



## Financial Planning Perspectives

# HSA: An off-label prescription for retirement saving

Choosing a health insurance plan involves a complex analysis of premiums, deductibles, out-of-pocket maximums, and tax costs. The right choice depends on an individual's policy options, budget, and expected health care needs.

The rapid growth of high-deductible health plans (HDHPs) and health savings accounts (HSAs) adds more complexity to the decision but also creates a unique opportunity to save for retirement and other long-term goals. We explore these underappreciated savings opportunities by reviewing the what, why, and how of HSAs.

### ■ The what.

HSAs are tax-sheltered savings accounts available to those enrolled in a high-deductible health plan (HDHP). An HDHP charges lower premiums than traditional insurance plans but comes with higher deductibles and out-of-pocket maximums. An HSA provides tax benefits to help defray these higher costs.

### ■ The why.

In tax-advantaged accounts such as IRAs, 401(k) plans, and 529 college savings plans, you pay taxes now or later. With an HSA, the "now" or "later" can become "never." These tax savings can compound to produce higher returns than those available from other accounts.

### ■ The how.

The *how* depends on how much you can afford to save. For those with enough savings capacity, the best strategy is to treat the HSA as a long-term investment account by paying for current medical expenses out of pocket. If you have less capacity to save, the decision is more complex, involving both investment and behavioral considerations.

## What are HSAs?

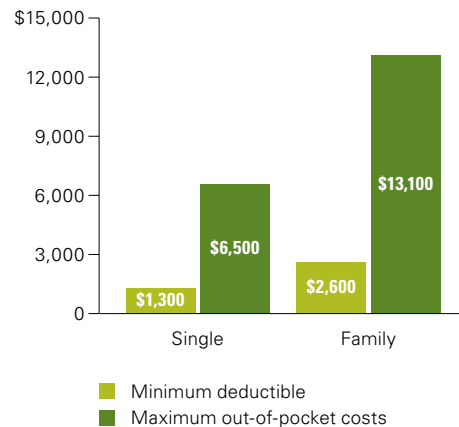
HSAs are a fast-growing tax-advantaged savings vehicle that can be paired with an HDHP. Introduced in 2003, HSAs now hold \$37 billion in assets, up from \$1.7 billion in 2006.<sup>1</sup> Growth is likely to continue, driven by the accelerating use of HDHPs.

In 2016, 29% of insured workers were enrolled in an HDHP, up from 4% a decade earlier, according to the Kaiser Family Foundation.<sup>2</sup> The percentage of workers covered by more familiar plans such as a Preferred Provider Organization (PPO) is higher but declining.

An HDHP charges lower premiums than a PPO but has higher deductibles and out-of-pocket maximums. **Figure 1** displays minimum deductibles and maximum out-of-pocket costs for HSA-eligible insurance plans in 2017. Health insurers can offer HDHPs with out-of-pocket maximums that are lower than these statutory ceilings.

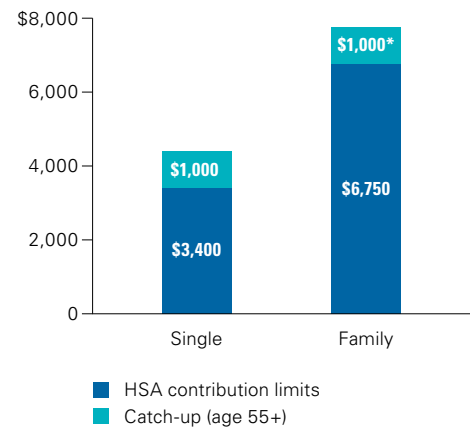
If an HDHP's higher out-of-pocket costs are the stick intended to promote greater price sensitivity among health care buyers, the ability to make tax-favored contributions to an HSA is the carrot. **Figure 2** displays the maximum HSA contributions for 2017, including individual and employer contributions. The contributions can be kept in cash or invested in longer-term assets such as stock and bond funds.

**Figure 1. High-deductible health plans must meet certain criteria**



Source: <https://www.irs.gov/pub/irs-pdf/p969.pdf>.

**Figure 2. Maximum HSA contributions for 2017**



\*Per eligible participant.

Source: <https://www.irs.gov/pub/irs-pdf/p969.pdf>.

<sup>1</sup> Through 2016. See Robb and Remjeske (2017)

<sup>2</sup> See Claxton et al. (2016).



An HSA offers considerable tax breaks, depending on the saver's income:

1. Contributions are deductible.<sup>3</sup>
2. Investment growth is tax-deferred.
3. Qualified withdrawals are tax-free.

