HSA — The Ultimate Retirement Savings Tool

Health Savings Accounts can be powerful long-term savings vehicles.

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As Health Savings Accounts (HSAs) gain popularity both in the workplace and in the marketplace, more and more consumers are beginning to understand the value of health savings accounts beyond just paying for current healthcare expenses tax-free.

Many consumers have viewed the HSA as a super FSA (Flexible Spending Account) and are choosing to spend down their HSA with current year out-of-pocket health care expenses and allowing any excess expenses to accumulate. We were well-trained on FSAs to spend down our current year expenses but with the HSA, we have the option to spend it down or save it and let it accumulate tax-free.

The real power of the HSA is allowing it to accumulate and grow tax-free, which allows use of the HSA to pay for out-of-pocket health care expenses in retirement with tax-free dollars. As such, for those with the means to pay out-of-pocket healthcare expenses during their working years with non-HSA funds, the HSA is really best thought of as sitting alongside a 401(k) plan as a retirement plan benefit.

The HSA Is a Beneficial Retirement Account

Some workers mistakenly think that Medicare will be free and that they will have all their medical expenses covered by Medicare, so when they arrive at retirement it's quite a shock to learn otherwise. The cost of Medicare Part B, and D, along with a supplement to Medicare can often exceed in cost what the worker was paying when they were working. In addition, Medicare does not cover everything. According to Fidelity, a person who retired in 2019 can expect to spend approximately $150,000 out-of-pocket in health care and medical expenses throughout retirement.

An HSA can reimburse Medicare premiums as well as uncovered medical expenses including dental, vision (eyeglasses), qualified long-term care services, and hearing aids. Instead of paying for these expenses using after-tax money from a traditional 401(k), tax-free HSA funds can be used. Relying on a traditional 401(k) or IRA to pay for those expenses will require about 25 percent more money to pay those expenses (or $187,500 to fund $150,000 in expenses).

Exhibit 1: Similarities of HSAs and 401(k)s

	HSA	401(k)
Reduce Taxable Pay for Federal and State Tax	✓	✓
Reduce Taxable Pay for FICA	✓	
Investable in Mutual Funds	✓	✓
Tax Free Withdrawals for Medical Costs	✓	
Take it with you if you leave your employer	✓ Always. You can transfer it to any HSA.	✓ Yes, with a rollover to your new plan or an IRA — either way, it's still yours.

Exhibit 2: Difference in $1000 Invested In an HSA vs. a 401(k) Over Time

HSA or 401(k)?

Assumptions:
- *Reducing take-home pay $1000 per year for 35 years; ages 30 – 65*
- *Assumed 6% per year earnings*
- *Payout in 25 "equal" installments; ages 65 – 90*
- *Assumes no change in marginal tax rates throughout the period*

	Health Savings Account	401(k) Account
Deposit per Year*	$1,603	$1,429
Balance at Age 65	$183,989	$164,017
Annual Payout to Age 90	$14,396	$12,833
Annual After-Tax Value to Age 90	$14,396	$8,983
Difference in Value	**$60.3% More!**	

**Assumes a 25% federal, 5% state, 6.2% FICA, and 1.45% FICA-Med marginal rate*

Disclaimer: This calculation is hypothetical and can also depend on your state. NJ, CA and some other states treat HSAs differently. This is for educational purposes and should not be considered advice.

HSA vs. 401(k)

Rather than compare the HSA with an FSA, lets look at the HSA compared to the 401(k).

From a savings account standpoint, the HSA and the 401(k) look alike. In addition, while they both offer pre-tax savings of Federal and State taxes, the HSA adds FICA tax savings when the deduction is taken through payroll.

Because most people do not focus on the long-term growth of the HSA, they often miss that the HSA can be invested — in options much like what a 401(k) offers. This allows the HSA to potentially grow like a 401(k) account.

The other key difference is that the HSA allows tax-free withdrawals for qualified medical expenses, and the 401(k) does not. In many ways, this allows the HSA to protect the 401(k).

Growth Potential of the HSA vs. 401(k)

As we compare the tax advantages more deeply, lets look at a sample investment of $1,000 yearly into both an HSA and 401(k) at the same time.

As Exhibit 2 shows, because of the FICA savings, we gain an advantage of the HSA having more to deposit (including the tax savings) over the 401(k).

The exhibit shows:

- In the contribution year, we save an extra $174 in our HSAs. While 401(k) deferrals are subject to FICA taxes, Health Savings Account contributions are not.
- One year of FICA savings may not seem like a lot, but when compounded over 35 years, it means our HSA balance is $19,972 bigger than our 401(k).
- That savings means that every year in retirement we can expect our HSA to pay $1,563 more than our 401(k) distribution. The payout we receive from our 401(k) is taxable, but our HSA distribution is not if we use it to pay for qualified medical expenses.
- When taken together, the tax benefits of HSAs results in 60 percent more savings than the 401(k).

Investing in the HSA

It is important to note that our example assumes that participants invest their HSAs, which is still a relatively under-utilized function of HSAs. As we stated earlier, an HSA offers an investment menu like a 401(k). In fact, some HSAs are even able to mirror an employer's 401(k) options.

In the past, some HSAs required a certain dollar amount be saved in the HSA before investment was allowed. A trend we are seeing is that many HSAs are lowering the limits for investing in the HSA. We encourage you to consider educating yourself or your plan participants about the investment options and utilizing them within the plan. As balances build, we expect to see more investments.

The Benefits of the HSA vs. 401(k)

The differences between the two cannot be overlooked, and they are important to discuss. See Exhibit 3.

How to Maximize the HSA and 401(k)

The HSA will not replace the 401(k), but an HSA should be considered equally as a long-term retirement savings vehicle, specifically for rising health care costs, in addition to its short-term savings power. The power of an HSA alongside a 401(k) makes the two an unbeatable pair.

In order to make the most of your HSA & 401(k), we recommend prioritizing your funds in this order, to the extent you can:

1. Deposit first dollar into HSA for eligibility
2. Save to employer's match in your 401(k)
3. Contribute to HSA maximum, or as much as you can manage
4. Return to 401(k) to save to maximum, or as much more as you can manage
5. Invest HSA for future expenses

Exhibit 3: Differences Between HSAs and 401(k)s

Benefits of HSAs (vs. 401(k)s)	Drawbacks of HSAs (vs. 401(k)s)
• Always 100 percent vested • Pretax contributions for all taxes, including FICA • Tax-free distributions for qualified medical expenses • Tax-free investment earnings • Always 100 percent portable • No required minimum distributions during lifetime • Pay-outs at any time for any reason (not subject to tax penalty prior to 65) making it both a short-term and long-term savings tool	• Lower contribution limits • Not available for loans • Match may be higher in 401(k) • 401(k) investment funds may have lower fees depending upon plan size

It is important to remember that HSAs have specific eligibility requirements and even those who are eligible may not be able to afford to reserve their HSA dollars for longer term savings. But, for those who can, HSAs represent an attractive option for adding to your retirement nest egg.

Summary

HSAs have become more popular as employers and workers begin to view them as a savings account, and not just a healthcare spending account. We expect this trend to continue as assets build in these accounts and knowledge of the superpower extends beyond just the savviest of participants. As HSAs gain traction as a dual-purpose retirement savings account, participants will no doubt begin to question how these accounts fit in with traditional retirement savings vehicles.

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