KIM: Unleash ‘triple-threat’ power of your Health Savings Account (HSA)

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If you started with a blank sheet of paper to design the “perfect” retirement account, it would have three non-taxable features: 1) dollars going *into* the account are not taxed (like traditional 401-Ks/IRAs); 2) investment income/gains are not taxed (like both traditional and Roth 401-Ks/IRAs) and 3) dollars going *out of* the account are not taxed (like Roth 401-Ks/IRAs). In short and with important caveats, I’ve just described a health savings account (HSA). In fact, a HSA ***is the only type of account having all three non-taxable features.***

HSAs were authorized in 2003 and are paired with eligible high-deductible health-care plans (HDHPs) meeting specific criteria (minimum annual deductible of $1,300/individual; $2,600 family and maximum annual out-of-pocket limit of $6,550/individual; $13,100 family). Given their high deductibles, the premiums on HDHPs are typically lower than for traditional health plans, which essentially pay for the first dollar of expense.

The maximum HSA contribution for 2017 is $3,400/individual and $6,750/family, with those over 55 able to contribute up to an additional $1,000.

HSAs are meant to be used to pay for qualified healthcare expenses not covered by the plan or if the deductible has not been met. In theory, if people spend funds in a HSA to pay for healthcare, they are better incentivized to be informed, price conscious consumers than if they were covered by a traditional plan with minimal co-pays. Also, unlike flexible spending accounts (FSAs), which are “use it or lose it” propositions, the unspent funds in a HSA can be carried forward to future years.

As long as HSA funds are used for medical expenses, there is no tax on the withdrawal. If you withdraw funds before age 65 for nonmedical expenses, you are subject to income tax and a 20% penalty. If you withdraw funds after 65 for nonmedical expenses, you pay tax only.

The vast majority view their HSA as a “checkbook” to pay for *current* medical expenses and spend most or all the funds in the account each year. Indeed, 96% of HSAs hold only cash equivalents. This is how I viewed my HSA until I started researching this column. However, with Fidelity estimating a 65-year old couple retiring now will need $260,000 to cover medical expenses not covered by Medicare throughout their retirements, HSAs can be better used to accumulate funds for *future* needs.

In a “perfect world,” you’d take four steps to maximize the power of your HSA. First, as with all saving/investing, ***start as early as possible*** to give the miracle of compound interest time to work its magic. Second, ***contribute the maximum*** amount allowable. Third, ***invest aggressively*** (i.e. high allocation to stocks). Fourth, ***pay healthcare expenses out-of-pocket*** (i.e. NOT with the HSA) *and* keep receipts.

Most folks are not in a financial position to contribute the maximum amount and/or pay all expenses out-of-pocket, but every little bit helps. Also, you should maintain a “cushion” of cash in your HSA for unexpected expenses. Regarding paying expenses, ***every dollar you can leave undisturbed in the HSA to compound tax-free will benefit you greatly down the road***. For example, if you pay a $1,000 expense out-of-pocket today and assume your HSA has a 7.2% annual return, then that $1,000 left undisturbed will have grown to $4,000 when you retire in 20 years.

Best of all, you can then reimburse yourself for the original $1,000 and use it for ***any purpose*** (tax-free because you **kept that receipt!**), plus you’ll still have $3,000 to spend on healthcare.

Your HSA may be an ***ideal retirement vehicle hiding in plain sight***, but it’s up to you to unleash its “triple-threat” power.
