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Health Care

USING HEALTH SAVINGS ACCOUNTS WISELY

EXECUTIVE SUMMARY

- Health savings accounts (HSAs) are rightfully viewed by financial planners as a powerful retirement savings tool with unmatched tax benefits—if used properly.
- Savers should consider a range of strategies with HSAs—and avoid situations where they can be suboptimal or even harmful.
- HSAs offer both short-term and long-term benefits, with very different financial planning ramifications.
- Eligibility for an HSA requires a high-deductible health plan, so individuals need to evaluate health coverage factors before seeking the tax benefits of the HSA.
- This paper addresses decisions such as how aggressively to fund an HSA, prioritizing these savings against other accounts, and how they fit into a distribution plan in retirement.

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INTRODUCTION

Since 2004, individuals enrolled in high-deductible health plans (HDHPs) have been able to fund HSAs. A Mercer survey showed 80% of large employers (20,000 or more employees) offered HSA-eligible health plans in 2016.[1] As more employers offer these plans, HSA usage has grown steadily to over 20 million accounts and $37 billion in assets.[2] We expect that HSAs will be a growing part of the health care landscape.

In an HDHP, the insured is responsible for a significant portion of health expenses up front before the insurance company pays. However, HDHPs must also include a limit on participants' out-of-pocket expenses. Premiums on these plans are generally lower than more traditional, lower-deductible policies. See Figure 1 for current IRS parameters on HDHPs and HSAs.

FIGURE 1: Key HSA facts (2018)[3]

	Individual	Family
Eligibility	Under 65 and enrolled in HDHP	
Minimum deductible for HDHP	$1,350	$2,700
Maximum out-of-pocket expense for HDHP	$6,650	$13,300
HSA annual contribution limits	$3,450	$6,900
HSA per-person catch-up contribution limit (age 55)	$1,000	$1,000

[1]Mercer National Survey of Employer-Sponsored Health Plans, 2016.
[2]Devenir Research 2016 Year-End HSA Market Statistics & Trends, February 22, 2017.
devenir.com/devenirWP/wp-content/uploads/2016-Year-End-Devenir-HSA-Market-Research-Report-Executive-Summary-1.pdf
[3]IRS Revenue Procedure 2017–37 and 2018–27.

HSAs offer a "triple tax benefit": tax deduction, tax-deferred growth, and tax-free qualified distributions. This essentially combines the benefits of Roth and pretax strategies in an IRA.

The HSA is structured with significant tax incentives to choose an HDHP and save or invest for health costs. Proponents of HSAs often refer to a "triple tax benefit": tax deduction, tax-deferred growth, and tax-free qualified distributions. This essentially combines the benefits of Roth and pretax strategies in an individual retirement account (IRA). In addition, the funds can be used before retirement for qualified medical expenses, without tax or penalty. If used before age 65 for other purposes, however, a 20% penalty is assessed. Figure 2 compares HSAs with other tax-advantaged savings vehicles.

A key consideration in the evaluation of HSAs is the definition of a "qualified medical expense." In general, expenses that would qualify for a federal income tax deduction are considered qualified. (As you might expect, you can't double-dip and count them both as qualified for your HSA and as itemized deductions.) Some insurance premiums are qualified: Medicare, long-term care, COBRA, and coverage while you're unemployed. However, one significant medical premium is not qualified: Medicare supplement insurance, also referred to as Medigap. Hybrid life insurance/long-term care policies are usually considered life insurance and, therefore, aren't qualified.

A helpful feature of HSAs is that qualified medical expenses from prior years can be used to take qualified distributions. The expenses need to have occurred after you established the HSA and cannot have been otherwise reimbursed or used for itemized deductions.[4] This feature adds to the flexibility of HSAs if you can keep good documentation of medical expenses and tax returns (potentially for a much longer time than you would ordinarily keep those records).

FIGURE 2: HSA tax benefits vs. Roth and pretax retirement accounts

Tax rules are federal, unless otherwise noted. Green text represents features of the HSA that are better than the Roth account, pretax IRA, or both. Red text represents relative weaknesses of the HSA.

		Health savings account	Roth (IRA unless noted)	Pretax (deductible IRA unless noted)
Impact of contributions on taxable income:	Federal	Deductible/excluded	Not deductible	Deductible
	FICA	Generally excluded	Included	Included
Maximum individual contribution/catch-up contribution		$3,450/$1,000	$5,500/$1,000	$5,500/$1,000
Maximum retirement plan (e.g., 401(k)) contribution/catch-up contribution		N/A	$18,500/$6,000	$18,500/$6,000
Age for catch-up eligibility		55	50	50
Income limitations to participate		No	Yes for IRA; no for retirement plan	Possible income limitations on deductibility for IRAs
Federal tax on account earnings		Deferred	Deferred	Deferred
Ending age for early distribution penalties		65	59½	59½
Penalty for early distribution		20%	10%	10%
Early distributions not subject to penalty		Qualified medical expenses	Contributions (and limited other penalty exclusions)	Limited penalty exclusions
Taxation of distributions in retirement (post-penalty age)		Qualified medical expenses: tax-free; others at ordinary rate	Tax-free for qualified distributions	Ordinary rate
Required minimum distributions (RMDs)		None	None (for original owner)	Begin at age 70½
Tax treatment for surviving spouse		Ongoing HSA treatment	Ongoing tax-free (but now with RMD)	Ongoing tax deferral (with RMD)
Tax treatment for other heirs		Value immediately subject to ordinary income tax	Ongoing tax-free (but now with RMD)	Ongoing tax deferral (with RMD)

