**369.01 What are the advantages and disadvantages of an HSA?**

*Advantages.* HSAs are tax-driven accounts and as such many of the benefits are tax related.

1. *Federal Income Tax Deduction.* HSA contributions reduce an account owner’s income for federal income tax purposes with personal HSA contributions tax deductible and employer contributions pre-tax. (see Q 372)
2. *State Income Tax Deduction.* Most states with income taxes allow account owners to reduce the state taxable income by the amount of the HSA contribution. California, New Jersey and Alabama are the only states that do not allow a state income tax deduction for an HSA contribution. All other states have either passed specific legislation allowing HSA deductions for state income tax purposes, have conforming legislation where the federal deductions flow through at the state level, or do not have a state income tax.
3. *Payroll Tax Avoidance.* Account owners receiving HSA contributions pre-tax through an employer, either employer contributions or employee payroll deferral through a Section 125 plan avoid Social Security taxes, Medicare taxes (together with Social Security referred to as FICA), federal unemployment taxes (FUTA), Railroad Retirement Act taxes, and in most cases state unemployment taxes (SUTA). (see Q 384).
4. *Tax Deferred Earnings Growth.* Any interest, dividends or other appreciation of the assets in an HSA grow tax-deferred while in the HSA. (see Q 379)
5. *Tax-free Distributions.* Account owners that use the HSA for qualified medical expenses enjoy tax-free distributions. (See Q 380) . This is more advantageous than traditional IRAs or 401ks because those plans are only tax-deferred, not tax-free (although Roth IRAs/401ks distributions are tax-free.

Non-tax benefits of HSAs are also significant.

1. *Balance Rolls Over.* HSA balances roll over from year to year and do not have “use it or lose it” restrictions as is true for other medical spending account plans.
2. *HSA Remains after Separation from Service.* An HSA remains with the account owner after separation from service even if the employer provided the HSA funding.
3. *Transferability.* Account owners can move their HSA to a new HSA custodian at any time (See Q 381).
4. *Ownership.* HSA account owners own the money in their HSA and can use it as they see fit. This relates to other benefits already mentioned, but also provides account owners the ability to name beneficiaries on the account, select investments, and decide when to take a distribution (even if the distribution is for a non-medical reason).
5. *Control Spending.* An HSA gives account owners some additional control over their medical spending. The account owner can decide where to spend the money and can negotiate with providers when appropriate. This gives the account owner some freedom to choose medical providers outside of an insurance company’s network or to try alternative approaches (within the definition of “qualified medical expense”).
6. *Lower Insurance Premiums.* HDHPs are generally less expensive than traditional insurance.

*Disadvantages*. For an individual unable to afford traditional insurance, the HDHP and HSA combination may provide an affordable approach to insurance not possible otherwise. Many people that can afford traditional insurance also choose HDHPs and HSAs because the combination reflects a cost savings and provides more pure insurance rather than pre-paid medical. This background is important because many of the disadvantages of HSAs are only in comparison to traditional low or no deductible health insurance. The following are potential disadvantages of a combination HDHP and HSA.

1. *Higher Deductible.* An account owner generally faces a higher health insurance deductible than a person with traditional insurance. This can be an increased cost burden.
2. *Expenses before Savings.* An account owner may face a large medical expense prior to having time to build a sufficient balance in the HSA.
3. *More Responsibility for Health Spending.* HSAs require individuals to take charge of their own health care spending. This will generally require more time devoted to learning about health care costs and alternatives than a person with traditional insurance coverage undertakes where much of the expense is simply paid.
4. *Tax Reporting.* Account owners are required to account for both HSA contributions and distributions each year on their income tax return. Plus, the account owner needs to save medical receipts.
5. *HSA Rules.* HSAs, similar to all tax-driven types of accounts, can get complex. The account owner is responsible to learn the HSA rules and follow them or face tax consequences.
6. *HSA Maintenance.* The account owner is responsible to maintain the HSA, pay medical bills, monitor the balance, choose beneficiaries, and otherwise maintain the HSA.