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Health Savings Accounts as a Retirement/Investment Vehicle

What does health care have to do with retirement? Plenty, and there's an investment vehicle that can help. Health Savings Accounts (HSAs) are an option that most people don't consider for retirement. As their name implies, these vehicles are designed to help Americans stash away cash for medical expenditures. Most people use them for near-term costs while still employed. But medical bills also accumulate in retirement and the money that builds up in your HSA can be used to meet such costs effectively.

HSAs are designed for people who use high-deductible health insurance plans that increasingly are included in benefits packages offered by employers. They also may be opened through the government health insurance marketplaces or exchanges. The following newsletter includes more information about HSAs and how you might benefit from them.

Retirement health estimates

Most people will incur substantial health costs in retirement, for which HSAs can help.

According to a 2017 survey performed by HSA Bank, most people underestimate how much they will need for healthcare expenses in retirement. Approximately two-thirds (67%) of consumers believe they will need less than $100,000 for healthcare expenses, when in reality they could need double that amount.

The Center for Retirement Research at Boston College has estimated that a typical 65-year-old couple would need roughly $197,000 for health care spending in retirement. The Employee Benefit Research Institute itself assumed a 65-year old couple would need $265,000, while Fidelity Investments projected that a couple, also starting at age 65, would need around $280,000. None of those estimates included potential costs for long-term care.

The Vanguard Group, with help from Mercer Health & Benefits, took a different tack, projecting a typical woman could face $200,000 in out of- pocket medical costs starting at age 65 and extending over her remaining estimated lifespan of 24 years. The costs are roughly 2% less for men, partly because they tend not to live as long.

But that report mostly focused on these costs as an annual expense, not as a lump sum, for which the yearly costs would be closer to $5,200 per person. The point wasn't to minimize the amount of money retirees might need but to portray the challenge in smaller, more manageable chunks.

Rare triple tax-free play

A key point here is to start using and funding HSAs now, while contributing close to the annual limits if you can. But don't tap the accounts too early. Workers who elect to pay current medical expenses from regular income can allow money in their HSAs to accumulate. As noted, the money will build up and withdrawals will come out tax-free if used for eligible medical costs, the definition of which is fairly broad.

Since you make contributions to an HSA using pre-tax dollars, you also reduce your current federal tax bill. Those contributions are deductible from state income as well.

Like a 401(k) plan, the money in an HSA grows tax-free. The savings can add up. Morningstar estimates that if you save in an HSA for 30 years you could end up with nearly $100,000 more than if you had saved in a traditional 401(k) where all withdrawals are taxed as income. You could save about $120,000 more than if the money had been invested in a regular taxable account, where withdrawn earnings would be taxes at 15%, the long-term capital gains rate for most people.

With an HSA, you can make withdrawals at any time and you won't pay taxes on that money as long as you use it to cover medical costs. This can help you avoid withdrawing funds—and paying taxes—from a traditional 401 (k) or IRA to cover health expenses.

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Because money pulled from HSAs during retirement avoids taxes, unlike that from traditional IRAs, it wouldn't cause problems if you already have started to claim Social Security retirement benefits.

Social Security benefits could be partly taxable if you have a significant amount of other income. Job earnings, pension withdrawals and traditional IRA distributions are among the income sources that could trigger taxes but not those from Roth IRAs or HSAs.

Timing rules

Similar to IRAs, a person has until April 15 to make an HSA contribution for the previous year. If a person makes his or her HSA contribution between January 1 and April 15 of the following year, he or she must indicate that the contribution is to apply to the prior year or it will automatically be applied in the current year.

Once during a person's lifetime, he or she may fund an HSA with a tax-free rollover from a traditional or Roth IRA, referred to as a qualified HSA funding distribution. The rollover amount is limited to the maximum deductible contribution to the HSA. This exception may be beneficial if a person does not have the cash to put into an HSA.

A person may also be able to roll over amounts from flexible spending accounts and health reimbursement accounts into an HSA in certain circumstances.

Is an HSA right for you?

Before deciding if using an HSA for retirement savings is right for you, ask yourself these three questions:

1. **Can I afford to put money in an HSA?** An individual can contribute up to $3,500 in 2019. A household with family coverage can contribute up to $7,000. Once you reach age 55 you can contribute an additional $1,000 a year. If you have family coverage and you are both 55 or over you may deposit a total of $9,000 including the $1,000 catch-up amount, per person. If you can't afford to save the maximum allowed in both your 401(k) and HSA, it is recommended that you invest enough in the 401(k) to get the maximum employer contribution, and then focus on funding the HSA.
   If you end up with low health care costs in retirement you can use your HSA for non-medical expenses. As long as you are age 65 or older, you can withdraw funds from an HSA for non-medical expenses, however you'll have to pay income tax, just like you would on a withdrawal from a traditional IRA or 401(k). Be aware that if you make such a withdrawal before the age of 65, you'll have to pay a 20% penalty plus pay the income tax.
2. **Can I cover my medical expenses today?** Besides putting money into your HSA every year, you should be able to cover your current medical expenses. This year, the minimum annual deductible plans is $1,350 for an individual and $2,700 for a family. You should check on the maximum annual out-of-pocket costs for your particular plan. Federal law currently limits the maximum to $7,900 for an individual and $15,800 for a family.

