The Triple Tax Benefits of Health Savings Accounts

When planning for retirement, most Americans think mainly about using tax-advantaged savings vehicles like 401(k) or individual retirement accounts, while failing to consider the triple tax advantages associated with saving for future health care costs using a health savings account, or HSA.

First established under the Medicare Modernization Act of 2003, HSAs are tax-exempt savings plans that must be paired with a high-deductible health insurance plan that meets certain criteria. An HSA owner can make tax-deductible (or pre-tax, if through an employer) contributions to the account, which can in turn be spent tax-free on qualified health care expenses, including on certain health insurance, Medicare, and long-term care insurance premiums. Moreover, any interest or other capital earnings from the account accrue tax-free as well. Thus, unlike any other tax-advantaged savings plan, the HSA offers triple tax benefits: tax-free contributions, tax-free earnings, and tax-free distributions.

Any taxpayer who is not enrolled in another health insurance plan is eligible to open a health savings account. Thus, HSAs are often used by self-employed individuals, small business owners, or those who otherwise lack access to a government or an employer-sponsored plan. Increasingly, however, high-deductible plans coupled with an HSA are being offered to employees as employers seek to shift their health care costs away from the company and onto workers.

Yet even if the plan is offered through an employer and the company makes contributions to employee HSA accounts, all the funds in an HSA are held by the account owner, not the employer, and any unused balances in a worker's account go with the employee when he or she leaves the company. The accounts are managed by a trustee or custodian, such as a bank, insurance company, or brokerage firm. Individuals looking to use all or a portion of the funds for retirement should consider opening an HSA with a financial institution that offers mutual funds or other long-term investment options.

While HSAs are similar in some ways to health care flexible spending accounts (FSAs), the maximum amount that can be carried over each year in an FSA is $500, whereas in an HSA there are no limits on the amounts that can be carried over, or on when the funds are used. Thus, HSAs are highly attractive vehicles for saving for medical expenses in retirement, when most people's health care expenses are highest.

There are, of course, a number of restrictions associated with HSAs. The IRS stipulates that for 2016, the annual deductible of an HSA-compatible health plan cannot be less than $1,300 for self-only coverage or $2,600 for family coverage, and that the annual out-of-pocket expenses (deductibles, co-payments, and other amounts; but not premiums) may not exceed $6,550 for self-only coverage or $13,100 for family coverage. The HSA contribution limits in 2016 are $3,350 for an individual and $6,750 for family coverage. Individuals over age 55 can put in an extra $1,000 per year in catch-up contributions.

Contributions to an HSA can be made only up until the account owner becomes eligible for Medicare, usually at age 65. However, an individual can continue to contribute after reaching age 65 if he or she has not yet signed up for Medicare. Conversely, an individual can no longer contribute if he or she qualifies for Medicare before reaching age 65.

Especially for higher-income savers who are generally healthy and do not need to draw down the funds to pay for medical expenses, HSAs are a potentially effective vehicle for saving for retirement. According to a study by the Employee Benefit Research Institute (EBRI), savers who contribute the maximum allowable amount in an HSA over 40 years and take no distributions over that period could accumulate up to $360,000 if the rate of return was 2.5%, $600,000 if the rate of return was 5%, and nearly $1.1 million if the rate of return was 7.5%.

Until the account owner turns 65 or becomes eligible for Medicare, the funds in an HSA can only be used to pay for qualified medical expenses. Withdrawals used for nonqualified medical expenses prior to this point are subject to income taxes and a 20% penalty. However, after age 65 or Medicare eligibility, withdrawals for non-medical expenses are not subject to the 20% penalty, though they are subject to income taxes as they would be from a traditional IRA. Thus, an HSA can be used as a back-up retirement plan—and one that has a number of added advantages, including no minimum distribution requirements and no income limits on contributions.

Another attractive feature of the HSA is that the tax-free distributions do not have to be taken in the year the qualifying expense is incurred. For example, the account owner could keep a list and receipts of the qualified health care expenditures he or she incurred while contributing to an HSA, but which were paid for at the time with after-tax dollars. The individual could then withdraw funds from the account for another reason, while reporting an equal amount of health care expenditures from prior years his or her tax return for the year in which the withdrawal was made.

In addition, an HSA owner between the ages of 59½ and 65 who also has IRA or 401(k) assets can take distributions from these retirement accounts and deposit the funds directly into an HSA. While the individual will owe tax on the distribution, he or she can reduce the tax owed by taking a deduction on the contribution to the HSA. This strategy provides a tax-efficient way to give the owner more funds that can be spent tax-free on medical expenses in retirement.