NORTHERN TRUST

SAVING AND INVESTING FOR HEALTH CARE

Health care is a lifelong need for everyone. So is the task of saving and investing for the care. We urge workers to understand and utilize tax-advantaged accounts, especially health savings accounts (HSAs) if available, to effectively prefund for future health care.

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Besides the usual tax-preferential 401(k)s and individual retirement accounts (IRA), HSAs can be excellent vehicles to enhance financial preparation for retirement. The HSA contribution limit in 2020 is $3,550 for self-coverage and $7,100 for family coverage, plus an optional $1,000 catchup contribution for those ages 55 or older. Over time, these contributions and investments can add up to be sizable resources dually for retirement and health care.

A CLOSER LOOK AT HSA

The potential benefits of HSAs should not be understated. The prerequisite for an HSA is the enrollment in a qualified high deductible health plan (HDHP). Thereafter, the funds can be saved pre-tax in HSA to pay current medical bills or invested for the long haul. It is not subject to the use-it-or-lose-it rule, unlike the flexible savings account (FSA).

FSA has its own merits and can complement an HSA. An FSA can be used to cover dental and vision care, but not (other) medical items until you have used the HSA (or other money) to meet the HDHP deductible. HSA can pay for vision, dental care, hearing aids, and nursing services, too. The idea is to use FSA, in addition to HSA, to enjoy a significantly greater savings capacity, tax free. That is, estimate expenses to be covered by FSA, use it all up during the year, and then use HSA to cover whatever remains (or invest the money otherwise). However, the use-it-or-lose-it FSA rule makes it very tricky for anyone to foresee the forthcoming health care needs and figure out a precise amount to be saved in an FSA during the annual enrollment period.

TAX ADVANTAGES OF HSA

HSA contributions are pre-tax, tax is deferred on investment returns, and withdrawals are tax exempt for qualified medical expenses now or in retirement. Moreover, HSA contributions are not subject to Federal Insurance Contributions Act

(FICA) taxes for Social Security and Medicare. These triple tax benefits make HSA the top choice of savings location for many workers.[1]

For comparison, the preferential tax treatment in general retirement accounts, such as 401(k)s and IRAs, is less generous than in HSAs. Traditional 401(k)s and IRAs allow participants to make pre-income-tax contributions, defer taxes on investment earnings, and then pay income taxes on all withdrawals. Roth plans reverse the order whereby participants pay income taxes on contributions up front and then accrue returns and make withdrawals without tax obligations. All of these contributions (up to certain income thresholds) are subject to FICA taxes.

USING HSA

An HSA is meant to pay for qualified medical expenses, but is actually more versatile and useful than many have realized. An HSA could be used for general consumption, subject to income taxes upon withdrawals, like 401(k)s and IRAs. At age 65 or later, such withdrawals have no penalty. Before 65, however, HSA withdrawals for non-medical expenses are required to pay a 20% penalty to the IRS. In comparison, 401(k) and IRA withdrawals earlier than age 59 ½ have to pay a 10% penalty.

In general, an HSA cannot be used to pay the premium for private health insurance. The exception is when the separated employees purchase the coverage through an employer-sponsored plan under COBRA or when they are receiving unemployment compensation and need to pay the insurance premium. This may serve as a helpful bridge for those who lose their jobs and others who retire earlier than 65 thus ineligible for Medicare yet. An HSA can pay certain Medicare expenses, including premiums for Parts B (outpatient coverage) and D (prescription drug coverage) but excluding supplemental MediGap (Plan F).

An HSA can be used to pay “tax qualified” long term care (LTC) insurance premiums, with a maximum annual tax-free amount that is set by the IRS based on age and indexed for inflation. For instance, tax-free withdrawal is up to $1,630 from HSA in 2019 to pay the LTC premium for a person age 51 to 60; $4,350 for age 61 to 70; and $5,430 for age 71 or older. This cap is per person, thus double that for married couples if they both have LTC policies.

Finally, HSAs can be invested, just like 401(k)s and IRAs. Arguably, HSAs have a better chance of beating 401(k) and IRAs in terms of generating wealth given their preferential tax status. In 2018, only six percent of accounts had investments other than cash.[2] HSAs should be invested like any other retirement account in order to maximize the benefits.

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[1] Northern Trust Asset Management: “A Horse Race Among Traditional, Roth, HSA and 529 Plans.” 2020 updated.

[2] Paul Fronstin Jake Spiegel. 2020. . “Trends in Health Savings Account Balances, Contributions, Distributions, and Investments, 2011–2018: Estimates From the EBRI HSA Database,” EBRI Issue Brief.

CONCLUSION: PREFUNDING HEALTH CARE WITH HSA

Saving for retirement is, to a significant extent, saving for health care at old age. Most categories of spending tend to drop upon retirement, perhaps with the exception of health care, which is one of the biggest expenses in retirement and continues to rise. Empirically, older households exhibited a slow pace of wealth decumulation in retirement. There was little evidence that their resources were being depleted by normal consumption, but rather the late-life assets were mainly drained by health shocks and changes in family composition (e.g., death).[3]

HSA is a convenient way to address health care expenses. A wide range of medical, dental, vision, and mental health services qualify for the tax-free treatments with regard to contributions, investments, and withdrawals. HSA is also portable, meaning you can carry over the savings if you do not need to spend it right away. Finally, if carried over savings are invested appropriately, HSA can grow to be a significant source of income for retirement.

[3] James M. Poterba, Steven F. Venti, David A. Wise. 2017. "What Determines End-of-Life Assets? A Retrospective View" in Insights in the Economics of Aging, by David A. Wise (editor), 127 – 157, University of Chicago Press.

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[4] Assets under management as of March 31, 2020.