Although designed to help people pay for health care, an HSA has more in common with traditional savings vehicles such as IRAs than with health care accounts such as Flexible Spending Accounts (FSAs) and Health Reimbursement Arrangements (HRAs). As with an IRA (but not an FSA), you can roll over savings from year to year, potentially accumulating a sizable long-term balance. And the accounts are portable. If you enroll in an HDHP through work, you're not limited to the HSA custodian chosen by your employer. You can open an account with, or transfer an existing account to, a custodian with lower fees or better savings and investment options.<sup>4</sup> If you leave your employer, you can take your HSA with you.

HSA withdrawals must be used for qualified medical expenses such as doctor visits, medications, and other expenses that can be deducted on a tax return.<sup>5</sup> Rules for withdrawals are relatively flexible. You can make a withdrawal at any point in the future for any qualifying expense incurred since you opened the account.

Making the most of this flexibility requires careful recordkeeping, but the flexibility also makes HSAs an attractive vehicle for a variety of long-term savings goals. Suppose you pay \$2,000 out of pocket this year for your daughter's braces. Save the receipt, and you can use that bill ten years from now to withdraw funds—tax-free—to pay for her college tuition. Or you can use it for your retirement expenses in 40 years.

If you don't have qualified medical expenses, withdrawals are subject to income taxes and a 20% penalty. If you're 65 or older, there's no tax penalty for nonqualified withdrawals, just the income tax. In this sense, the taxation is similar to how traditional IRA assets are treated. In any case, the risk of incurring a penalty or tax is low. Health care costs are all but inevitable. And in addition to typical out-of-pocket costs, an HSA can be used to pay Medicare premiums (with the exception of Medigap premiums) or to buy long-term-care insurance.

An HSA has more in common with savings vehicles such as an IRA than with health care accounts such as an FSA.

### As always, costs matter



An HSA's power as either a short-term spending or long-term investing account depends on its costs. Account maintenance fees at the largest HSA custodians range from \$0 to \$4.50 per month, according to a 2017 Morningstar report.<sup>6</sup> Some also charge an investment fee for account owners who invest in mutual funds. And these funds have their own underlying expenses, which range from 0.05% to 1.15%, according to Morningstar. The lower your costs, the harder your HSA can work for you. Costs are one factor, and there may be other material differences between products that must be considered prior to investing.

<sup>3</sup> Contributions are also exempt from Federal Insurance Contributions Act (FICA) taxes for Social Security and Medicare if made through payroll deductions, but this exemption may lead to lower Social Security benefits.

<sup>4</sup> Rollovers to another custodian are limited to once every 12 months.

<sup>5</sup> See IRS Publication 502 for more information: <https://www.irs.gov/pub/irs-pdf/p502.pdf>.

<sup>6</sup> See Acheson, Spiegel, and Larsen (2017).


If an account owner dies before spending all the HSA funds, a spouse who inherits the account can use it as his or her own. A nonspouse beneficiary would owe income taxes on the inherited amount, but the taxes can be offset by the deceased's end-of-life care or other unpaid out-of-pocket costs, as long as they are paid within a year of death.

### Why use an HSA?

The power of an HSA is most obvious when compared with other long-term savings accounts. **Figure 3** compares the tax treatment of HSA contributions, investment growth, and withdrawals with the taxes for other tax-advantaged and taxable accounts.

An HSA receives more favorable tax treatment than other tax-advantaged accounts.

**Figure 3. Taxes now, taxes later, taxes never**

Savings account	Contributions	Investment growth	Withdrawals	Other considerations
 <b>Health savings account</b>	<b>Pre-tax</b>	<b>Tax-deferred</b>	<b>Tax-free*</b>	Receives favorable treatment from most states. Exempt from FICA taxes if contributions are made through payroll deductions.
Roth IRA or employer plan	Taxable	<b>Tax-deferred</b>	<b>Tax-free</b>	Most states follow federal rules for income taxes, though there are exceptions.
Traditional IRA or employer plan	<b>Pre-tax</b>	<b>Tax-deferred</b>	Taxable	Most states follow federal rules for income taxes, though there are exceptions.
529 plan	Taxable	<b>Tax-deferred</b>	<b>Tax-free*</b>	Contributions are deductible from state income tax in most cases.
Taxable investment accounts	Taxable	Taxable	Taxable gains	