[4]Internal Revenue Bulletin 2004-33 Notice 2004-50, Health Savings Accounts—Additional Qs&As, Answer 39, August 16, 2004.

It is also important to distinguish HSAs from other tax-favored health plans: flexible spending arrangements (FSAs) and health reimbursement arrangements (HRAs). Like HSAs, these other plans feature contributions that are excluded from gross income and tax-free withdrawals for qualified medical expenses. However, there are key differences:[5]

- FSAs have a lower contribution limit and are generally “use it or lose it.” Only $500 of unused amounts at year-end may be carried over to the next year, if permitted by the employer; other unused amounts are forfeited.
- HRAs are funded solely through employer contributions, not employee salary deferrals. Unlike HSAs, they are generally not portable to another employer or convertible to cash.

With this backdrop, some of the key questions facing individuals include:

- Should I fund an HSA before my emergency account? Before my retirement plan?
- How do I choose between the HSA and getting my employer retirement plan match?
- Should I use my HSA for annual expenses or invest it for the future? How should I invest it?
- How do I decide between an HDHP and a health plan with a lower deductible?
- How much is a reasonable amount to put into the account?
- What level of medical expenses should I expect in retirement?
- In what order should I withdraw money from accounts (HSA, Roth, pretax IRA, taxable, etc.) in retirement?

HEALTH SAVINGS ACCOUNT BEST PRACTICES

RANGE OF STRATEGIES AND OUTCOMES

First, let’s evaluate how the HSA can be used, assuming an HDHP is available and cost-effective in your situation. (We will come back to the issue of whether the HDHP makes sense.) Most of the possible outcomes are positive, but there are some situations to avoid. We’ll start with the good ones.

Good: Contribute the amount of medical expenses you expect to incur in a year and use it as needed. You get two of the three HSA tax benefits: deductible contribution and tax-free withdrawal. In this case, you would keep the balance in cash (or something similar), so you wouldn’t really get the third benefit of tax-deferred investment earnings. Essentially, you get a deduction for your medical expenses without having to itemize or exceed the minimum threshold. If you don’t use an HSA (or other tax-advantaged account), you can only deduct medical expenses that exceed a percentage of your adjusted gross income.

If you have trouble estimating your medical expenses for the year, consider contributing enough to cover a single sudden expense before meeting your deductible.[6]

Better: Contribute more than your expected medical expenses, building the account to completely cover one or more years of maximum out-of-pocket costs. Build the cushion by only drawing on the account for large or unusual medical expenses, not the routine ones. This reduces the financial risk of a major health issue. While most of this balance should be in cash, you can start investing the longer-term portion, which puts you on the path to the “best” scenario below.

[5] IRS Publication 969.

[6] If you have a choice between low- and high-deductible plans, you could instead contribute an amount that helps you evaluate whether you made the right choice. See the Appendix on page 13 for further information.

If you're in a position to invest the HSA for the long term, it can help cover a significant expense in retirement.

This approach may have you thinking of the HSA as part of your emergency fund, but you need to be careful here. Using HSA funds in the event of job loss, major home repair, or other nonmedical emergencies is a bad idea because of the 20% penalty. You still need other emergency savings.

Best: Contribute at or near the maximum and invest most of it for the long term. By long term, we mean investments such as stocks, bonds, and funds that contain those securities, as opposed to cash and equivalents. This strategy provides the full triple tax benefit. If you're in a position to use this strategy, it can help cover a significant expense in retirement. And in addition to the benefits already mentioned, using tax-free distributions instead of tax-deferred accounts may prevent you from jumping to a higher tax bracket or incurring higher Medicare premiums.

As noted above, Medigap premiums are not qualified expenses for the HSA. If you build a significant HSA balance, you could be in a position to shift your expenses from nonqualified to qualified by choosing the high-deductible version of Medigap Plan F. That type of plan may be more cost-effective than one with a lower deductible, especially if you're fairly healthy.

Conversely, here are some HSA situations with negative consequences that can be avoided.

Very Bad: Using the account before age 65 for nonqualified expenses. As noted in Figure 2, this results in ordinary tax on the withdrawal plus a 20% penalty. This penalty is worse than early withdrawal penalties from retirement accounts, so drawing on the HSA for nonmedical spending should be a last resort. Since it's logistically easy to take money out of your HSA (compared with a retirement account), you need to be careful to avoid this temptation. The HSA should not be considered your emergency fund.

