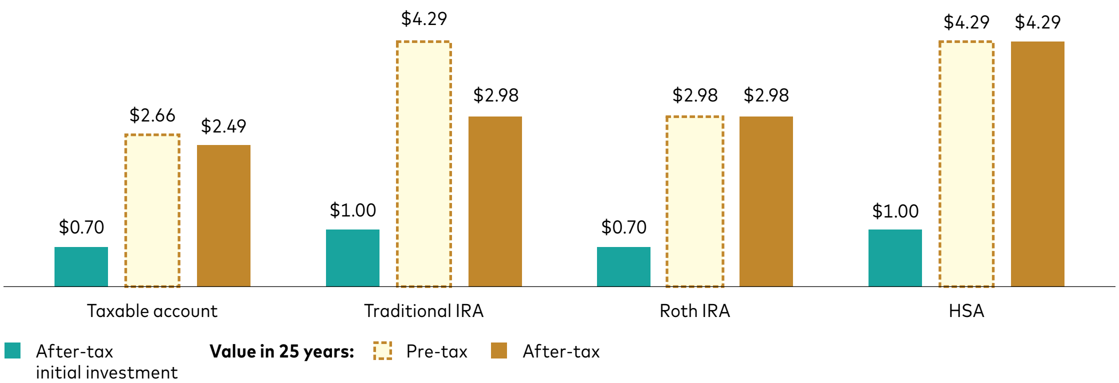
Notes: Generally, when taking nonqualified withdrawals from an IRA or employer plan before age 59½, ordinary income tax plus a 10% federal penalty tax may apply. For nonqualified HSA distributions taken before age 65, ordinary income tax plus a 20% federal penalty tax may apply. This figure does not address nondeductible contributions made to a traditional IRA or employer plan.

Source: Vanguard.

HSAs' tax advantages can translate into greater growth in spending power, and the longer the time horizon, the larger the potential advantage. **Figure 3** displays the tax-adjusted values of one dollar of marginal income invested in tax-favored and taxable accounts over 25 years.

FIGURE 3

The favored tax status of HSAs can boost long-term savings



Notes: This hypothetical illustration does not represent the return on any particular investment, and the rate of return is not guaranteed. Calculations assume a 6% annual total return (4% annual capital return and 2% annual income return), a 24% federal income tax rate, a 6.49% state income tax, and a 15% capital gains tax rate. Lower tax rates may make the taxable investment more favorable and lessen the difference between taxable and tax-deferred accounts. Any future changes in tax treatments of investment earnings or a rate of return lower than the assumed rate of return may further affect the comparison. Investors should consider their time horizon as well as their current and expected future tax rates before making an investment decision. All after-tax values assume any distributions are qualified.

Source: Vanguard.

One way to think about contributions to an HSA is in terms of what the tax code "pays" you—that is, the state and federal marginal taxes that would otherwise apply to the dollars you contribute.[14] If you make contributions through a salary reduction agreement (also known as a payroll deduction) rather than making a direct contribution, you can avoid paying taxes on another 1.45% or 7.65% for FICA taxes—7.65% for income below the Social Security taxable wage base or 1.45% for amounts above it.[15]

Consider a single filer in New York State with a gross annual income of $100,000. After an assumed 24% federal tax, a 7.65% FICA tax, and a 6.49% state tax, one dollar of marginal income would be worth 62 cents. If that dollar were contributed to an HSA, all 100 cents would be sheltered from taxes for long-term growth or short-term medical bills.[16]

14 All states with an income tax allow for deductible contributions except for California and New Jersey, which also tax income distributions and realized capital gains.

15 The Social Security taxable wage base is projected to be $167,700 for 2024 by the OASDI Trustees. Report is available at www.ssa.gov/OACT/TR/2023/tr2023.pdf. HSA contributions would also not be subject to the 0.9% additional Medicare surtax, if applicable.

