Saving for Retirement with an HSA

HSA is an acronym for Health Savings Accounts. They came into being in 2003 as part of the Medicare Prescription Drug, Improvement, and Modernization Act. They are defined for tax purposes under Section 223 of the IRS Code.

With increasing attention on the millions of Americans who will soon retire, and their general lack of funds with which to retire and live comfortably for the next two or three decades, HSAs are increasingly seen as another way to help pay for that retirement.

The following best summarizes an HSA. "Health Savings Accounts (HSAs) allow individuals who are covered by an HSA-compatible health plan to save money to pay for eligible medical expenses on a tax-free basis. You own the funds. Funds automatically carry over each year. Funds earn interest or can be invested and remain tax-free. It is the best tax-advantaged account available."

Some of you will not qualify, for any number of reasons. But if you do and are interested in setting aside additional money for your future retirement, they are a real option.

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Everyone knows about 401(k)s and IRAs, but there's another vehicle for retirement savings that's been getting a lot of attention lately: health savings accounts (HSAs). Most people think of HSAs as a tax-advantaged way to save up for future medical expenses, but they have a lot more to offer.

Here's a closer look at how they work and how you can use an HSA to supplement your retirement savings.

Can I contribute to an HSA?

To be eligible for an HSA, your health insurance policy must be a high-deductible health plan (HDHP). This is defined as a plan with a deductible of $1,350 or more for individuals or $2,700 or more for a family. Once you've enrolled in the plan, you can open an HSA account with your bank and begin contributing funds. If your employer is offering the health insurance plan, your company may set up an HSA for you as an employee benefit.

Single adults can contribute up to $3,500 to an HSA in 2019 while families can contribute up to $7,000. Adults 55 and older are allowed another $1,000 in catch-up contributions. These limits may change from year to year, and so might the minimum health insurance deductible required to qualify for an HSA. It's important to check these limits every year to see if they have risen. You can contribute up to the annual HSA limit every year from the time you open the account until you become eligible for Medicare at age 65, as long as you keep your high-deductible health plan.

Any after-tax money you contribute can be deducted from your taxable income for the year. If your employer's health insurance plan comes with an HSA option, you may be able to contribute pre-tax dollars directly to your HSA and your employer may match some of your contributions. However, the total contributions that you and your employer make to your account cannot exceed the annual contribution limits.

Some HSAs keep your money in cash while others enable you to invest in mutual funds or other investment products, just like you would with a 401(k) or IRA, to help your savings grow faster. If you choose to invest your HSA, consider allocating the funds in a similar manner to your 401(k) and IRA funds to ensure that your investments match your risk tolerance and investing goals. You may need to save a certain amount before your bank will let you invest the sum.

Unlike flexible spending accounts (FSAs), money in your HSA rolls over from year to year, so you keep it until you need to spend it. You can also take your HSA with you if you leave your current job, though you won't be able to make any new contributions unless you keep your high-deductible health plan.

What can HSA distributions be used for?

You're allowed to take distributions from your HSA at any age as long as you use it for a qualified medical expense -- paying for hospital bills, prescription medications, specialist visits, and other medical costs.

And the best part is, you won't pay any taxes on these withdrawals. For this reason, it's a great place to stash emergency cash to help you cover out-of-pocket costs you incur if you become seriously injured or ill. You can also save the money for planned medical expenses, like pregnancy and childbirth, non-emergency surgeries, long-term care, and treatment for mental health or substance abuse.

But HSAs have another benefit for seniors that few realize. Once you turn 65, you can use your HSA funds for non-medical expenses too, though you will pay income tax on these withdrawals. You can also make non-medical withdrawals if you're under 65, but you'll pay a 20% penalty, making this a rarely desirable option.

Another benefit to HSAs: Once you turn 65, the HSA becomes similar to a traditional IRA or 401(k), but unlike those retirement accounts, HSAs have no required minimum distributions (RMDs). The government requires you to begin taking these distributions from all retirement accounts except Roth IRAs by age 70 1/2 to ensure that it gets its tax cut of your earnings. The amount you are required to withdraw will depend on your age and the value of your retirement accounts. The problem with RMDs is that they can force you to take out more than you want, pushing your taxable income into a higher income tax bracket. But not taking RMDs is not an option unless you want to pay a 50% penalty on the amount you should have taken out.

You won't have to worry about any of this if you keep your money in an HSA. Your money can sit tax-deferred for as long as you want it to, and distributions for qualified medical expenses will still be tax-free, even after you can no longer make contributions to the account.

How can HSAs be used strategically?

It's a good idea to contribute at least as much as your health insurance deductible to your HSA, even if you don't plan on using it for retirement savings. This way, if an unexpected medical expense arises, you can cover it without pulling out your credit card to meet your deductible before insurance kicks in. But for small medical expenses, you may prefer to pay out of pocket, letting your HSA savings continue to grow for bigger costs down the road.

An HSA can be a great supplement to your other retirement savings accounts, but you must evaluate its terms carefully. If your account enables you to invest your money in mutual funds, it also charges expense ratios. These are annual fees that all shareholders pay, and they can hamper your money's growth. Look at the prospectus for the funds you're invested in to see how much you're paying in fees. If it's more than 1% of your assets each year, your HSA may not be the most efficient retirement savings vehicle for you. Consider moving your money to more affordable investments, like index funds, or not investing your HSA funds at all and contributing the bulk of your retirement savings to a 401(k) or IRA instead.

You can set up automatic deposits to your HSA from your paycheck if your employer allows this, or budget a certain dollar amount each month that you would like to contribute. Keep an eye on the contribution limits each year and don't exceed them, or else you'll pay income tax and a 6% excise tax on the excess.

With all of the tax benefits, there's no reason not to open an HSA if you're eligible for one. But like all of your retirement savings accounts, you should evaluate the HSA thoroughly so you understand what you're getting and what the account may cost you.