Suboptimal: Dying with a significant unused balance and leaving the account to a non-spouse beneficiary. This isn't as bad as the "very bad" example above because upon death, the balance is not subject to the 20% penalty. It does, however, incur ordinary tax for your beneficiary. In a sense, this is like a Traditional (pretax) IRA, except you don't have the ability to stretch the tax deferral to the next generation.

The HSA should not be considered your emergency fund.

This scenario is especially undesirable if your beneficiary has a higher tax rate than you did when you contributed. In this case, it would have been better to use a Roth account or even a taxable account with gains free of tax due to the step-up in basis. This may seem like an unlikely scenario since someone able to amass a large HSA balance might have been in a high tax bracket. However, prodigious savers aren't necessarily high earners—a person's natural inclination to save is a major factor.

Leaving a balance to your spouse is a different story—it becomes his or her HSA, which is fine. Then, the outcome depends on whether the surviving spouse uses the account effectively or leaves a balance to other beneficiaries.

Fair: Using the HSA for nonqualified expenses after age 65. This results in ordinary tax but does not incur the 20% penalty. Like the previous suboptimal example, it's similar to using a Traditional IRA. This isn't the preferred way to use the HSA, but it does not leave a big tax bill for your heirs in a single year after you die.

If you won't be able to spend all of your HSA for medical expenses, you have a choice between this scenario (spending it on other things) and leaving it to a beneficiary (as noted previously). If your heirs are in a lower tax bracket than you, the "suboptimal" strategy of leaving it unused could actually be better. But remember that a large HSA inheritance could bump someone into a higher bracket for that year.

PRIORITIZING HSA CONTRIBUTIONS

There are many competing priorities for the money we're able to save. While HSAs are a great way to save, we need to consider how they fit in an overall plan.

First, because of the steep penalty for nonqualified expenses, building your emergency fund and paying off high-interest debt (credit cards) should take priority. This keeps you away from the "very bad" outcome of a 20% penalty.

Next, consider the "good" strategy described previously. That approach is an expense management tactic, rather than an investment decision. If you're likely to incur those medical expenses, you should get the tax benefit. (And unlike FSAs, which have use-it-or-lose-it issues, your HSA balance fully carries over year to year.)

Now, the next question may be whether to invest in the HSA or your company retirement plan. If the 401(k) offers a company match, you generally want to get that match first. The HSA has a more limited purpose than a retirement plan, and the company match is an automatic benefit you usually don't want to leave on the table. In addition, if you're cash constrained and have to choose between the HSA and your match, the money you're putting into the HSA is likely to be used sooner rather than invested long term. However, depending on your tax bracket and match percentage, the HSA may be better on paper if held long term and used for qualified expenses.[7]

After getting the employer match, the next decision is when to consider the "better" strategy. That strategy is primarily a short-term backstop in case of significant medical costs. Because it's important to begin investing for the long term as early as possible, we recommend that you achieve a solid retirement savings rate before using the "better" strategy. Based on our research, we recommend that people save 15% of their salary (including company contributions) to support their lifestyle in retirement. You don't necessarily have to get to the 15% before starting to invest in the HSA, but you should be making meaningful progress.

At this point, you may also be weighing HSA long-term investments against saving for your children's future college costs, a home purchase, or other goals. The HSA is more tax-advantaged than the typical vehicles for those goals (such as 529 plans and taxable accounts). However, it is certainly reasonable to forgo the HSA tax benefits to achieve important, nearer-term objectives. Again, you don't want to fund those other goals with the HSA because of the 20% penalty.

When you're on track for other goals and able to save the recommended 15% for retirement, you should include the "best" strategy described previously as part of your retirement savings.

In the following sections, we'll discuss whether a high-deductible plan makes sense for you and, if so, how much to invest in an HSA.

HIGH-DEDUCTIBLE VS. LOW-DEDUCTIBLE PLANS

Now that we've covered the basics of HSAs and how they can fit into your financial plan, let's take a step back. Some employers offer a choice of low-deductible health plans (LDHPs) and HDHPs. (The deductible in the former may not seem particularly low to you, but we'll use that terminology to make the distinction.) Since only HDHPs are eligible for HSAs, you need to make this decision first. However, that analysis should reflect the value of the HSA tax benefit versus other alternatives.

The first step is to estimate your annual health care expenses (before the impact of insurance plan rules). This is obviously challenging because your usage of health care services can vary widely year to year. As a baseline, you can start with the expenses you incurred in previous years and adjust for any known changes.

[7] Geisler, Greg. 2016. "Could a Health Savings Account Be Better Than an Employer-Matched 401(k)?" *Journal of Financial Planning* 29 (1): 40–48.

If you are able to invest long term using the HSA, the additional tax benefit could make a high-deductible health plan more appealing.

Using that estimate, calculate your costs under the different plans offered. In addition to providing legally required examples, your employer may offer an online tool to compare the plans based on your situation. If not, the Appendix on page 13 shows how to estimate your costs (with some simplifying assumptions). The key factors are typically annual premiums, deductibles, coinsurance percentages, and out-of-pocket maximums.

