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How An HSA Compares To A 401(k) For Retirement Planning

David Kudla *Forbes* Contributor
Retirement
I write about investing, retirement, & workplace savings plans.

A Health Savings Account (HSA) is a savings vehicle for people who are enrolled in high deductible health plans to save for future medical bills. The features of HSA accounts also make it a very good retirement savings vehicle, and in some ways, are better than a 401(k).

HSA contributions are pre-tax, if made by payroll deduction, or tax deductible if made by the participant. Maximum contribution amounts for 2020 are $3550 for self-only and $7100 for families. There is an annual "catch-up" amount for individuals age 55 or older of $1000. Contributions to HSA accounts are allowed up to that year's tax deadline (usually April 15).

Unlike a Flexible Spending Account, contributions to an HSA are allowed to grow tax free and can be carried over from year to year. It can be used for current medical expenses or be used for expenses down the road. If the investment choices within the HSA plan are adequate, the participant should consider keeping the contributions in the plan to grow tax free until retirement, unless a large medical emergency arises. Any distributions made for qualifying medical expense are completely tax free. Also, once a participant turns 65, the participant can take distributions penalty-free (but not tax free) from an HSA. This would essentially turn the HSA into a retirement account when considering taxes.

Now let's compare the HSA to a 401(k) by their most basic tax benefits. With a 401(k), contributions are made on a pre-tax basis but are subject to Social Security and Medicare tax. On the other hand, contributions to an HSA are not subject to Social Security and Medicare tax. Both allow the contributions to grow tax free. With a 401(k), distributions are taxed as ordinary income and can be taken out penalty-free after age 59 ½. There are some circumstances where you can take distributions before age 59 ½, but for purposes of this article, we will discuss them at a different time. HSA distributions can be made at any time, penalty and tax free, for qualified medical expenses and after age 65 penalty-free. You can also use the HSA to pay for Medicare Part B, Medicare Advantage (Part C), a prescription drug plan (Part D), and out of pocket Medicare expenses such as co-payments and deductibles penalty and tax-free. However, you cannot pay premiums for a Medicare supplemental policy tax-free. You can also pay for qualified long-term care services and certain amounts for premiums for long-term care insurance. It's fairly clear by now that the advantage of the HSA is its flexibility in terms of distributions and tax treatment.

When deciding how much to add to your HSA and your 401(k) there are some easy rules of thumb. First, many employers will match up to a certain percentage of an employee's contribution to a 401(k). Always make sure you contribute enough to get the entire match. After that, you may want to consider investing into the HSA before adding more dollars to a 401(k). Consider this: an HSA has a potential triple tax benefit that a 401(k) does not have. The initial dollars you contribute are free of Social Security and Medicare tax. Second, contributions that are made are considered pre-tax. Third, if the dollars are spent on qualified medical expenses, then the distribution is tax free and penalty free. If you do not ever need to spend your HSA contributions on medical expenses (although you probably will at some point), you can treat the account as a retirement account and take them out with the same tax treatment as a 401(k) after age 65. The only downside compared to a 401(k) is you lose the ability to take money out of the plan between 59 ½ and 65 without a penalty and possibly before 59 ½ in some circumstances.

The HSA and 401(k) have different benefits and features and using both together as a retirement savings tool can add flexibility in retirement and stretch your retirement assets further. There are other rules for HSA accounts and 401(k)s not discussed here, so make sure that you discuss further details with a qualified financial professional.