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Health Savings Accounts Can Double as Shadow IRAs

For Investors Who Can Afford It, HSAs Can Serve as Retirement Savings Accounts

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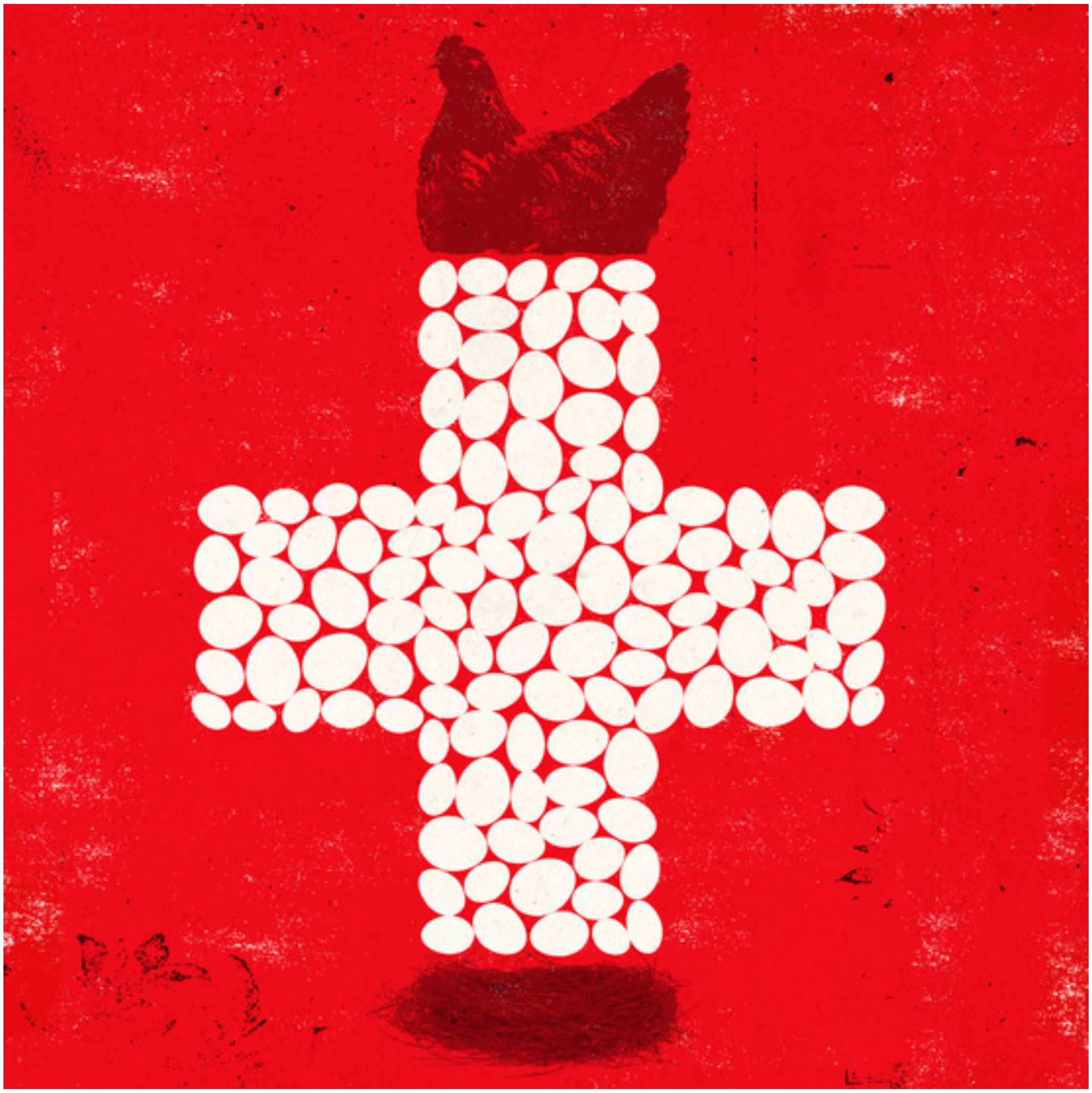

Richard Mia

Some Americans who contribute to health savings accounts are finding these plans' best use may be not for paying medical expenses, but as supplementary retirement accounts.

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A married couple who qualify can put away as much as $8,550 in 2014 and have some or all of that money grow in mutual-fund investments for many years without any immediate taxation.

"The tax-shelter properties are powerful," says Louis Kokernak, a financial planner with Haven Financial Advisers in Austin, Texas.

The basic purpose of an HSA is to salt away pretax income to cover medical expenses not covered by health insurance. But those who generously fund their HSA may find some or all of those dollars can grow in a tax-deferred investment account for many years. Along the way, the money can be used tax-free to pay medical expenses or premiums on long-term-care insurance. After age 65, there's no penalty for withdrawing money for nonmedical use; the money will be taxable, but will still have benefited from years or decades of tax deferral.