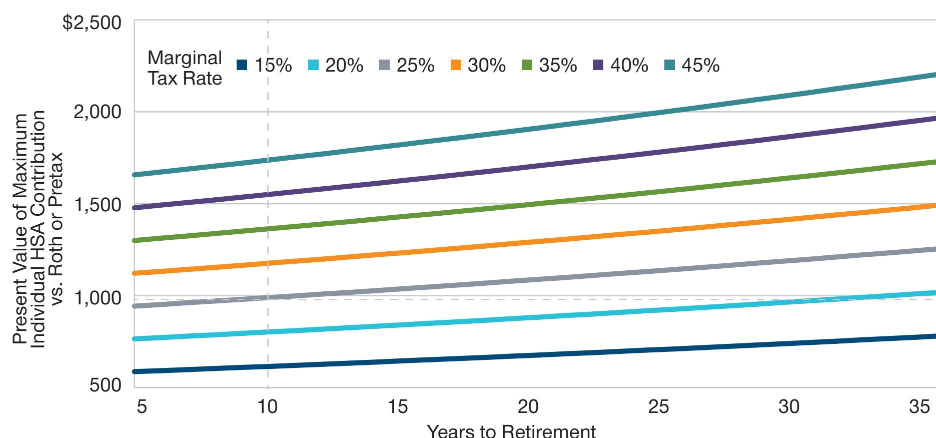
For example, the Appendix shows a choice where the high-deductible plan has a $1,100 lower annual premium and a $2,600 deductible versus $800 for the low-deductible plan. Coinsurance percentages are 20% and 10%, respectively. In that situation, if you incur $2,022 of medical expenses, your total cost will be the same under the two plans. If you expect less than $2,022 of expenses, the high-deductible plan is better; otherwise, the low-deductible plan is preferable.

If you are not in a position where long-term investments in an HSA make sense, this is probably where your analysis ends. Many people have access to an FSA with their low-deductible plan. In that case, in the short term, you get similar tax benefits with an FSA and HSA: tax-deductible contributions and no taxes when used for medical expenses. As previously noted, the FSA has more limitations, including allowable contribution amounts, portability and ability to carry forward balances. However, those differences might not sway the decision if you expect significant medical costs.

If you are able to invest long term using the HSA, that adds a significant tax benefit to consider. Suppose you could shift some of your retirement contributions away from your 401(k) and use the HSA instead. As we've discussed, the HSA has better tax benefits than either Roth or pretax retirement savings if ultimately used for qualified medical expenses. We can estimate the after-tax future value of these different types of contributions at retirement age, based on assumed return rates, number of years, and tax rates. Then, to help with the HDHP/LDHP decision today, we discount those values—essentially converting them to present day values. Figure 3 shows the present value of a single $3,450 HSA contribution, less the value of making an equivalent contribution to a Roth or pretax plan.[8] (By "equivalent," we mean the net after-tax impact on your paycheck is the same.)

FIGURE 3: Incremental value of an HSA contribution

Present value of HSA contributions vs. other tax-advantaged savings at different marginal tax rates (federal plus state)



Assumes 5% return, 4% discount rate, 1.45% FICA tax rate, $3,450 HSA contribution.
Notes on assumptions: If your FICA rate is higher than 1.45%, add the difference to the federal and state rates to determine the marginal tax rate. The values are based on holding the investment until retirement, not longer. Analysis assumes tax rates remain the same from now until retirement (which makes Roth and pretax options equivalent). No company match is included.

[8]Calculations and assumptions by T. Rowe Price. Uses formulas based on: Geisler, Greg. 2016. "Could a Health Savings Account Be Better Than an Employer-Matched 401(k)?" *Journal of Financial Planning* 29 (1): 40–48.

For example, suppose you are in the 25% federal tax bracket, have no state income tax, and are 10 years from retirement. Using Figure 3 (highlighted by dotted lines), contributing $3,450 to an HSA adds incremental value of approximately $1,000 in today's dollars versus using a Roth or pretax plan.[9] As a reminder, that assumes several things, including returns, a discount rate, and especially your intention to hold the investments until retirement. If your hypothetical contribution is different from $3,450, the benefit is proportional (e.g., approximately $500 benefit for a $1,725 contribution).

Armed with that knowledge, your decision on an LDHP versus an HDHP may change. For example, if you estimated that the LDHP would cost you $600 less based on your projected expenses, the additional $1,000 tax benefit means a high-deductible plan with HSA may make sense.

As a reminder, medical expenses are hard to estimate. You should consider a range of possibilities up to the out-of-pocket maximum when making this decision.

A retiree can easily spend $5,500–$11,000 per year on medical expenses, even without long-term care.

