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Could a Health Savings Account Help Strengthen Your Retirement Plan?

In a 2019 Gallup poll, 25% of Americans age 50 to 64, and 23% of those age 65 and older, said health-care costs were their top financial concern.

By one estimate, a 65-year-old couple who retire in 2019 may need about $300,000 in savings to pay their health-care expenses in retirement. This includes premiums for Medicare Parts B and D, supplemental (Medigap) insurance, and median out-of-pocket prescription drug expenses, but not other health expenses such as long-term care, dental care, and eye care.[1]

Health expenses are rising faster than inflation, and even insured workers are finding it harder to pay their portion from year to year (premiums, copays, coinsurance, and deductibles), much less plan for the future. The stakes are even higher for early retirees (younger than 65) and self-employed individuals who must purchase their own health insurance and bear the entire cost themselves.

A health savings account (HSA) is a tax-advantaged account linked with a high-deductible health plan (HDHP). They work together to help you cover your current health-care costs and also save for your future needs.

Tax trifecta

HSAs offer several tax benefits to help encourage diligent saving.

1. Pre-tax contributions can often be made through an employer via payroll deduction, or you can make contributions yourself and take a tax deduction whether you itemize or not. Either way, HSA contributions reduce your adjusted gross income and federal income tax for the current year.
2. Any interest or investment earnings compound on a tax-deferred basis inside the HSA.
3. Withdrawals are tax-free if the money is spent on qualified medical expenses. When HSA money is spent on anything other than qualified medical expenses, withdrawals are taxed as ordinary income, and an onerous 20% penalty applies to taxpayers under age 65.

Depending on your state, HSA contributions and earnings may or may not be subject to state taxes.

Contribution rules

The maximum HSA contribution limit in 2020 is $3,550 for individual coverage or $7,100 for family coverage. This annual limit applies to all contributions, including those made by you, your family members, or your employer. You can contribute an additional $1,000 starting the year you turn 55. Once you sign up for Medicare, you can no longer contribute to an HSA.

Funds roll over from year to year and are portable, which means they are yours to keep. When HSA balances reach a certain threshold, you can steer the funds into a paired account with investment options similar to those offered in a 401(k). You can make 2019 contributions up to April 15, 2020.

Pros and cons

HDHPs are designed to help control health costs. HSA owners are forced to pay attention to prices, so they may select lower-cost providers and be more likely to avoid unnecessary spending. On the other hand, some people with HDHPs might be reluctant to seek care when they need it, because they don't want to spend the money in their account. A high deductible can make it difficult to pay for a costly medical procedure, especially if there hasn't been much time to build up an HSA balance.

To be eligible to establish or contribute to an HSA, you must be enrolled in a qualifying high-deductible health plan — an HDHP with a deductible of at least $1,400 for individuals, $2,800 for families in 2020.

Workers who are offered HDHPs (as a choice or their only option) or purchase their own insurance often face much higher deductibles. In 2019, the average deductible for employer-provided HDHPs was $2,486 for individual coverage and $4,779 for family coverage.[2]

Qualifying HDHPs also have out-of-pocket maximums, above which the insurer pays all costs. In 2020, the upper limit is $6,900 for individual coverage or $13,800 for family coverage, but plans may have lower caps. This feature could help you budget accordingly for a worst-case scenario.

Premiums are typically lower for HDHPs than traditional health plans. Until the deductible is satisfied, members usually pay more up-front for services such as physician visits, surgery, and prescriptions, but typically receive the insurer's negotiated discounts.

Some preventive care, such as routine physicals and cancer screenings, may be covered without being subject to the deductible. Under new IRS guidance issued in July 2019, the list of preventive care benefits that HDHPs may provide was expanded to include certain medications and treatments for chronic illnesses such as asthma, diabetes, depression, heart disease, and kidney disease. Providing this coverage encourages patients to seek care before problems become more serious and costly.

Retirement strategy

Another HSA benefit is that account funds not needed for health expenses are available for any other purpose after you reach age 65. Although HSA funds cannot be used to pay regular health plan premiums, they can be used for Medicare premiums and qualified long-term care insurance premiums and services that you may need later in life.

If you can afford to fund your HSA generously while working, some of those dollars could be left untouched to accumulate for many years. You could even pay current medical expenses out of pocket and preserve your HSA assets for use during retirement. But save your receipts in case you have an unexpected cash crunch. You can reimburse yourself for eligible expenses at any time.

Compare carefully

Open enrollment is the time of year when employers typically introduce changes to their benefit offerings. If you purchase your own health insurance, you might also be presented with new options for 2020. The bottom line is that choosing and using your health plan carefully could help you save money. If you choose an HDHP, make sure to contribute the premium dollars you are saving to your HSA, and more if you can.

Before you sign up for a specific plan, read the policy information and look closely for any coverage gaps or policy exclusions, consider the extent to which your prescription drugs are covered, estimate your potential out-of-pocket costs based on last year's usage, and check to see whether your doctors are in the insurer's network.

1) Employee Benefit Research Institute, 2019

2) Kaiser Family Foundation, 2019
