Optimize Retirement Savings With an HSA Investment Strategy

By Beth Braverman

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What You Need to Know

- Many Americans don't know they can invest their HSA assets and use the gains to cover health costs in retirement, tax-free.
- Money withdrawn for non-medical uses after age 65 carries no penalty but is taxed as income.
- HSA investors should avoid building too large of a balance as leftover funds can cause tax headaches for heirs.

One of the biggest challenges that your clients face when preparing for retirement is making sure they have enough savings to cover their future health care costs. For most Americans, this is one of the biggest expenses they'll face in their golden years: The average 65-year-old couple that retired in 2022 would need $315,000 to cover their health care costs in retirement, **according to an analysis by Fidelity**.

One important tool your clients may be able to use to help cover those costs is a health savings account (HSA). These accounts have become much more popular in recent years, as high-deductible health plans have become more common. There were more than 11 million HSAs with nearly **$33 billion in assets at the end of 2020**, according to the Employee Benefit Research Institute, but many of those accountholders are not making the most of these accounts.

Here's what financial advisors and clients need to know about making the most of these tax-advantaged accounts.

What is a health savings account (HSA)?

An HSA is an account available to consumers with a high-deductible health plan (HDHP) as long as they don't have any other health insurance coverage (including Medicare) and are not claimed as a dependent on anyone else's tax returns. (In 2023, HDHPs must have deductibles of at least $1,500 per year for an individual or $3,000 per year for a family.)

HSAs are the most tax-favored accounts available under the tax code. HSA assets go into the accounts before income taxes and grow tax-free, and withdrawals are also tax-free as long as they're used for qualified medical expenses. They are not subject to required minimum distributions.

Qualified medical expenses include a wide range of out-of-pocket health-related costs, including Medicare and long-term care insurance premiums, co-payments and deductibles for visits, and dental or eye care — **even items like sunscreen and tampons**. (Funds withdrawn for non-medical expenses before age 65 are subject to income tax as well as a 20% early withdrawal penalty.)

Many people get their HSAs through their employer and make HSA contributions via payroll deductions; the money in the account belongs to the owner. It rolls over year to year (unlike flexible spending account funds, which are "use it or lose it"), and the owner retains access to the funds after they leave their job.

While you can use the funds to cover current medical expenses, you can also let the money grow and use it to cover such costs in the future.

How much can you contribute to an HSA?

In 2023, you can contribute up to $3,850 for an individual and up to $7,750 for a family in an HSA, including both employee and employer contributions. Those limits are in addition to 401(k) or other retirement account contributions that an individual might make throughout the year.

Like an IRA, you can make contributions to an HSA for the previous tax year until the tax deadline of the next calendar year. That means that you can make a 2022 HSA contribution (up to $3,650 for individuals and $7,300 for families) until April 18, 2023. HSA contributions for tax year 2023 will be due on April 15, 2024.

Can you invest HSA money?

Yes, but the HSA administrator sets the rules for each account. Many custodians have a minimum account balance, typically around $1,000, required before you can start investing, and some only allow accountholders to keep their funds in cash or cash equivalents.

When invested, HSA funds can essentially become an additional spending account in retirement that clients can tap into along with other retirement funding sources such as a **Roth IRA** or Social Security.

However, fewer than 30% of employers position HSAs to employees as retirement savings vehicles, **according to the Plan Sponsor Council of America**. As a result, the vast majority of HSA accountholders (more than 90%, **according to EBRI**) do not invest their HSA funds.

What are the benefits of HSA investing?

There are many benefits to investing HSA funds. For account holders who aren't planning on using the money until retirement, keeping the entire account in cash means that it could lose value over time due to inflation.

Investing the funds, on the other hand, in a diversified portfolio provides the potential for higher longer-term returns. Particularly for those with a longer time horizon, there's an opportunity to invest in assets, such as stock funds, that may have short-term volatility but provide higher returns in the long run.

The favorable tax treatment of HSAs makes them even more valuable when invested. **A Morningstar analysis** found that funds invested in an HSA could potentially triple over 20 years, for a balance 18% higher than the same assets in a 401(k) or IRA account and more than 30% higher than those in a taxable account.