Using an HSA as a shadow retirement account is wise planning, says Lazetta Rainey Braxton, founder of Financial Fountains, a financial-planning firm in Baltimore. "Individuals who have good cash flow and liquidity and good health can greatly benefit from having an HSA," she says. Mrs. Braxton notes that HSAs must be held by trustees, much like 401(k)s and other traditional retirement plans. Many advisers recommend putting the money into mutual funds and letting it sit.

A taxpayer can fund an HSA only if she or he has a high-deductible insurance plan—carrying a deductible of between $1,250 and $6,350 if it covers only one person, or $2,500 to $12,700 if it covers a family, according to IRS rules on HSAs.

The accounts work as supplements to your retirement package only if you have relatively few medical expenses that you need to pay out-of-pocket—or if you can pay whatever medical expenses you do have from other sources, so that the HSA dollars stay in place and compound.

Growing in Popularity

HSAs are growing in popularity, probably spurred by changes in health-care laws and increasing use of high-deductible health plans. HSAs and related accounts known as health reimbursement arrangements exploded from 1.3 million accounts with $873 million in assets in 2006 to 11.8 million accounts holding $23.8 billion in 2013, according to the nonprofit Employee Benefit Research Institute. About 23% of HSAs and HRAs received employer contributions of an average $1,000, making them even more like a 401(k).

Christopher Van Slyke, an adviser with WorthePointe in Austin, says he wouldn't advise anyone but the very wealthy to use HSA money for retirement because of a 20% penalty if the money is spent on anything other than medical expenses before 65. Also, any spending for nonmedical purposes is taxable income before *and* after 65.

HSA contribution limits in 2014 are $3,300 a year if the high-deductible plan covers only a single person, or $6,550 if the plan covers a spouse or family. After age 55, catch-up contributions allow those annual amounts to be increased by $1,000. A couple on the same high-deductible health-care policy can each make the $1,000 catch-up contribution if each has their own HSA, for a total contribution of $8,550 per family.

One important caveat: The benefit research institute noted in a 2010 study of HSAs that the statutory limits on contributing to the accounts mean "they are unlikely to play more than a minor part in savings for health-care costs in retirement." Retirement health-care costs not covered by Medicare may exceed $300,000 over a retiree's lifetime, the institute says.

Many Providers

For employees in group medical plans, HSA providers typically are hired by the employer. For individuals with high-deductible plans, many banks, credit unions and other firms offer HSAs, says Mrs. Braxton. Individuals should compare fees and features across providers.

Mr. Kokernak, who at age 53 has accumulated more than $45,000 in his own HSA, encourages clients to use low-cost stock and bond funds in their HSA accounts. He uses a custodian called HSA Bank, a unit of Webster Financial Corp. WBS -0.19% , based in Sheboygan, Wis. HSA Bank has a slate of mutual funds available and lets account holders direct their own investments through TD Ameritrade. AMTD +0.22%
Some of the largest HSA custodians by HSA assets are UnitedHealth Group Inc.UNH -0.15% 's Optum Bank, J.P. Morgan Chase JPM -0.46% & Co., HealthEquity Inc.,Xerox Corp.'s XRX +1.80% BenefitWallet and HSA Bank, says Jon Robb, senior vice president for research and technology at Devenir Group LLC, an independent investment adviser and HSA consultant based in Minneapolis. Devenir's HSASearch website has detailed information on almost 90 HSA custodians, including fee information.
Health Savings Adminstrators, which offers investments in 22 low-cost Vanguard Group mutual funds, is an independent provider favored by Helen Huntley, a financial planner with Holifield Huntley Financial Advisers in St. Petersburg, Fla. Ms. Huntley and her husband each have an HSA and share a health-insurance plan with a $7,000 family deductible, "which means we have to be prepared to come up with $7,000, even while hoping that we never need to,'' she says.

Choice to Make

Whether to save your HSA money for retirement or use it to pay current medical expenses is a harder question, says Ms. Huntley. "If you save it all for retirement, you are paying your current expenses with after-tax dollars and your future expenses with pretax dollars. If you spend it now on medical expenses, you are doing the reverse.''

First, she says, decide whether you think you'll be in a higher tax bracket now, or after retirement. If the answer is now, use your HSA money to pay medical expenses now. Ms. Huntley and her husband pay some of their medical expenses out of their HSAs, particularly dental care, which isn't covered by their health insurance: "You could call that hedging our bets on tax brackets,'' she says.

High earners who put money into an HSA can lower taxable income and thus reduce the risk of getting hit with the 3.8% surtax on net investment income.

At age 65, if you switch to Medicare health coverage, you will no longer be eligible to contribute to an HSA. If you claim Social Security benefits, you'll be signed up for Medicare Part A whether you want it or not, and that will end your eligibility to keep paying into an HSA.

At death, an HSA passes to the holder's designated beneficiaries. It's tax-free to your spouse if used for qualifying expenses, but taxable income to anyone else, says Ann Reilley Gugle, a financial planner at Alpha Financial Advisors in Charlotte, N.C. If a beneficiary isn't named, the account will go to your estate.

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