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Making the Most of an HSA Account

Health Savings Accounts are one of the most tax beneficial accounts available. In many ways they are better than retirement accounts and can produce up to 66% more value in retirement than a retirement account. For some, HSAs can be used to reduce the need for long-term care insurance. Ironically, using them for regular health expenses eliminates a substantial portion of the benefit.

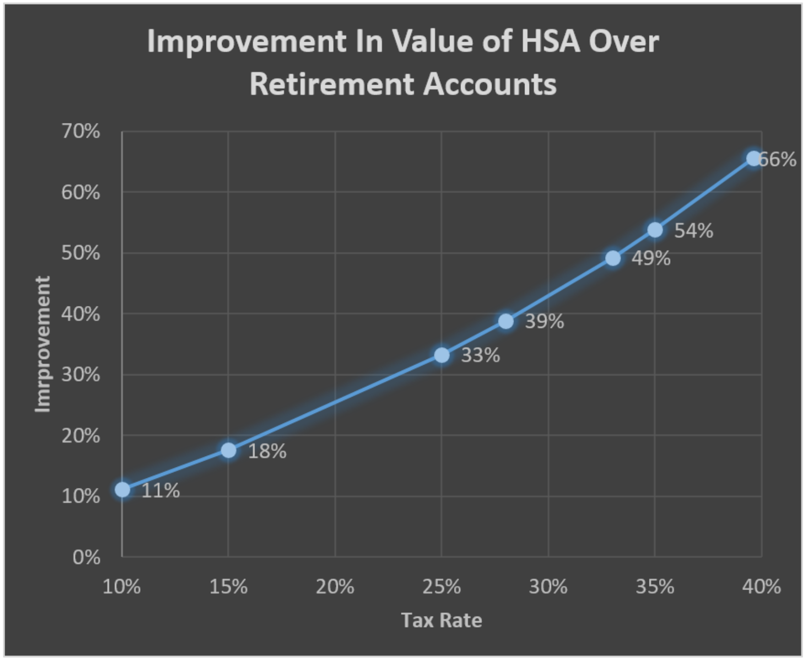
Health Savings Accounts are tax favored investment accounts that are intended to be used for health expenses. The accounts are only available to those with certain health insurance policies that have high deductibles. For 2016, the maximum individual contribution for those under age 55 is $3,350 and the maximum family contribution is $6,750. For those 55 and over, an additional $1,000 may be contributed. The contributions usually can be made until the participant reaches age 65.

HSA accounts offer significant tax advantages over traditional IRAs, 401(k)s and similar accounts, as well as the Roth versions of such accounts. The following table compares tax features of HSAs and the retirement counterparts. For each measure, the HSAs are as good as or better than retirement accounts. HSAs can be tapped tax-free before retirement for medical expenses and used penalty-free for any type of expense in retirement. Also, there are no required minimum distributions.

	Traditional 401(k) or IRA	Roth 401(k) or IRA	HSA
Tax Free Contributions	Yes	No	Yes
Penalty For Early Withdrawal	Yes*	Yes*	No (For Medical Expenses)
Penalty for Non-Medical Expenses in Retirement	No	No	No, Ordinary Taxes Apply
Tax Free Withdrawals	No	Yes	Yes (For Medical Expenses)
Required Minimum Distribution	Yes	No	No

*Some narrow exceptions exist for hardship reasons, etc.

The key feature of an HSA that improves its value over retirement accounts is that both the contributions and withdrawals can be tax free. The improvement depends on the tax rate, as shown in the chart below. For example, suppose that one is in the 25% tax bracket when the contribution is made. An income of $1,333 is needed to fund a $1,000 contribution to a Roth since the 25% tax is applied to the income. However, $1,333 in income will generate a $1,333 contribution to an HSA since it is tax free. If the money is not used for medical expenses and withdrawn after age 65, the value of the HSA withdrawal be 33% greater than the Roth withdrawal, assuming the marginal tax rate has not changed. The chart shows the amount of improvement in value of an HSA over retirement accounts.