How do you invest your HSA?

You invest an HSA through your account custodian much like you would a 401(k) account. Most custodians offer a menu of investment options, including index funds or exchange-traded funds, from which you can choose. A few HSAs allow for self-directed investments, meaning accountholders can choose to invest in most types of securities, including individual stocks or bonds as well as **alternative investments**.

What HSA investment strategies can be used?

As with other types of investment accounts, there are several strategies you can use when it comes to investing within your HSA. These depend on the options available through the accountholders.

Go all in with a target-date fund.

Like retirement accounts, many HSAs offer target date funds (TDFs) as an investment option for participants. These funds hold a mix of stocks, bonds and other types of investments selected based on your projected retirement date. Over time, they shift to more conservative assets to reduce the risk of losses as that date approaches. They're meant for investors to put their entire balance into the fund, and don't require rebalancing by the accountholder.

Allocate across multiple funds.

If your client's HSA offers a variety of stock and bond index or exchange-traded funds or mutual funds, you can help them determine the most appropriate allocation for their financial picture from those funds. These fund options are often similar to those found in a typical **401(k) retirement plan**.

Build a custom portfolio.

While most employer linked HSA accounts offer only fund or cash investment choices, there are also self-directed HSAs, which allow the accountholders to invest much like they would in a self-directed IRA.

The IRS allows HSA rollovers once per year, so clients interested in building a custom portfolio can move the funds out of their workplace account and into a self-directed HSA if they're interested in investments that are not available in their workplace HSA. Or clients can contribute the cash directly into their out-of-plan HSA and deduct the contributions on their tax returns.

What are the potential drawbacks of HSA investing?

While there are many benefits to investing via an HSA, there are also drawbacks to consider.

The account could lose value over time.

As with any investment strategy, there's always the possibility that the portfolio could lose value during times of market volatility. Those who need their HSA funds to cover current medical expenses, or those they expect to incur in the near few years, are likely better off keeping some or all of their HSA in cash. Or, they might work to build up an emergency fund with at least enough money to cover the **annual out-of-pocket maximum** for an HDHP ($15,000 for families or $7,500 for individuals in 2023).

The fees may be high.

The fees associated with HSAs can be higher than some other types of retirement savings. Most employers cover account maintenance fees, which average under $3 per month, **per a report from the Plan Sponsor Council of America**. The average HSA also has six to 10 additional one-off fees, according to Morningstar.

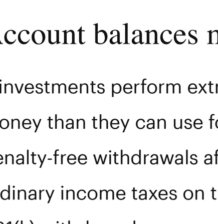
Account balances might grow too large.

If investments perform extremely well over time, accountholders might have more money than they can use for medical expenses. In this case, they can still make penalty-free withdrawals after age 65 for non-medical purposes, but they'll owe ordinary income taxes on the distribution, meaning they're treated essentially like 401(k) withdrawals.

A bigger drawback to overfunding HSA accounts is that if you die and want the assets to go to anyone other than your spouse, they'll likely face a large tax bill. That's because while HSA ownership can transfer easily to a spouse who is a named beneficiary, the account will convert to an ordinary, taxable account for any other heir, and they'll have to claim it as taxable income.

Here's how to get started with HSA investing.

Getting started with HSA investing is fairly straightforward. Most HSAs have an online portal, typically accessible through an employer benefits website, through which accountholders can make changes to their account allocation. If their HSA does not offer investment options, they can open an account at an outside brokerage firm and roll the funds over to start investing.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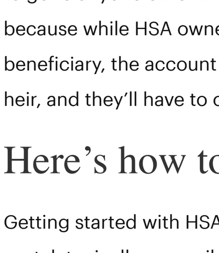
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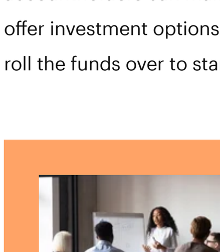
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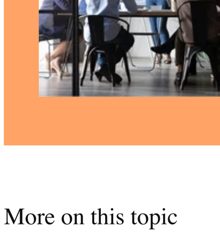
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