Should I invest the money in my HSA? Most of the money people tuck into their HSAs is kept in bank savings accounts. But if you don't plan to use the funds for 10 years or more, you might be better off investing it. Many of the mutual funds offered in HSA plans through employers tend to come with high fees. However, you might take advantage of a quirk in HSA plans: You can move your money from your employer-provided plan to an HSA offered by a different provider such as Health Savings Administrators—even while you remain an employee of the company.

It offers low-expense funds from Vanguard, Dimensional Fund Advisors and TIAA. You could also turn to another provider, HSA Bank, which offers self-directed HSAs through TD Ameritrade that includes a lineup of mutual funds you can buy commission free. Many credit unions also offer HSA investment options.

The list of qualified medical expenses is extensive

In addition to a wide range of medical services, equipment, and supplies, qualified expenses include prescription drugs, diagnostic services, some nursing services, and dental and vision care—including LASIK surgery. For a full list, refer to IRS Publication 502.

Insurance premiums are qualified expenses sometimes.

The money in an HSA can be used tax-free to pay deductibles and copayments, but generally not insurance premiums unless the premiums are for:

- Long-term care insurance
- Health care continuation coverage, such as COBRA
- Health care coverage while receiving unemployment compensation
- Medicare (but not Medigap) and other health care coverage if you are age 65 or older

You can use your HSA funds for your spouse's and children's qualified expenses also

Even if they are not on your health plan, the money in your HSA can be used tax-free to pay the qualified medical expenses of your spouse and your dependents.

Over-the-counter drugs require a prescription to be a qualified medical expense

So, if your doctor recommends an over-the-counter drug for you, consider asking for a prescription for it. Over-the-counter items, such as insulin, bandages, and catheters, are qualified medical expenses and do not require a prescription.

Employer contributions

Employers may contribute to an employee's HSA and can pay the premiums for a high-deductible health plan on a deductible basis, and those contributions are not taxable to the employee. Also, although cafeteria plans generally do not include deferred compensation plans, HSAs may be offered through cafeteria plans. This approach provides income tax and employment tax savings to both the employer and the employee.

How Medicare affects eligibility

An individual ceases to be an eligible individual starting with the month he or she is entitled to benefits under Medicare. Under this provision, mere eligibility for Medicare does not make an individual ineligible to contribute to an HSA. Rather, the term "entitled to benefits under" Medicare means both eligibility and enrollment in Medicare. Thus, an otherwise eligible individual who is not actually enrolled in Medicare Part A or Part B may contribute to an HSA until the month that individual is enrolled in Medicare. The IRS has clarified that the amount of the maximum HSA contribution deduction in the year an individual reaches age 65 is prorated based on the number of months that the individual isn't enrolled in Medicare.

Not all high deductible plans qualify

A high deductible health insurance policy does not automatically qualify you for an HSA. When the Affordable Care Act (ACA) was passed, the bronze, silver and gold levels of coverage often mandated a high deductible insurance policy as defined by ACA. This level of deductibility is not the same as qualified high deductible levels established for qualified HSAs. They each use separate levels of minimum coverage and one does not necessarily meet the requirements of the other. In order to qualify to make an HSA contribution the taxpayer's insurance must be titled "Qualified" high deductible under the HSA limits.

Excess contributions

The IRS is somewhat lenient when it comes to correcting excess HSA contributions. If the excess contributions (and any earnings associated with the contribution) are withdrawn before the due date of the person's tax return, including extensions, then no penalties apply.

- However, the earnings on the excess contributions should be included in the account holder's income in the year in which the distribution is received.
- This is true, even if the distribution is used to pay medical expenses.

If the contributions are not withdrawn until after the due date of the tax return, including extensions, then an annual 6% excise tax/penalty tax is imposed. The tax is 6% of the cumulative amount of excess contributions that were not withdrawn from the HSA by the contributor. This 6% penalty is imposed each year in which the excess contributions remain in the account until the over-contribution is rectified.

HSAs are largely underutilized

HSAs have been around since 2004 and thus don't have as long of a track record as IRAs or 401(k)-style workplace retirement plans. More than three in four HSAs were established just within the past four years, according to the Institute, a research group that focuses on health, savings and retirement issues.

Participants often use HSAs as a type of checking account, pulling out money to meet short-term health expenditures. Still, even these people typically withdraw less than

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they contribute, which explains how account balances continue to grow.

For accounts that received at least some contributions during 2017, the average balance rose to $2,764 at the end of the year, up from $1,873 at the start. HSA balances can be rolled over to future years.

Half of HSA owners contributed money in 2017, averaging $1,949, with employer contributions averaging $895, according to the study. Only 13% of individuals saved the full allowable limits.

Most account holders keep their balances in cash, further underscoring the checking-account feel. Those who invested in growth vehicles such as stock mutual funds and let their money compound had higher balances on average, according to the study. Mutual funds and exchange traded funds are especially good choices for HSA balances, providing broad diversification and allowing low minimum investments.

One thing to watch are fees: A Morningstar study stated that fees can pose a problem, and they might exert a greater impact on low-yielding cash instruments.

Summary

An HSA is an account that people with a high-deductible health plan can use to save for their current and future medical expenses. Unlike regular savings and investment accounts, HSAs are generally tax-free as long as your withdrawals are used to pay qualified medical expenses incurred by you, your spouse, and your dependents.

Combined with the deductibility of the contribution to the HSA and the tax free growth in the account, an HSA is the only investment vehicle that is triple tax free.

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