Year-end Health Savings Account Tax Strategies

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2007 is just around the corner, and there are several issues to consider if you currently have a Health Savings Account (HSA), or are planning on getting one in the near future.

100% of the deposit you place in your HSA is deductible on your federal income taxes. All but four states also make HSA contributions tax-deductible on state income taxes. If you are looking to reduce your 2006 tax burden and put away more money for retirement, your HSA is the first place you should put your money if you have not yet maximized your contribution.

The maximum you can contribute to your HSA in 2006 is the lesser amount of your deductible, or $2,700 for singles and $5,450 for families. Individuals who are 55 or older may contribute an additional $700. Note that contribution limits are pro-rated, based on the number of complete months during the year in which you have a qualifying HSA health insurance plan.

You have until April 15 (or later if you file for an extension) to make your 2006 contribution. If you do not fully fund your account for the current year, you cannot make a catch-up contribution for 2006 after this deadline. However, you can reimburse yourself in later years for qualified expenses incurred in 2006, even if you do not have the funds in your account to reimburse yourself at this time.

In 2007, the maximum annual HSA contribution will go up to $2,850 for individuals and $5,650 for families. Individuals 55 or older will be allowed to contribute an additional $800.

To maximize your tax benefit for 2007, it is important to have your HSA-qualified health coverage in place no later than January 1.

In order to pay for a medical expense from your HSA, it must be a qualified expense. Some of these qualified expenses include dental expenses, eyeglasses, chiropractic visits, over-the-counter medications, and sometimes even nutritional supplements.

Now is a good time to make sure you have an accurate record of your medical expenses for the year. Make sure you separate the expenses for which you have reimbursed yourself from your HSA from those that you paid for out-of-pocket. You'll want to keep receipts for all medical expenditures paid from your HSA with your 2006 tax records. Place the "non-reimbursed medical expenses" in a separate file, keeping them with the concurrent year's tax records in whatever year you decide to reimburse yourself.

The penalty for over-funding your HSA is a whopping 6%. You have until April 15, 2007 to withdraw excess funds for the 2006 tax year to avoid the penalty. Your HSA administrator may notify you of any over-funding, but they are under no obligation to do so. It is your responsibility, so make sure you check into this if you think your may have over-funded you account.

The minimum deductible for HSA-compatible health insurance plans in 2006 was $1,050 for individuals and $2,100 for families. In 2007 this will increase to $1,100 for individuals and $2,200 for families. If you currently have an HSA-qualified plan with the lowest eligible 2006 deductible, that deductible will automatically go up on January 1 to the new minimum.

Strategies to Maximize Your Tax Benefits

There are basically three different strategies you can take when deciding how to fund your health savings account.

1. Put no money in the account, except when you incur a medical expense. This strategy allows you to legally "launder" any money used to pay medical expenses. In other words, by depositing money into your HSA, then immediately withdrawing it to reimburse yourself for medical expenses, you are making your medical expenses all tax-deductible. You may want to use this strategy if you are on a tight budget and want to keep your cash outlay as low as possible.
2. Fully fund the account, or at least put in as much as possible based on your budget. Take money out of the account any time medical expenses are incurred, and let the rest grow tax-deferred. This strategy will maximize your tax deduction, while making your HSA funds available to pay any non-covered medical expenses before your deductible is met.
3. Fully fund the account, but pay all medical expenses from a non-HSA account. Reimburse yourself for medical expenses at a later date. This strategy will allow you to maximize your tax deduction, and will also allow you to maximize the tax-deferred growth of your HSA. You can then reimburse yourself, tax-free, at any time in the future for medical expenses incurred over the ensuing years.

To maximize the potential growth of your funds, you may want to make your 2007 deposits as early in the year as possible. Any growth in your account is tax-deferred, like an IRA. If possible, you should plan to make your deposit the first week in January.

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