ESTIMATING AND FUNDING HEALTH CARE EXPENSES IN RETIREMENT

Deciding how to use an HSA also depends on health insurance and expenses during retirement, which can be very complex. This paper is not intended to explain the full range of options or coverage rules. (For example, we won't address details on Medicare Advantage plans, Medicaid, employer-based retiree coverage, or the many exceptions to general rules around Medicare.) However, we can summarize the likely costs for many people. Upon eligibility for Medicare at age 65, a person's medical expenses can include:

- Medicare Part A (hospital) premiums (but most people get this free)
- Medicare Part B (medical insurance) premiums
- Medicare Part D (drug coverage) premiums
- Medicare Supplement Insurance (Medigap) premiums
- Out-of-pocket expenses such as deductibles, coinsurance, and items not covered by insurance
- Long-term care expenses

These expenses can vary widely, largely due to the Medicare premiums. People with higher income levels pay higher premiums. While this affects less than 5% of the Medicare enrollees,[10] it's important to consider, especially for people in a position to aggressively fund an HSA. Figure 4 shows the range of Medicare Part B premiums.

FIGURE 4: Annualized standard Medicare Part B premiums in 2018, based on modified adjusted gross income (MAGI) in 2016[11]

Individual MAGI	Married filing jointly MAGI	Annual Part B premium (per person)
$85,000 or less	$170,000 or less	$1,608
Above $85,000 up to $107,000	Above $170,000 up to $214,000	$2,250
Above $107,000 up to $133,500	Above $214,000 up to $267,000	$3,215
Above $133,500 up to $160,000	Above $267,000 up to $320,000	$4,180
Above $160,000	Above $320,000	$5,143

[9] If you are already maximizing your retirement plan contributions, then the comparison would be between the HSA and savings using a taxable account. The timing and rate of taxation for a taxable account depend on many factors. However, using a taxable account cannot be more tax favorable than a Roth account. Therefore, in this circumstance, the incremental value of the HSA investment is at least as large as the amounts in Figure 3 (given all of the other assumptions).

[10] Social Security Administration Publication No. 05-10536, January 2017.

[11] Source: Medicare.gov. These rates apply to many people, but rates can be lower for those in the lowest income range whose premiums are deducted from Social Security, due to a cap based on cost-of-living adjustments. The average annual premium in that case is $1,308.

LONG-TERM CARE

You will notice that long-term care (LTC) expenses are excluded from the analysis of health care expenses in retirement. LTC can range from in-home assistance, to assisted living environments, to full nursing home care. In general, most of those costs are not covered by Medicare, and Medicaid only comes into play after most of a person's resources are exhausted.

While long-term care should not be ignored, these costs are even more difficult to estimate than ongoing medical costs. A sizable portion of the population will have no long-term care expenses. Others will have some LTC needs but for a limited period (such as the final months of life). Some people will require multiple years of extensive nursing care, which is a major financial risk. In general, because HSAs are not estate-friendly, we do not recommend building an HSA balance large enough to cover multiple years of LTC.

Another option for LTC expenses is to purchase insurance using your HSA. There is a segment of "mass affluent" people who theoretically benefit from shifting this risk to an insurer. (People at the lower end of wealth can't justify or afford the expense, and high-net-worth individuals can successfully self-insure.) Unfortunately, the premiums for LTC insurance have risen sharply, and many companies have gotten out of the business. Given the current state of this insurance market, we would be very cautious about purchasing a long-term care policy. As noted previously, hybrid policies that avoid some drawbacks of traditional LTC insurance are really life insurance, which would not be a qualified medical expense.

Premiums for Medicare Part D vary by location, and the estimated national average annual premium is approximately $650.[12] In addition, these are also subject to income-related adjustments, up to $898 per year in 2018. Even with this insurance, there are typically additional costs out of pocket, such as copayments and coinsurance.

While roughly 80% of Medicare participants do not have Medigap policies,[13] people who have the means to purchase them should certainly consider doing so. As the name suggests, these policies fill gaps in Medicare coverage. Annual Medigap premiums average approximately $2,400;[14] this can vary by plan type, location, and other factors. As noted previously, these premiums are not considered qualified expenses for the HSA.

Out-of-pocket expenses in retirement can also vary widely. Interestingly, people with private insurance such as Medigap tend to spend a little more out of pocket than people relying on Medicare alone. Median annual out-of-pocket payments for individuals age 65 and older (excluding long-term care) were $741 in 2014; nearly 20% of people spent at least $2,000.[15]

Summarizing all of these components, a retiree can easily spend $5,500–$11,000 per year on medical expenses, even without long-term care. Of those costs, roughly $3,000–$9,000 would be qualified expenses for the HSA (see Figure 5).

FIGURE 5: Summary of potential annual health care costs in retirement (per person)
Excluding long-term care (rounded). In 2018 dollars.

	Lower earners; median OOP	Middle of five income ranges; median OOP	Highest earners; top-quintile OOP
Medicare Parts B and D premium	$2,250	$4,250	$6,700
+Out-of-pocket (OOP)	$750	$750	$2,000
=Total qualified medical expenses	$3,000	$5,000	$8,700
+Medigap premium (estimated median)	$2,400	$2,400	$2,400
=Total excluding long-term care	$5,400	$7,400	$11,100

It's worth noting again that these are rough estimates with a wide range of possibilities. In preparing for retirement, individuals should consider many factors—state of residence, overall health level, family history, prescription drug requirements, medical specialists needed, and others. And while we didn't discuss Medicare Advantage plans, those plans are often cheaper than the combination of Medicare Part B and Medigap.