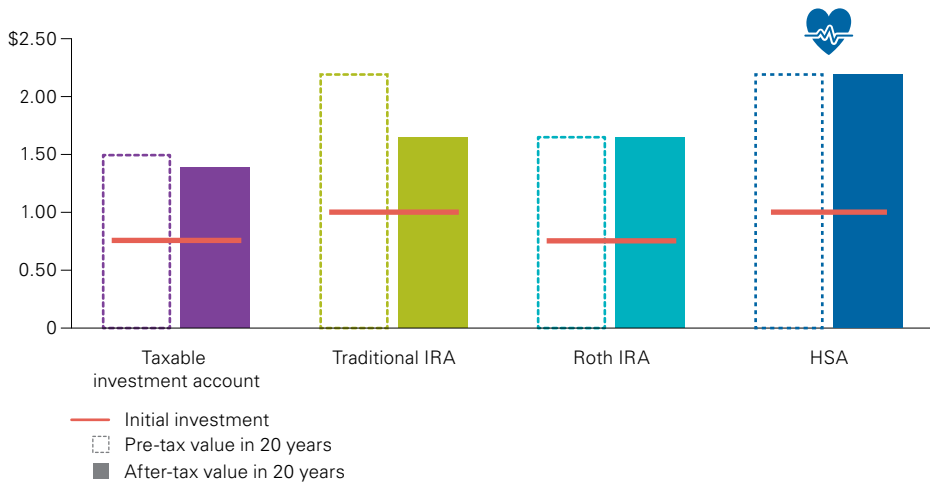
\*Distributions must be offset by qualified expenses.

**Note:** When taking withdrawals from a tax-deferred plan before age 59½, you may have to pay ordinary income tax plus a 10% federal penalty tax. This table does not address nondeductible contributions made to a traditional IRA or employer plan.

HSA's greater tax advantages translate into greater growth in spending power, and the longer the time horizon, the greater the advantage. **Figure 4** displays the tax-adjusted values of one dollar of marginal income invested in tax-favored and taxable accounts over 20 years.

**Figure 4. The favored tax status of HSAs can boost long-term savings**

\$1 of marginal income



You can think of your tax savings on HSA contributions as a “tax code bonus.”

**Note:** This hypothetical illustration does not represent the return on any particular investment, and the return rate is not guaranteed. Calculations assume a 4% annual real return, a 2% annual income return, a 25% income tax rate, and a 15% capital gains tax rate. Lower tax rates may make the taxable investment more favorable and the difference between taxable and tax-deferred less. Any future changes in the tax treatment of investment earnings or a rate of return that is lower than the assumed rate of return may further affect the comparison. Investors should consider their time horizon and current and expected future tax rates before making an investment decision.

**Source:** Vanguard calculations.

One way to think about contributions to an HSA is in terms of what the tax code “pays you” to contribute. This “tax-code bonus” is simply the state and federal marginal rate that would otherwise apply to the dollars you contribute.<sup>7</sup> If you make contributions through payroll deductions, add another 1.45% or 7.65% for FICA taxes—7.65% if your income is below the Social Security taxable wage base,<sup>8</sup> 1.45% if it’s above.<sup>9</sup>

Consider a single filer in New York with a gross income of \$100,000. After a 25% federal tax, a 7.65% FICA tax, and a 6.65% state tax, a dollar of marginal income would be worth 61 cents. If that dollar were contributed to an HSA, all 100 cents would be sheltered from taxes for long-term growth or short-term medical bills.<sup>10</sup>

<sup>7</sup> All states with an income tax allow for deductible contributions with the exception of California, New Jersey, and Alabama. Tennessee and New Hampshire tax HSA earnings upon withdrawal but not contributions.

<sup>8</sup> The Social Security taxable wage base is \$127,200 in 2017.

<sup>9</sup> HSA contributions would also not be subject to the 0.9% additional Medicare tax, if applicable.

<sup>10</sup> This calculation assumes that the taxpayer is not itemizing deductions.

## How to use an HSA

Why you should use an HSA is straightforward; the *how* is more complex. A 2016 survey of HSA owners hints at a number of missed opportunities. According to the Employee Benefits Research Institute:<sup>11</sup>

An estimated **7.3 million** people who are enrolled in an HSA-eligible plan haven't opened an HSA.

If you already maximize contributions to all tax-favored accounts *and* save in taxable accounts, treat the HSA as a retirement savings account.



Of open HSA plans...



**only 48%**

of those with an HSA contributed to it,



**and only 4%**

of HSA owners hold assets other than cash, suggesting that few people take advantage of the account's long-term investing benefits.

If you already maximize contributions to all tax-favored accounts for which you qualify, and you save in taxable accounts, the best strategy is simple: Fund the HSA. Treat it as a retirement savings account. Allow the assets to compound as long as possible, and pay out-of-pocket medical costs with taxable funds.

But most people face limits on how much they can save, and prioritizing what to save in which type of account is key. **Figure 5** presents prioritization guidelines that can maximize the tax-adjusted growth of your savings.

Once you secure your employer's match on your 401(k) plan contributions, it makes sense to save your next dollar in an HSA. The trickier question is whether it's better to treat the HSA as a long-term investment account or to use it like a checking account for medical expenses.

**Figure 5. Smart account prioritization can maximize long-term tax-adjusted asset growth**



<sup>11</sup> See Fronstin (2017).

