HSAs Offer Benefits Over 401(k)s

BY ANNE TERGESEN

When saving for retirement, there is a place to put money that may be even better than your 401(k).

Most people overlook health-savings accounts, or HSAs, as a retirement-savings vehicle. But these accounts, which were authorized in 2003, come with more tax advantages than 401(k)s and individual retirement accounts when used to cover medical costs, which are a major expense in retirement.

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"It's the most tax-preferred account available," says Michael Kitces, director of financial planning at Pinnacle Advisory Group Inc. in Columbia, Md. "Using one to save for retirement medical expenses is a better strategy than using retirement accounts" to cover those expenses, he says.

Money in HSAs grows tax-free and, if used for medical expenses, also can be withdrawn tax-free.

As with a traditional 401(k) or IRA, an HSA allows you to set aside pretax money without paying federal or state income tax on it. Most people who contribute through payroll deductions also save 7.65% in FICA tax, which finances Social Security and Medicare.

Money in HSAs grows tax-free and, if used for medical expenses, also can be withdrawn tax-free. In contrast, with a traditional 401(k) or IRA, you pay income tax on your withdrawals.

Due to this combination of tax advantages, HSAs—which are paired with the HSA-qualified health plans available on health-care exchanges and offered by 43% of employers—can be a better deal than a 401(k) with an employer matching contribution. That is most likely to be the case if you are in a high tax bracket and the 401(k) match is less than dollar for dollar, says Greg Geisler, an associate professor at the University of Missouri-St. Louis.

For people with a high deductible health plan, "an HSA should be either the first or second place they look to save" for later life, Prof. Geisler says.

To open an HSA, you must be covered by an HSA-qualified health plan.

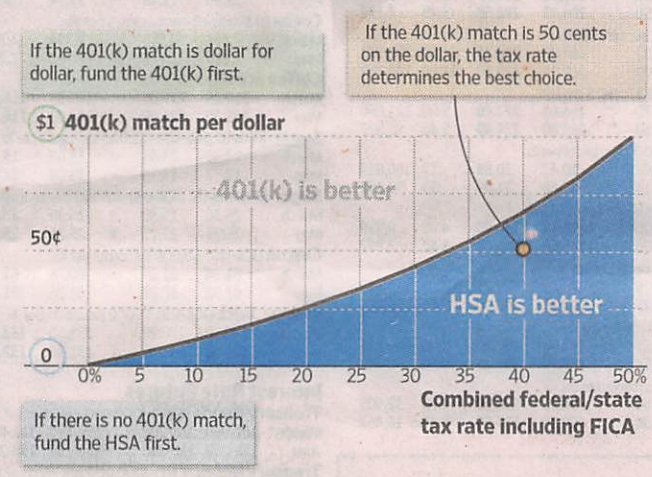
For 2016, these plans have deductibles of at least $1,300 for individuals and $2,600 for a family. In return for exposing policyholders to potentially higher out-of-pocket costs, the plans generally charge lower premiums and offer individuals and families the chance to save up to $3,350 or $6,750 a year, respectively, in an HSA. (Those over 55 can save $1,000 more).

Because employers save on premiums, too, with a high-deductible plan, many contribute to employees' HSAs as an incentive to get them to enroll, says Eric Remjeske, president of Devenir Group LLC, which advises banks offering HSA investment platforms.

The biggest payoff with an HSA comes when the money set aside isn't all used for current medical bills and instead compounds over time, before being used for qualified expenses.

401(k) or HSA?

To figure out if a retirement contribution would grow to a larger sum in a 401(k) or health-savings account, look to your combined federal/state tax rate and any 401(k) match.



Note: Assumes all dollars in HSA go to qualified medical expenses and so aren't taxed.
Source: Greg Geisler of University of Missouri-St. Louis THE WALL STREET JOURNAL.

Those expenses can include not just medical bills but also dental and vision-care expenses, Medicare premiums and a portion of long-term-care insurance premiums.

According to Fidelity Investments, a 65-year-old couple who retire today and live another two decades will spend $245,000 on expenses including Medicare premiums and the 20% of medical costs Medicare doesn't cover—a number that doesn't include dental and long-term-care expenses.

"A lot of people don't think about how to save for health care in retirement, yet it's one of the major expenses people will have," says Roy Ramthun, president of HSA Consulting Services in Silver Spring, Md.

Once you are enrolled in Medicare you no longer can contribute to an HSA. But you can continue to tap your HSA balance for medical expenses for yourself, your spouse and any dependents you may have.

You also can use your HSA for nonmedical expenses, but you will owe income tax on your distributions—and a 20% penalty if you are younger than 65.

Experts recommend those who can afford to contribute to an HSA and a 401(k) kick in the maximum to both. Some employees may want to allocate enough dollars to a 401(k) to get the company match and then direct the next dollars of savings to the HSA.