An estimate of annual medical costs should be factored into overall spending and/or income needs, along with other spending categories that could go up or down in retirement.

[12]Source: Jester Financial Technologies.
[13]Neuman, Tricia and Cubanski, Juliette, The Gap in Medigap (The Henry J. Kaiser Family Foundation, September 27, 2016). kff.org/medicare/perspective/the-gap-in-medigap/, accessed April 19, 2017.
[14]Source: Jester Financial Technologies
[15]Gwet, P., Anderson, J., Machlin, S. Out-of-Pocket Health Care Expenses in the U.S. Civilian Noninstitutionalized Population by Age and Insurance Coverage, 2014. Statistical Brief #495. October 2016. Agency for Healthcare Research and Quality. Rockville, MD. meps.ahrq.gov/mepsweb/data_files/publications/st495/stat495.shtml

HSA CONTRIBUTIONS BASED ON POTENTIAL QUALIFIED MEDICAL EXPENSES

Now that we have a rough idea of medical expenses in retirement, we can evaluate how an HSA can help cover those expenses. We built a model that calculates the annualized withdrawals you could take from an HSA under different circumstances. The results are shown in Figure 6, using the following assumptions:

- A single person makes the maximum contributions in an HSA until age 65 ($3,450 today).
- The maximum contribution rises along with health care cost inflation (but is not sharply increased by tax reform or health care reform legislation). Note that this does not include taking advantage of the $1,000 catch-up contribution.
- The HSA is intended to be used over a 20-year period. Often, analyses assume a 30-year retirement, in case people live beyond the median life expectancy. However, because there are disadvantages to leaving a large HSA balance, this analysis uses a shorter time frame.
- The starting age for contributions ranges from 30 to 60.
- Investment returns range from 1% to 3% above the health care inflation rate until retirement. (This helps us to show the results in today's dollars.) For example, if the health care inflation rate is 4%,[16] this assumes investment returns of 5% to 7%.
- Investment returns drop by one percentage point after age 65, reflecting a more conservative asset allocation.

FIGURE 6: Hypothetical annual withdrawals from an HSA

Over a 20-year period from age 65 to 85 (in today's dollars), funded by continuous maximum HSA contributions (currently $3,450)

		Investment return, net of health care inflation		
		1%	2%	3%
Starting age of contributions	30	$7,258	$9,653	$12,882
	35	6,060	7,833	10,136
	40	4,921	6,184	7,768
	45	3,836	4,691	5,725
	50	2,804	3,339	3,963
	55	1,823	2,114	2,442
	60	889	1,005	1,131

Notes: Assumes withdrawals are for qualified medical expenses. Numbers in green are lower than the approximate annual qualified expenses for lower earners with median out-of-pocket expenses in Figure 5. Numbers in red are higher than the approximate annual qualified expenses for the highest earners with top-quintile out-of-pocket expenses in Figure 5. The circled number refers to the example that follows.

Comparing these numbers with Figure 5, some observations can help guide decisions. First, if you're starting to fund an HSA at age 50 or later, you have a pretty good chance to use the account entirely for qualified medical expenses over a 20-year period. There is little downside to fully funding the account if you are able.

If you maximize contributions continuously starting at a younger age, you could end up with more in the account than you will spend on qualified medical expenses in retirement. Preretirement qualified expenses that you haven't already used for itemized deductions or HSA distributions reduce this potential excess. Remember, however, that you can't count non-Medicare insurance premiums as qualified expenses, and you need to keep good records of your expenses for a long time.

[16]Kaiser Family Foundation estimated that the Medicare per capita spending growth rate from 2015 to 2025 will be 4.3%. Cubanski, Juliette and Neuman, Tricia, The Facts on Medicare Spending and Financing (The Henry J. Kaiser Family Foundation, July 20, 2016). kff.org/medicare/issue-brief/the-facts-on-medicare-spending-and-financing/, accessed April 20, 2017.

There is little downside to fully funding an HSA if you are starting after age 50. If you're younger, determining how much to contribute takes more analysis.