We consider the question from the perspective of a single HSA owner in New York state with:

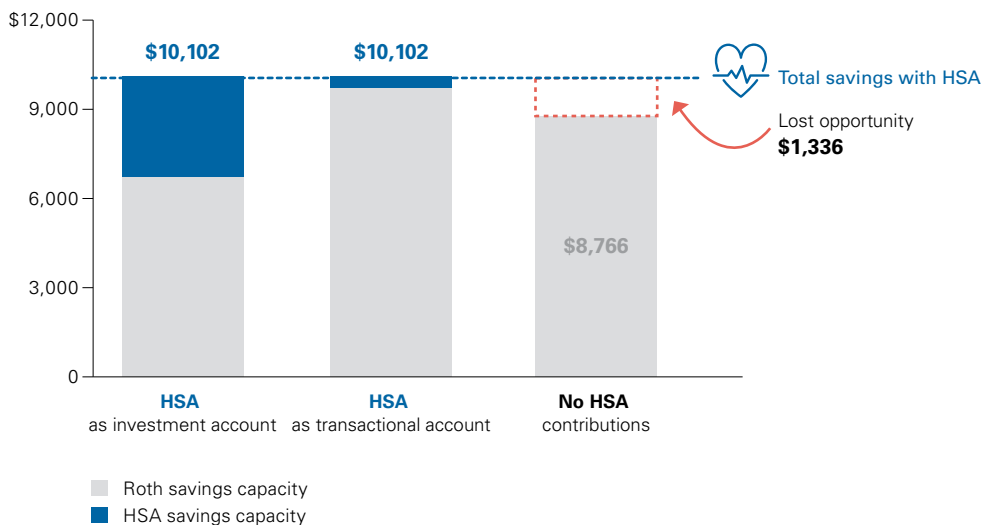


**Annual gross income: \$100,000**  
**Annual health care expenses: \$6,000**  
(\$3,000 in insurance premiums and \$3,000 in expected out-of-pocket health care costs)  
**Annual spending on food, housing, and other expenses: \$55,000**

Using an HSA as either an investment or transactional account increases an individual's capacity to save.

These constraints leave the HSA owner with \$39,000 for taxes and savings. The amount that goes to each depends on whether, and to what extent, the HSA is used. If the account is funded, the \$3,400 contribution escapes tax-free.<sup>12</sup> Of the remaining \$35,600, \$28,898 goes to taxes and an additional \$6,702 goes to savings, for total savings of \$10,102. If the owner elects *not* to use the HSA, the \$3,400 that could have been tax-free is instead fully taxable. The \$39,000 is then broken down to \$30,234 for taxes and \$8,766 in savings.

Figure 6. Smart use of HSAs can increase total savings capacity



**Note:** The \$1,336 difference in the right bar represents an additional \$850 in federal taxes, \$226 in state taxes, and \$260 in FICA taxes. In this example, we assume the investor has access to an employer plan that allows designated Roth contributions.  
**Source:** Vanguard calculations.

The analysis makes clear that, if you can use an HSA, using it is more important than how it is used. In this example, using the HSA as either an investment or transactional account increases an individual's capacity to save by more than \$1,300, as shown in **Figure 6**. When the HSA is used as a long-term investment account, medical expenses will be paid out of pocket—money that could otherwise have been used to fund retirement accounts. If the HSA is used as a transactional account, the saver has more income to contribute to the retirement account.

<sup>12</sup> In this case, \$3,400 is the maximum HSA contribution allowed for a plan covering a single individual under age 55.

The right decision in this case incorporates elements other than the tax code; it would depend on the investment options and costs in each account. That consideration would probably favor the retirement plan, which typically has access to a more comprehensive selection of investments and lower-cost funds.

The decision might also include a behavioral dimension. Perhaps framing effects make it more likely that assets in a retirement account, rather than those in a designated health care account, will be treated as long-term investments. On the other hand, an investor's perception of an HSA can change over time as balances accumulate, making it a more versatile savings option than a retirement plan. For instance, what an investor once considered a medical checking account may become an emergency account, college savings account, or long-term retirement savings account.

## Conclusion

Health care costs are an inevitability. Even if you're hale and hearty—and lucky—enough to reach retirement without ever setting foot in a doctor's office, you can use assets accumulated in an HSA to pay Medicare premiums or buy long-term-care insurance.

HSAs represent a unique opportunity to prepare for these and other health care costs. For those who maximize their contributions to tax-favored accounts and also save in taxable accounts, the best strategy is simple: Treat the HSA as a uniquely tax-advantaged retirement savings vehicle. Pay for any out-of-pocket health care costs with taxable funds.

For those unable to fund all tax-advantaged vehicles, the calculus is more complex. Even so, the HSA is valuable; the question is whether to use it as a transactional or investment account. The answer depends on investment and behavioral considerations. As an individual's capacity to save increases, the decision becomes simpler.

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