The Manifold Beauties of the "Health Care IRA"

When people think about investment options for retirement, they typically focus on the more well-known options such as IRAs and 401(k) plans. Perhaps those more in the know would include Roth IRAs and 403(b) plans in the discussion. But there is another option that, while much less understood, is potentially even more beneficial to savers than any of those other options: the Health Savings Account, or HSA for short.

HSAs were established in 2003 as part of the Medicare Prescription Drug, Improvement, and Modernization Act, in order to provide individuals like us a way to pay for qualified medical expenses in a tax-advantaged way. But in addition to paying for medical expenses, HSAs have great value as a potential retirement savings vehicle. We'll get to that below, but first let's examine the HSA basics: who can contribute to them, and how and when they can use the funds.

The Mechanics of HSAs

To be able to enroll in an HSA, there are a number of conditions that you must meet:

- You must be enrolled in a high-deductible health plan (HDHP)
- You must not be covered by a non-high-deductible health plan (for example, through a spouse)
- You must not be enrolled in Medicare
- You cannot be claimed as a dependent on someone else's tax return

The third and fourth points seem self-explanatory, but in order to understand the first two we must first know what the heck an HDHP is. A high-deductible plan (HDHP) is a specific term that is defined each year by the IRS, set by the minimum deductible and maximum out-of-pocket expenses allowed.

According to healthcare.gov, for 2019 the IRS defines a high-deductible health plan as "any plan with a deductible of at least $1,350 for an individual or $2,700 for a family. An HDHP's total yearly out-of-pocket expenses (including deductibles, copayments, and coinsurance) can't be more than $6,750 for an individual or $13,500 for a family." For 2020, as in most years, those limits will be increased by about 2% or 3%.

Most Americans get their health insurance through their employers and, thus, most employers that offer high-deductible health plans also offer HSAs. But if your employer does not offer them, you can open your own separate HSA as long as you have a qualifying plan.

When you open an HSA, you will receive either a debit card or checks which can be used to pay for eligible medical expenses. Eligible medical expenses include deductibles, copays, and coinsurance, along with other qualified expenses not covered by the health plan. Insurance premiums cannot be paid for with HSA funds. For a more exhaustive list of what is considered a "qualified medical expense," you can consult this IRS publication that spells out all the details.

Similar to an IRA, there are limits on how much can be contributed into an HSA. For 2019, the annual contribution limits for individuals and families are $3,500 and $7,000, respectively. For those participants that are age 55 or older by the end of the tax year, there is a "catch-up" provision, where the contribution limits are increased by $1,000. For example, a couple in their late 50s with an eligible health insurance plan could set up an HSA and contribute $9,000 to it this year (i.e., the family limit of $7,000 plus a catch-up contribution of $1,000 for each person).

The Advantages of HSAs

IRAs and 401(k)s are great, because they are doubly tax-advantaged: first you are allowed to deduct from your taxable income the money you contribute to them, and then as the account grows any interest or dividends or capital gains accrue to you without being taxed. However, when you withdraw money from an IRA or 401(k) plan, that withdrawal is treated as ordinary income by the IRS. (Roth IRAs are also doubly tax-advantaged but in a different way: the money is taxed before it goes in, and then grows and gets distributed tax-free.) HSAs go one better than that, in that they are *triply* tax-advantaged:

1. HSA contributions are either pre-tax (if through an employer) or tax-deductible (if opened on your own). This tax deductibility applies even for those who claim the standard deduction and don't itemize deductions.

2. You pay no taxes on the growth of the account (like dividends and capital gains).

3. If the withdrawals you make are for eligible expenses, you won't pay any taxes on those withdrawals either.

It is important to note that, assuming you are eligible to contribute to an HSA, you can contribute to it *in addition to* an IRA. You could, in that case, max out your contribution to both tax-advantaged accounts. Also, just like with an IRA, you can invest your HSA funds in things like mutual funds and stocks which have the potential for a much higher returns than cash over the long term.

And if all of this so far has not sold you on opening up your own HSA tomorrow, consider this. Any money taken out of an HSA prior to age 65 and used for non-qualified expenses are subject to both regular income taxes and a 20% penalty. However, after age 65 that penalty goes away, which means that if you don't have enough qualifying expenses to use up all the money in your HSA, then your HSA has basically just converted itself into an IRA. That is, after age 65 you can use HSA funds for anything you want. Sure, the IRS will treat those distributions as taxable, but that's the same thing it does already for IRA distributions. It is for this reason that some financial planners refer to HSAs as "health care IRAs."

Still not convinced? OK, we'll give you one more selling point: you don't need to disburse the funds in an HSA at the same time the qualified health care expense is incurred. In other words, you can use tax-free HSA funds to reimburse yourself for qualified medical expenses that you had made years earlier. Thus, the best way to use these accounts is to let them grow untouched for many years, growing in a tax-free manner. During that interim, surely you will have some medical expenses that you pay out-of-pocket. Then, decades later you can reimburse yourself for those expenses from the HSA account. And all that time you will have paid no taxes on any of it.

Caveats

The only caveat on the point immediately above is that it is imperative that you keep good records over the years. You will need to save all your expense receipts and credit card statements, showing that you originally used non-HSA funds to pay for those expenses that you will later be reimbursed for. But that burdensome process should be worthwhile in light of the potential tax savings.

Also, HSAs differ from another government program designed to help us save for healthcare expenses. This is called an FSA (Flexible Spending Arrangements), which does not have as many restrictions as an HSA does, but it also does not offer nearly as many benefits.

Given that the federal government and the IRS are involved in the administration of HSAs, there are several little details to be aware of so that you don't get tripped up. For instance, even though HSAs can be used to pay for the medical expenses of yourself, your spouse, or any dependents you have, they are still listed in one person's name only. So if you and your spouse each want to take advantage of the $1,000 catch-up contribution, you can contribute $8,00 to your HSA (the 2019 family limit of $7,000 plus your 55-&-up $1,000 catch-up) but your husband will have to open his own HSA into which he can contribute *his* 55-&-up $1,000 catch-up contribution. Weird, yes, but we didn't make the rules. In short, you should probably check in with a good CPA to make sure you understand all the little intricacies.

Conclusion

If you are currently enrolled in a high-deductible health plan that is HSA-eligible, you should seriously consider opening an HSA. Not only do these accounts help, in a tax-advantaged way, to pay for the rising cost of medical expenses, but they also serve as great vehicles to save for retirement. While these accounts are less used and less understood than the more widely-used IRAs, they are potentially better saving vehicles.

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