April 2022

Health Savings Accounts: The Ultimate Retirement Account

Looking to save for retirement?

The first account you should open and fund is not an IRA (regular or Roth) or 401(k).

If you qualify, your first retirement account should be a Health Savings Account (HSA). Don't let the name fool you. The HSA may be the ultimate retirement account.

Not looking to save for retirement?

You should still open an HSA, as you will see in this article.

Big Deal

The HSA is the only tax-advantaged account that gives you both

- a tax deduction for the money you put in, and
- tax-free withdrawals.

What's an HSA?

The HSA is a tax-advantaged medical savings account much like an IRA that is paired with a high-deductible health plan. To have an HSA, your healthcare plan must have[1]

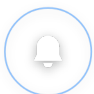
- a minimum annual deductible of $1,400 for self-only coverage ($2,800 for family coverage), and
- a maximum annual deductible of no more than $7,050 for self-only coverage ($14,100 for family coverage).

Good Health

If you or other family members are in poor health and currently need substantial amounts of expensive medical care, a high-deductible health plan may not be best for you. If you don't require much medical care, however, the high-deductible plan with an HSA can work very well.

Self-Employed

If you're self-employed or your employer doesn't provide health benefits, you may open an HSA yourself with an HSA provider, which may be a broker, a bank, a credit union, or an insurance company. You can enroll in an HSA-qualified high-deductible health plan through your Affordable Care Act health insurance exchange or obtain coverage outside the exchange.[2]



Operate as a Corporation

If you operate your business as a corporation and you work in the business, you are an employee.

Many corporate employers offer HSAs and high-deductible health plans as an employee fringe benefit. If an HSA is opened through an employer-sponsored program, the money in the HSA account belongs to the employee.

Medicare

You can’t open a new HSA if you’re on Medicare. But you can keep your old HSA after you turn 65 and enroll in Medicare—you just can’t make any more tax-deductible contributions to the account.[3]

Triple Benefit

Whether you’re self-employed or an employee, HSAs can have a triple tax benefit.

HSA Benefit #1: HSA Contributions Are Tax-Deductible

Employer, employee, and self-employed contributions to HSAs are tax-deductible up to annual limits. The employee, employer, or both may contribute to the employee’s HSA in the same year, up to the annual limit.

Employee HSA contributions by pre-tax payroll deduction are excluded from the employee’s taxable income and escape FICA taxes.

Direct contributions by employees to their HSA are 100 percent tax-deductible.[4]

Annual limits. The 2022 HSA contribution limits are $3,650 for individual coverage and $7,300 for family coverage.[5]

If you’re age 55 or older during the tax year, you may make an additional catch-up contribution of up to $1,000 per year.[6] So that’s up to $4,650 ($8,300 for family coverage) per year for taxpayers ages 55 to 65.

Unlike with IRAs, the tax code allows you to contribute to an HSA regardless of income.

Medicare stop limit. Beginning with the first month you are enrolled in Medicare, your contribution limit is zero.[7]

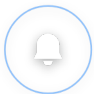
Claiming the deduction. As mentioned above, HSA contributions by the self-employed are 100 percent tax-deductible.[8] Individuals, such as the self-employed and employees, claim the HSA deduction on Schedule 1 of their Form 1040 as an “above-the-line” adjustment to income.

Many employers contribute to their employees’ HSAs, although they are not required to do so. For those individuals who are not more than 2 percent S corporation shareholder-employees, such contributions are tax-deductible to the employer and tax-free fringe benefits for the employees.

Contributions by an S corporation to a 2 percent shareholder-employee’s HSA are deductible by the S corporation and includable in the shareholder-employee’s gross income. The shareholder-employee then deducts the HSA contribution on his or her Form 1040.[9]

HSA Benefit #2: Tax-Deferred Growth

As with an IRA, the money in the HSA rolls over each year and grows tax-free.[10]



Depending on the HSA provider, you may invest the HSA money in money market accounts, bank certificates of deposit, stocks, bonds, mutual funds, Treasury bills, and notes. You can even obtain a self-directed HSA that gives you complete control over how your money is invested.

You may take distributions from your HSA at any time. But, unlike with a traditional IRA or 401(k), you don't have to take annual required minimum distributions from the account after you turn age 72.

Indeed, you don't have to take any distributions from your HSA.

When you die, if your spouse is the designated beneficiary of your HSA, it will be treated as your spouse's HSA. No tax need be paid.

