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Health savings accounts: Getting the most out of your HSA

Make Your Plan

Key Insights

- Health savings accounts (HSAs) offer a "triple tax benefit" for federal taxes.
- A good strategy is to contribute enough to the HSA to cover the next year or more of out-of-pocket medical expenses.
- Contributing the maximum annual contribution and investing for the long term is the best way to get the most benefit from your HSA.
- Avoid using the HSA as your emergency fund because nonqualified withdrawals are subject to ordinary taxes and possibly penalties.

Roger Young, CFP®
Thought Leadership Director

Now that you've chosen your 2025 health insurance, you may be able to benefit from one of the best tax breaks available: the health savings account (HSA). It pays to find out whether you're eligible to contribute to an HSA and the three ways to maximize its "triple tax benefits."

How do health savings accounts work?

Under a high-deductible health plan (HDHP)—which requires a minimum deductible of $1,650 for an individual or $3,300 for a family in 2025—you're eligible to contribute to an HSA. But how exactly does that work? Typically, HSA contributions can be made via payroll deductions and may include contributions from the employer. There are annual contribution limits, depending on whether the health plan covers an individual or a family. Then, you can use your HSA money at any time, preferably to pay for qualified medical expenses.

In another article, I described the insurance and tax factors to consider when choosing an HDHP. However, to take advantage of the HSA, there is a different set of decisions to consider.

The benefits of HSAs

As a quick refresher, HSAs offer three major benefits for federal income taxes:

From how much to contribute to considerations for investing the money, here's how to use the account to save on your tax bills.

As with an IRA, you have until your tax filing deadline in April 2025 for 2024 HSA contributions.

- Contributions reduce your taxable income without having to itemize deductions.
- Growth of the account is tax-deferred.
- Distributions for qualified medical expenses—for you and your family—are tax-free.

Three ways to maximize your tax break

There are three ways you can maximize an HSA's potential. The right choice depends on your situation.

1. **Good. Contribute the amount of out-of-pocket medical expenses you expect to incur in a year and use it as needed.** With this option, you'll get two of the three HSA tax benefits: deductible contributions and tax-free withdrawals. Since your balance would remain relatively small—and you may want to keep it in cash—you wouldn't get much of the other benefit, tax-deferred investment earnings. There's also an advantage of HSAs aside from taxes: Unlike with flexible spending accounts (FSAs)—which have use-it-or-lose-it rules—if you overestimate your expenses for the year, you won't forfeit the balance.

2. **Better. Contribute enough to cover your expected medical expenses—and then some.** Aim to build the account to completely cover one or more years of maximum out-of-pocket costs. Only draw on the account for large or unusual medical expenses, not the routine ones. Doing this helps you establish a reserve over time in case of a major health expense.

3. **Best. Contribute at or near the maximum and invest most of it for the long term.** This affords you the full triple tax benefit. For 2025, contribution limits are $4,300 (an increase of $150 from 2024) for individual coverage and $8,550 for family coverage (an increase of $250). With this approach, you should have an investment strategy for your HSA, just like you do for a retirement account. Because earnings in an HSA are tax-free if used properly, you may want to invest the HSA more aggressively early in your career.

Leading up to and during retirement, you may want to shift your investments to a more conservative mix. Ultimately, you'll want to draw down this account in retirement.

If you're in a position to use this long-term strategy, the HSA can help cover significant expenses in retirement. Using tax-free distributions instead of tax-deferred accounts may also prevent you from jumping to a higher tax bracket or incurring higher Medicare premiums.

Costly HSA mistakes to avoid

The tax benefits of an HSA are great, provided the account is used appropriately. However, there can be downsides to an HSA if used in certain ways:

- **Using the account for nonqualified expenses.** If you do this before age 65, there's a double whammy: paying ordinary tax on the withdrawal plus a 20% penalty. That's worse than the 10% early withdrawal penalties from retirement accounts. After age 65, withdrawals for nonqualified expenses result in paying ordinary tax on the amount. Tapping into this account for nonmedical expenses should be considered a last resort. Nonqualified expenses can range from the obvious (e.g., buying a boat) to a potentially surprising one—some health insurance premiums.

- **Leaving a large balance to a non-spouse beneficiary.** Upon the account holder's death, the non-spouse beneficiary will have to pay taxes on the balance in that same year. This could bump your beneficiary into a higher tax bracket. This is why it's better to draw down the account in retirement to pay for medical expenses, as opposed to preserving it for your heirs. Fortunately, a spouse who inherits an HSA assumes ownership of the account and doesn't pay tax on the balance.

A few final tips about HSAs

- Amounts contributed to an HSA via payroll deductions are generally not subject to payroll (FICA) taxes. So that's usually the best way to contribute, especially if your wage income is under the threshold for Social Security taxes ($168,600 in 2025).

- That said, if you find you're able to save more than you set up through payroll deductions, you can make additional contributions to the HSA on your own, up to IRS limits. As with an IRA, you have until your tax filing deadline in April 2025 for 2024 HSA contributions.

- The HSA should not be considered your emergency fund, due to taxes and potential penalties on nonqualified withdrawals.

- While you can't make additional HSA contributions once enrolled in Medicare, you can use the funds in the account to cover Medicare premiums, out-of-pocket expenses, and even a portion of long-term care policy premiums. However, Medicare supplemental policy (Medigap) premiums are not considered qualified expenses.

Don't worry if you're not currently in a position to save for the long term with your HSA. Using the account to cover your projected medical expenses is perfectly fine, especially if you have other financial goals like saving for a down payment on a home or for your kids' education. However, saving in an HSA early can give you more options down the road to pay for health care expenses.

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