After age 65, the HSA withdrawals that are not used for medical expenses are taxable, but there is no penalty -- just like a traditional IRA. Also, expenses incurred at any time after the HSA is set up can be reimbursed. If the HSA is created at age 50, all the unreimbursed medical expense receipts from that point on should be saved. Years later, after the HSA has had an opportunity to grow, the expenses can then be withdrawn tax free. In a sense, every unreimbursed medical expense is like a contribution to a tax-free retirement account.

HSAs as an Alternative to LTCI

One possible use of the HSA is to treat it as a long-term care (LTC) fund, which may reduce or eliminate the the need for long-term care insurance (LTCI). Many types of insurance are useful and necessary, but in general, one should strive to purchase the minimum insurance necessary to mitigate the effects of a risk. Ironically, the more likely a claim is to be made, the less valuable insurance becomes. For example, the cost of term life insurance for a healthy 30-year old will be very low relative to the payout because the payout is so rare. The cost of a claim is spread out among many policy holders. On the other end of the spectrum, no one buys insurance for grocery or gasoline purchases because that would simply add an expensive middleman to regular, certain expenses. Insurance is best when the claims are anticipated to be rare and catastrophic. To an extent, LTC does not fit this description.

According to Long-Term Care Over an Uncertain Future: What Can Current Retirees Expect? in the journal Inquiry, 58% of men and 79% of women 65 and older will need some LTC. Thus, the rarity condition is not met. But is such an event catastrophic? While LTC can be very expensive, it is not necessarily catastrophic for wealthier individuals who have the means to pay for the care. Similarly, the expense is not catastrophic for less wealthy individuals who ultimately have their expenses covered by Medicaid. Finally, the cost of LTC is often reduced when a loved one helps provide the care. According to the study, 82% of elderly incur LTC out-of-pocket costs of $25,000 or less. As a result, LTC does not neatly and definitively fit the criteria as a rare and catastrophic risk that should be insured without question.

An alternative for many individuals is to consider using the HSA instead of LTCI. For example, Joe is a married 50-year old with an HSA. He and his spouse can contribute $6,750 per year until age 65. When he turns 55, he can contribute an additional $1,000 per year. Assuming Joe reaches age 65, his life expectancy will be 83, according to the CDC. If the account was properly allocated and managed, when Joe turns 80, he could anticipate taking a tax-free payout of $225,000 in today's dollars to cover his medical care. Furthermore, there is an 85% probability the account will be worth more than $225,000, and a 50% chance the payout could be $550,000 or higher. That amount of money will pay for a lot of care, if it is needed.

The HSA Strategy

The bottom line is that HSAs are more flexible and tax advantaged than retirement accounts such as traditional and Roth 401(k)s and IRAs. One possibility for retirement saving priorities is to:

1. fund the 401(k)s to the extent they it is matched by an employer,
2. fully fund an HSA, and
3. fully fund the 401(k)s and IRAs.

Keep the HSA untouched and save medical receipts. Copy or scan the receipts since some register printer inks fade with time. Be careful to choose a well-positioned set of investments within the HSA, according to age, risk tolerance, and other factors. And understand that such an investment may lose money periodically, just as other retirement investments do. Stick things out for the long run, and feel free to ask us for help in understanding the risks and investment selections for your particular situation.

Of course, HSAs may not be for everyone. If you have a chronic illness or frequent medical bills, a high deductible medical insurance plan required for an HSA may not be the best option. Also, using the HSA as a long-term investment means that you must have the financial wherewithal to cover your medical plan deductible on a regular, annual basis. Dipping into a long-term investment after a short time can substantially increase the risk. Again, if you have any questions, we'd be glad to help.

P.S. Here are a few expenses that qualify for HSA withdrawals:

- Medical insurance premiums, including Medicare
- Travel to and from doctors/hospitals
- Contact lenses and eye glasses, vision testing
- Laser eye surgery
- Dental treatments
- Weight-loss programs
- Breast reconstruction
- Wigs (when hair is lost from disease)
- Dentures
- Hearing aids
- Bandages
- Home improvements for disability access
- Long-term care insurance premiums
- Lifetime Care
- Home healthcare
- Nursing home care

Here are some things not allowed (yes these are listed in IRS Publication 502):

- Illegal drugs
- Dancing lessons
- Swimming lessons
- Veterinary fees
- Teeth whitening
- Gym memberships
- Toupees (unless hair loss is from a disease)

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