To address the possibility of amassing too much in your HSA, you could scale back your contributions accordingly, especially if you have other financial goals to fund. Alternatively, you could start contributing aggressively since you have time to make course corrections. If you do, be sure to reevaluate the situation periodically, including the following factors:

- Whether you expect to face income-related Medicare premium adjustments
- Your health and family history (which could affect typical costs and life expectancy, but perhaps in opposite directions)
- Your likelihood of needing long-term care and whether family members may be potential caregivers
- Your likelihood of continued HSA eligibility
- Preretirement qualified medical expenses (out of pocket) that you haven't used yet for HSA distributions or itemized deductions
- Health care expense trends and legislative developments
- How well your HSA investments have performed
- Your tax bracket (and expected bracket of your heirs, if possible)

CONTRIBUTION STRATEGY EXAMPLE

To help illustrate how someone might choose an appropriate HSA contribution level, consider Jane, a successful, single (and hypothetical) 35-year-old. She earns a low six-figure salary, which would put her in the middle of the three Medicare rate categories (Figure 4). She's in good health and doesn't have large out-of-pocket expenses yet, but her parents have had their share of medical issues. Based on this, she uses the middle column of Figure 5 and estimates that her qualified medical expenses in retirement will be around $5,000 per year (in today's dollars).

Jane's not the most aggressive investor, so she doesn't want to assume the highest potential return on her HSA assets. At this point, retiring at 65 and living at least to 85 seems like a good guess. Therefore, she looks at Figure 6, focusing on the middle column, which assumes a return 2% above health care inflation. That table tells her that if she continually contributes the maximum to her HSA ($3,450, adjusted for inflation), the account could hypothetically cover $7,833 of qualified medical expenses annually for 20 years (circled in Figure 6).

With this in mind, Jane needs to decide whether to fully fund her HSA (and possibly make course corrections in the future) or choose an amount intended to cover her expected expenses. Jane has always worked for large companies and thinks there's a reasonable chance that she will continue to be eligible for an HSA. She also has other financial goals, so she'd prefer to fund those goals, rather than potentially overinvest in her HSA. Since $5,000 is 64% of $7,833, she contributes 64% of the maximum, or around $2,200 per year, to the HSA. She invests it for the long term since the intent is to use the funds in retirement. (Additional amounts could be contributed to cover preretirement qualified expenses.)

So far, our examples have focused on single people, for simplicity. It is important to note that medical costs incurred by a spouse or dependents are considered qualified expenses. This could justify a larger HSA contribution for one spouse, especially when a dual-income household is covered under one medical plan. For example, suppose Jane is married, her husband earns a similar salary, and they have family coverage in the HDHP at Jane's employer. Combined, they may still face Medicare income-related premium increases, so their qualified medical expenses in retirement might be twice as much as Jane's alone. Since we estimated Jane's target contribution around $2,200 if she were single, a $4,400 annual contribution could make sense for their family. Fortunately, that's within the $6,900 limit for a family plan.

BEYOND HEALTH CARE: INVESTMENT AND DRAWDOWN STRATEGY

Once you've started contributing to a health savings plan, you need to manage it. This includes an investment strategy. After you turn 65 and can withdraw the funds penalty-free, you also need a drawdown strategy.

As noted in the section describing a range of overall strategies, there is a difference between short-term expense management and long-term investment. Your HSA can include a combination of both. For expenses you might incur in the next few years (including a reserve for out-of-pocket maximums), keeping your account in cash or a similar short-term option is the appropriate strategy.

For money you plan to invest for the long term, your investment allocation could be similar to a retirement portfolio. In general, that should be a diversified mix, with an emphasis on equities early in your career. Because earnings in an HSA are tax-free if used properly, you want investments with high potential returns. As with a Roth account, you may want to be more aggressive in an HSA than in a pretax account.

Unlike a Roth account, however, you will ideally exhaust your HSA assets before you die. (See the "suboptimal" outcome on page 4.) That leads into both the drawdown strategy and investment approach in retirement.

If there is a significant chance you will not have enough qualified expenses to fully draw down the HSA before death, take distributions from the health savings account for qualified expenses quickly to reduce this risk. This is especially true if you have Roth assets, since you can use the Roth account to continue receiving tax-free growth. And as noted, the Roth account is better for the estate.

However, you may also be choosing between drawing on your HSA and your pretax retirement account. After you turn 70½, that pretax account will have RMDs. If those RMDs could push you into a higher tax bracket, draw down the IRA and/or retirement plan account first to reduce the RMD.

Because you can defer qualified medical expenses to future years for HSA distributions, this gives you additional tax planning flexibility. Consult with a tax advisor or financial planner on an integrated plan. Just remember that you want to ultimately use the HSA for qualified expenses, and you need good documentation.

Because your time horizon for the HSA is shorter than for a retirement account, it should be more conservative approaching and during retirement. Combined with the previous advice about starting out more aggressively, that means the HSA allocation to equities should be decreased fairly rapidly as retirement approaches. The need to adjust equity exposure suggests that an active asset management approach is likely appropriate. Multi-asset products may be useful to help adjust the asset allocation, but they should be reviewed periodically, especially as the time horizon shortens.

It's also worth spending a moment to consider account fees. Because most HSA assets today are in cash, rather than investments, the fee structure may look more like a bank account than an investment account. These accounts often include some combination of fixed monthly charges, fees based on a percentage of assets, and costs per transaction. In total, this may work out to a higher percentage on assets than in a typical retirement account (which usually has larger balances).