16 This calculation assumes that the taxpayer is not itemizing deductions.

Putting HSA flexibility into practice

Why you should use an HSA is straightforward, but the "how" can vary. In one survey, about 1 in 3 adults enrolled in an eligible HDHP did not have an HSA at all (Kullgren et al., 2020). Additionally, a recent report on HSA owners by the Employee Benefits Research Institute hints at several potential opportunity areas. According to that report, among HSA plans open in 2021:[17]

Only 60% of account owners made a contribution (either an employer or employee contribution)

Only 15% of account owners contributed the maximum amount

Only 12% of account owners invested some portion of their assets

If you have an eligible HDHP and do not have an HSA, consider taking action to set one up.

If you have an eligible HDHP and do not have an HSA, consider taking action to set one up, whether through an employer or a custodian that offers the ability to have a self-directed HSA.

Next, if you are already maximizing contributions to all eligible tax-favored investment opportunities, including any employer match, nonmatched employer savings, IRAs, and 529 education savings plans, a possible next step is to fully fund your HSA. If you pay for near-term medical costs out of pocket, you could invest your HSA assets in low-cost funds that align with your financial objectives and give them the chance to grow and compound for as long as possible.[18]

17 See Spiegel and Fronstin (2023).

18 We recommend that you consult a tax or financial advisor about your individual situation.

But people often face budgeting constraints on how much they can save. Prioritizing how much to save in which type of account is key. **Figure 4** offers guidelines for prioritizing savings that seek to maximize the long-term tax-adjusted growth of your assets.

Once you secure your employer's match on your 401(k) plan contributions, it might make sense to save your next dollar in an HSA rather than another type of account.[19] The more fluid question is whether it is better to treat the HSA as a vehicle for long-term investment by saving, or to use it like a checking account for present medical expenses by spending.

FIGURE 4

Smart account prioritization can work to maximize long-term tax-adjusted asset growth

1	Employer plan with matching contributions
2	Health Savings Account
3	Other types of tax-advantaged savings accounts: • Roth IRA or nonmatched employer plan • Traditional IRA or nonmatched employer plan • 529 education savings plan
4	Taxable accounts

19 See Felton and Paradise (2023).

Case study

We consider this question of saving versus spending from the perspective of a hypothetical single 40-year-old HSA owner in New York State using the Vanguard Financial Advice Model (VFAM), reviewing balances across their assets at age 65.[20] This person saves in a taxable brokerage account, traditional IRA, and HSA, with all assets invested in 60% stocks and 40% bonds.*

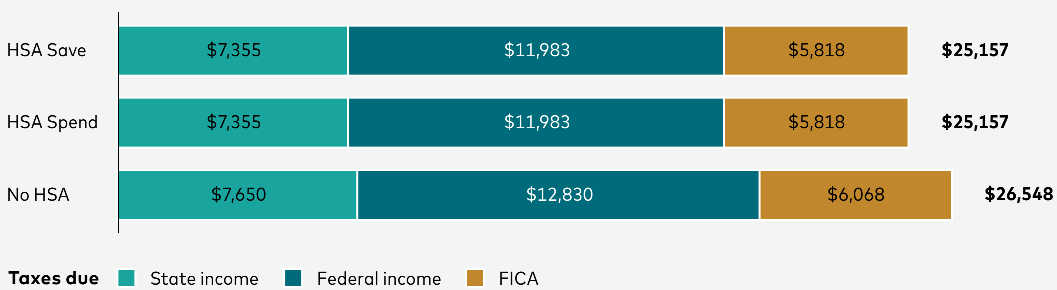
Annual gross income	Annual health care expenses	Annual spending on food, housing, and other expenses
$100,000	**$6,000** • $3,000 Health insurance premiums • $3,000 Other expected out-of-pocket medical costs	**$54,000**

***** For this case study, we assume the investor is eligible for salary reduction contributions to their HSA and can avoid FICA taxes on their HSA contributions.

This leaves the HSA owner with $40,000 for taxes and savings annually. The question then becomes, should the owner save in the HSA and cover the $3,000 in expected health care costs out of pocket (the "Save" strategy), save in the HSA and take distributions from it to pay for health care costs (the "Spend" strategy), or ignore the HSA altogether and only use taxable earnings to cover health care costs (the "No HSA" strategy). **Figure 5** demonstrates the annual tax benefits of making contributions.

