The Retirement Account Hiding in Plain Sight

If you've been saving towards retirement for any length of time, chances are you've heard about IRAs, Roth IRAs, 401(k)s, 403(b)s, and 007(e)(i)(e)(i)(o)s (okay, that last one wasn't real). All these accounts are great, and you should be using them as best fits your circumstance, but there is one other account that can boost your retirement savings that flies under the radar: The Health Savings Account (HSA)*.

For those who aren't familiar with the benefits of an HSA, here are the best features of HSAs so you can understand their value:

- Convenience: You typically contribute to an HSA via employer payroll deduction.
- Tax Savings: Your contributions are tax-deductible (i.e. you don't pay federal or state income taxes on the contributions).
    - For 2021, a family can contribute a maximum of $7,200 into an HSA or and individual can contribute $3,600.
- *Even better*, your contributions avoid payroll deductions for Social Security and Medicare. That's a 7.65% savings on every dollar you contribute! (Not even 401(k) contributions avoid payroll taxes.)
- You have the option of investing your HSA in stocks, bonds, and cash.
    - If you invest your account, any growth is tax-deferred and potentially tax-free (see next feature).
- You can withdraw money from your HSA for out-of-pocket qualified medical expenses as a tax-free withdrawal.
- Unlike IRAs and Roth IRAs, there are no income limitations to disqualify you from contributing to an HSA.
- HSA owners age 55 and older can contribute an additional $1,000, for a maximum of $9,200 for a family (2021).
- You can use your HSA to pay for Long-Term Care (LTC) insurance premiums, which qualify as an approved, tax-free withdrawal. Compared to paying for LTC premiums using after-tax dollars, this is another great tax savings!

Now, you may be thinking, 'That's a medical emergency account, not a retirement account' or 'I pay enough towards medical-related things, do I really need to pay more?'. And you are right, the HSA is a great way to save for and pay out-of-pocket medical expenses. But have you ever wondered what happens to the money in the HSA if it never gets used for medical expenses? Unlike a Flexible Savings Account (FSA), where if you "don't use it, you lose it", with the HSA, if you don't use it, you KEEP it!

*For purposes of this article, we'll assume you participate in a high deductible health plan (HDHP) and are eligible to contribute to an HSA.

Before reaching retirement age, the account is great for covering out-of-pocket medical expenses in a tax-efficient way. However, if you were to withdraw from your HSA for a family vacation (not a qualified medical expense), you would be subject to paying income taxes on your withdrawal PLUS an IRS penalty of 20% on the total amount withdrawn for the non-qualified expense.

> As an example, if you withdrew $10,000 for a non-qualified expense before reaching age 65, you would pay $3,000 in taxes (assuming 30% combined tax rate) and $2,000 in penalties, so you would only keep $5,000. If that sounds like a bad financial decision, you're exactly right.

However, and this is the punchline, once you turn age 65, the HSA essentially becomes a Traditional IRA for withdrawal purposes. You can continue to withdraw from it tax-free for qualified medical expenses, but you no longer have a 20% penalty for non-qualified withdrawals! You would pay income taxes on any non-qualified withdrawal (just like a Traditional IRA) but the 20% penalty goes away once you turn age 65, creating another retirement account you can use to fund expenses (and no Required Minimum Distributions apply either!).

If you have left HSAs behind at old employers or have questions about how an HSA fits into your personal retirement plan, please reach out to Kaleb Paddock at Ten Talents Financial Planning.

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