If you're using the HSA appropriately, the tax benefit should outweigh the costs unless you're making very small contributions. That doesn't even include potential investment gains. However, if your HSA has a significantly higher expense ratio than your retirement asset accounts, that would be another reason to avoid investing more than necessary to cover expected qualified medical expenses.

An HSA is less estate-friendly than a retirement account, so ideally, you will exhaust your HSA assets before you die.

Because your time horizon for the HSA is shorter than for a retirement account, it should be more conservative approaching and during retirement.

CONCLUSION

Health savings accounts are a wonderful tool to help prepare for a key expense in retirement. While there are many details to consider when using HSAs, here are the key points to remember:

- Due to the 20% penalty on early nonqualified withdrawals, the HSA should not be considered your emergency fund.
- By investing in your HSA and using it for qualified medical expenses in retirement, you get the triple tax benefit: deductible contribution, tax-deferred growth, and tax-free distributions. This can be an important part of your retirement saving strategy.
- Most people should take advantage of the company retirement plan matching contribution before investing for the long term in an HSA.
- If you are committed to a long-term strategy with your HSA assets, that could motivate your decision to choose an HSA-eligible, high-deductible plan instead of a low-deductible plan.
- Leaving a large HSA balance to someone other than your spouse isn't ideal. Try to use the assets for qualified expenses in retirement. That entails estimating your medical expenses and planning the level of HSA contributions accordingly.
- There are many factors that affect your potential medical expenses. Review those factors periodically, especially if you're contributing aggressively to the HSA.
- To take advantage of tax-free earnings, invest your long-term HSA contributions in high-potential asset classes. But as retirement approaches, reduce the risk sharply to prepare for distributions soon after age 65 or 70½.
- As you make key decisions such as participating in an HSA, determining the right contribution level, investing the assets, and taking distributions, consider consulting with tax and financial planning professionals.

APPENDIX: COMPARING LOW-DEDUCTIBLE AND HIGH-DEDUCTIBLE PLANS

In general, a high-deductible plan is preferable if you have relatively low medical expenses. However, calculating which plan is better for you may not be a back-of-the-envelope task. Some, but not all, employers provide online calculators to help with this decision.

In many health plans, the insured pays a deductible before the insurer incurs any costs. (Some employers make a contribution to an HSA or HRA, which could be viewed as a reduction in the deductible.) After the deductible, the insured pays a percentage of costs called coinsurance. The deductible and coinsurance together represent out-of-pocket expenditures. After reaching a maximum out-of-pocket level, the insurer pays all costs. Total costs for the insured include out-of-pocket payments and premiums.

We can represent this mathematically. This model excludes complexities such as different rules for in-network or out-of-network providers, different coinsurance levels for different services, and separate deductibles for the family and each family member.

This model also excludes any tax effects. For someone considering an HSA for short-term spending needs, this is realistic in many cases because a flexible spending arrangement might provide a similar tax benefit.

d = deductible ($)

c = coinsurance (%)

m = maximum out-of-pocket cost ($)

p = premium ($)

x = expenses incurred (in dollars, after any discounts negotiated between the plan and medical providers, but before allocation between insurer and insured)

t = total cost to the insured ($) = $p + \text{minimum}(x, m, d + c(x - d))$

L = subscript to denote low-deductible plan

H = subscript to denote high-deductible plan

To determine whether the low-deductible or high-deductible plan is preferable, we look for a break-even point: the level of expenses (x) where total costs are equal for the two plans ($t_L = t_H$). This is complicated, somewhat, because the formula for t includes a minimum of different values. So let's assume that the difference in deductibles for the two plans is greater than the difference in premiums, which seems like a common plan design. (More precisely, the break-even point below holds where $(d_H - d_L)(1 - c_L) > p_L - p_H$). In this case, the break-even is:

$$x = (p_L - p_H)/(1 - c_L) + d_L$$

You will notice that if there is no coinsurance, the break-even point is the difference in premiums plus the deductible in the low-deductible plan. Assuming the coinsurance percentage is relatively small, this is a helpful approximation or rule of thumb.

FIGURE 7: High deductible vs. low deductible example

	Low deductible	High deductible	Difference
Deductible	**$800**	$2,600	-$1,800
Coinsurance	10%	20%	-10%
Maximum out-of-pocket cost	$4,000	$8,000	-$4,000
Annual premium	$5,400	$4,300	**$1,100**
Expenses incurred at break-even point	$2,022	$2,022	—
Out-of-pocket cost	$922	$2,022	-$1,100
Total cost to insured	$6,322	$6,322	—

So in the Figure 7 example, if the employee expects to incur medical expenses below $2,022, the high-deductible plan is preferable. For higher expected expense levels, the low-deductible plan is better. Note that the break-even point is a little above the rule of thumb, which works out to $1,900. (That's from simply adding the bolded numbers in the example.)

In this example, suppose you chose the HDHP, contributed $2,022 to the HSA, and took withdrawals from the account for all qualified expenses (the "Good" scenario on page 3). Then after a year, if you increased the balance from the prior year, that quickly verifies that the HDHP was the right decision for that year.

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