FIGURE 5

Contributing to an HSA can help lighten annual tax burdens



Notes: Tax calculations assume 2023 brackets, thresholds, and account limits. Calculations assume claiming the standard deduction. State taxes are assumed to be 6.49%. FICA stands for Federal Insurance Contributions Act, which deducts 6.20% from covered wages up to the Social Security wage base and 1.45% for Medicare on all covered wages. Lower (or higher) assumed taxes may decrease (or increase) differences between the calculations. Values presented are rounded to the nearest dollar.

Source: Vanguard.

As the tax projections show, whether saving or spending, contributing to an HSA results in a tax bill that is about $1,390 less than if the HSA was ignored as a savings opportunity. Breaking down the savings, about $295 comes from reducing FICA taxable wages, about $847 comes from reducing federal taxable income, and about $250 comes for reducing state taxable income.[21] Whether the contributions are saved or spent, an HSA allows for income to avoid taxation today.

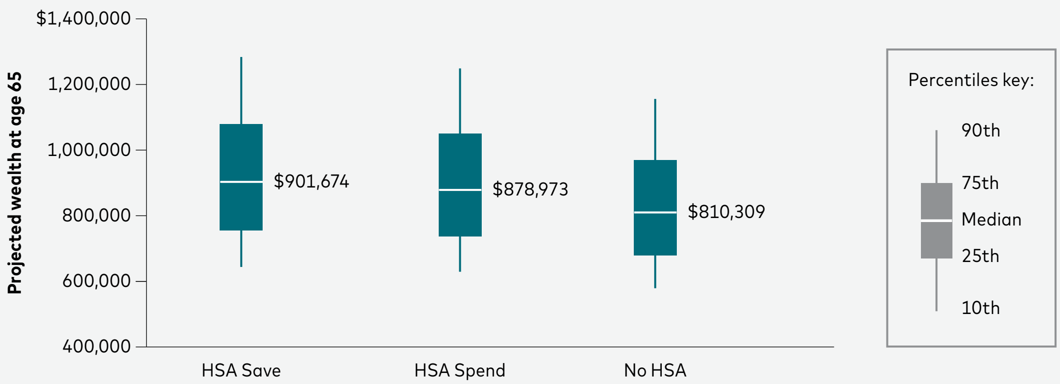
20 Please see **Appendix 1** for additional information about the VFAM.

21 If making direct contributions rather than salary reduction contributions, there would not be a reduction in FICA taxes due.

Given that the annual tax benefits are similar either way, why should an investor seek to save HSA contributions rather than spend them? The potential difference in projected wealth at age 65 can help to illustrate the long-term value of saving, as demonstrated in **Figure 6**.

FIGURE 6

Saving rather than spending HSA funds can help increase long-term wealth



Notes: Projections are made using the Vanguard Financial Advice Model and the Vanguard Capital Markets Model. Investment allocation is 60% equities and 40% bonds, held constant over time. For the projected wealth calculations, HSA balances are assumed to be for qualified use, traditional balances are taxed at 24% income rate, and accrued taxable capital gains are taxed at a 15% rate. See Appendix 1 and 2 for additional information. Percentiles shown are the 90th, 75th, 50th, 25th, and 10th. Median values are labeled and rounded to the nearest dollar.

Source: Vanguard.

IMPORTANT: The projections and other information generated by the Vanguard Capital Markets Model® (VCMM) regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from the VCMM are derived from 10,000 simulations for each modeled asset class. Simulations are as of May 31, 2023. Results from the model may vary with each use and over time. For more information, see Appendix 2.

At the median, the Save strategy results in about $22,700 of additional wealth over the Spend strategy and an additional $91,000 over the No HSA strategy. When it comes to just HSA assets, the Save strategy has a median HSA balance of nearly $203,500 while the Spend strategy has a balance of about $58,000. In addition, when following the Save strategy, keeping receipts from qualified health care expenses allows for $75,000 in tax-free withdrawals to be taken at any time, providing powerful financial planning flexibility.