If you have an HSA beneficiary other than your spouse, the account stops being an HSA when you die, and its fair market value becomes taxable to the beneficiary.[11]

HSA Benefit #3: Tax-Free Distributions for Medical Expenses

Here's where HSAs really shine. You pay no tax on distributions you make from your HSA to pay for qualified medical expenses for yourself, your spouse, or your dependents.[12]

No other tax-advantaged account gives you both a tax deduction for contributions and tax-free distributions.

- With IRAs, you get one or the other, but not both. Regular IRA contributions are deductible, but distributions are taxed.
- With Roth IRAs, distributions are tax-free after five years, but you get no deduction for contributions.

Moreover, qualified medical expenses are broadly defined to include any medical or dental expense that qualifies for the itemized deduction for medical expenses. It also includes insurance premiums for long-term care, COBRA health care continuation coverage, and Medicare if you are 65 or older.[13]

If you take distributions to pay for anything other than qualified medical expenses, you must pay income tax on the amount at ordinary income rates. If you're under age 65, you must also pay an additional 20 percent penalty tax on the distributions.[14]

Little-known fact about HSAs. There is no time limit on when you may take a distribution to pay qualified medical expenses. Thus, for example, you can take a tax-free distribution in 2022 to reimburse yourself for a medical expense incurred in any earlier year, so long as the expense was incurred after you established your HSA.[15]

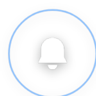
How Best to Use an HSA

The best way to use an HSA is to take full advantage of its triple tax benefits. This means you should

- contribute the maximum amount every year until you enroll in Medicare,
- defer taking distributions as long as possible, and
- take tax-free distributions only to pay for medical expenses.

You should max out your HSA contribution each year before you put any money into retirement accounts such as IRAs or 401(k)s. Because of the HSA's triple tax benefit, money invested in an HSA can be worth far more than a like amount invested in any other account.

Example. You invest $1,000 in an HSA. After 30 years you'll have $7,612 if you obtain a 7 percent annual return. If you withdraw $7,612 to pay for medical expenses, the money is tax-free.



If you withdraw $7,612 from a traditional IRA to pay for medical expenses or anything else, you'll have to pay income tax on the distribution. If you're in the 22 percent income tax bracket, you'll be left with only $5,938 to pay your medical expenses.

If you max out your HSA each year and don't take many distributions, you could end up with a substantial sum saved. A family that makes maximum HSA contributions for 30 years can end up with nearly $1 million after 30 years, based on an annual 7 percent growth rate. A couple that opens an HSA at age 50 could have over $200,000 in their account by the time they reach age 65 and enroll in Medicare.

Doubt that you'll ever have enough out-of-pocket medical expenses to justify putting so much money in an HSA? Think again. Personal finance experts estimate that an average retired couple age 65 will need at least $300,000 to cover health care expenses in retirement.[16] Some will need more.

Takeaways

You can open an HSA if you are covered by a high-deductible health plan with a minimum annual deductible of $1,400 for self-only coverage and $2,800 for family coverage. The maximum annual deductible may not exceed $7,050 ($14,100 for family coverage).

An HSA is like an IRA for health care. Contributions are deductible up to annual limits. You can invest the money in various ways, and the money in the account grows tax-free.

Although HSAs were intended to help people pay medical expenses, HSAs can serve as a highly flexible retirement account because you are not required to take minimum distributions or distribute any amount at all.

HSA distributions used to pay medical expenses are tax-free. Distributions for anything other than medical care are taxed at regular income tax rates and, if taken before age 65, are subject to a 20 percent penalty.

No other tax-advantaged account gives you

- a tax deduction for contributions,
- tax-free growth, and
- tax-free distributions.

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1 IRS Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans (2021), dated Jan. 6, 2022, p. 4.
2 Ibid., p. 3.
3 Ibid.
4 Ibid., p. 8.
5 Rev. Proc. 2021-25, Sec. 2.01.
6 IRC Section 223(b).
7 IRS Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans (2021), dated Jan. 6, 2022, p. 7.
8 IRC Sec. 223(a).
9 Ibid.
10 Ibid.
11 Ibid., p. 10.
12 Ibid., p. 8.
13 Ibid., p. 9.
14 Ibid., p. 10.
15 IRS Notice 2004-50 (Aug. 9, 2004).
16 Fidelity Retiree Health Care Cost Estimate.