The Spend strategy still has advantages, as it provides about $68,500 in additional wealth at the median over the No HSA approach. However, only withdrawals made for qualified medical expenses would be tax-free; income taxes would apply on any nonqualified distributions. Rather than accumulating assets in the HSA, which would avoid taxation if used for qualified expenses, the Spend approach directs more savings to the taxable account, with a median age-65 balance of $373,000 versus the $246,000 of the Save approach. Therefore, the Spend approach may be more reasonable for those with a delicate liquidity situation, as it allows for more money to be available for nonmedical emergency expenditures, like a flat tire or leaky roof.

How people use HSAs might also include a behavioral dimension. Perhaps employers, HSA custodians, and financial practitioners can help investors view their HSA as a long-term savings vehicle as well as a spending account. That said, an investor's perception of an HSA can evolve over time as balances and eligible expenses accumulate, making it more of a versatile savings option than a pure retirement plan. For instance, what an investor once considered a medical checking account may become an emergency account, college savings account, or long-term retirement savings account.

Conclusion

HSAs represent a uniquely flexible opportunity to prepare for various health care costs. For those who maximize their contributions to tax-favored accounts and also save in taxable accounts, one potential strategy to consider is treating the HSA as a retirement savings vehicle, and paying for any out-of-pocket health care costs with taxable funds.

For those unable to fund all tax-advantaged vehicles, the ideal approach may vary. Even so, an HSA is valuable; the question is whether to use it as a transactional or investment account. The answer depends on budgeting, investment, and behavioral considerations. As an individual's capacity to save increases, the decision becomes simpler.

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Appendix 1. The Vanguard Financial Advice Model

The Vanguard Financial Advice Model (VFAM) is designed to exhaustively simulate combinations of financial planning strategies over a life cycle of potential market and economic forecasts to assess how each strategy would perform. All projections presented are evaluated in inflation-adjusted dollars. Market and inflation expectations are utilized from the Vanguard Capital Markets Model (VCMM). See Appendix 2 for additional information on the VCMM.

2023 marginal tax and capital gains rates and breakpoints, as well as Medicare surcharge amounts and breakpoints, are assumed to continue, adjusted for inflation. State tax taxes are assumed to be a flat 6.49%.

Account contributions limits are based on 2023 values, $3,850 for a self-covered HSA and $6,500 for Traditional IRA, adjusted for inflation. IRA catch-up contributions ($1,000) are inflation indexed while HSA catch-up contributions are fixed ($1,000) per current statute.

Capital gains are assumed to be realized in order from the highest basis lots to the lowest basis (HIFO).

Gross income and all expenses assumed to grow at the modeled rate of inflation.

Appendix 2. The Vanguard Capital Markets Model

IMPORTANT: The projections and other information generated by the Vanguard Capital Markets Model regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. VCMM results will vary with each use and over time. VCMM results presented are as of May 31, 2023.

The VCMM projections are based on a statistical analysis of historical data. Future returns may behave differently from the historical patterns captured in the VCMM. More important, the VCMM may be underestimating extreme negative scenarios unobserved in the historical period on which the model estimation is based. Our simulations of market returns assume investors invest 60% of their equity sub-asset allocation to U.S. equities and 40% to non-U.S. equities. For bonds, our simulations assume sub-asset allocations of 70% to U.S. bonds and 30% to non-U.S. bonds.

The VCMM is a proprietary financial simulation tool developed and maintained by Vanguard's Investment Strategy Group. The model forecasts distributions of future returns for a wide array of broad asset classes. Those asset classes include U.S. and international equity markets, several maturities of the U.S. Treasury and corporate fixed income markets, international fixed income markets, U.S. money markets, commodities, and certain alternative investment strategies. The theoretical and empirical foundation for the VCMM is that the returns of various asset classes reflect the compensation investors require for bearing different types of systematic risk (beta).

At the core of the model are estimates of the dynamic statistical relationship between risk factors and asset returns, obtained from statistical analysis based on available monthly financial and economic data. Using a system of estimated equations, the model then applies a Monte Carlo simulation method to project the estimated interrelationships among risk factors and asset classes as well as uncertainty and randomness over time. The model generates a large set of simulated outcomes for each asset class over several simulation horizons. Forecasts are obtained by computing measures of central tendency in these simulations. Results produced by the tool will vary with each use and over time.

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