PNC CENTER FOR FINANCIAL INSIGHT

The PNC Center for Financial Insight℠ builds bridges from thought to action, creating practical, applicable strategies to help benefit you and your family.

Planning for the Future with Health Savings Accounts

Health savings accounts (HSAs) can provide a unique means to fund medical expenses in retirement. For those who wish to retire early, HSAs can help cover health care expenses before becoming eligible for Medicare.

Many people tend to use their HSAs to pay for medical expenses in real time, withdrawing money as expenses are incurred. But we believe there's a real planning opportunity in waiting. HSAs can provide a unique solution to help cover future medical costs, from out-of-pocket expenses for those who retire early to large medical expenses in retirement that would otherwise require a retirement plan withdrawal.

HSAs offer multiple tax benefits as well. Similar to 401(k) retirement plans and individual retirement accounts (IRAs), money can be allocated to investment options.[1] There are no federal taxes on the money you contribute through payroll deduction or on any investment earnings while the money is in the account.[2] Unlike 401(k) plans and IRAs, there are no taxes on qualified withdrawals.[3]

You can create a nest egg for future health care expenses by leaving your money in an HSA to accumulate and grow while using other funds to pay for current expenses. You can also apply your HSA to cover not only current expenses but any past qualified expense that has been paid with non-HSA funds as long as the expense was incurred after you established the HSA and you retain receipts.

Funding Postretirement Medical Expenses

Many people who wish to retire before age 65 find a major roadblock to their plans can be the ability to pay for medical expenses during the gap before they become eligible for Medicare.[4] While premiums for health insurance other than Medicare are generally not qualified expenses, you can use HSA money for deductibles associated with the health insurance plan you do obtain as well as co-pays and prescription drug costs.[5]

[1] Once your balance reaches a minimum specified by the trustee/custodian.

[2] Internal Revenue Service. February 10, 2017. *Publication 969 Health Savings Accounts and Other Tax-Favored Health Plans*, Department of the Treasury, p. 2. Accessed August 28, 2017, https://www.irs.gov/pub/irs-pdf/p969.pdf.

[3] Ask your advisor for PNC's article *Health Savings Accounts* for more details on how HSAs work.

[4] Centers for Medicare & Medicaid Services, *Original Medicare (Part A and B) Eligibility and Enrollment*. Accessed June 28, 2017, https://www.cms.gov/Medicare/Eligibility-and-Enrollment/OrigMedicarePartABEligEnrol/.

[5] Insurance premiums are considered qualified expenses if they are for the following: long-term care insurance; health care continuation coverage, for example, COBRA;

For example, a 65-year-old man may need as much as $168,000 and a 65-year-old woman as much as $187,000 to cover health care costs in retirement beyond what Medicare covers, according to research by the Employee Benefit Research Institute.[6] HSAs can be used to pay Medicare premiums, deductibles, and co-pays and to cover medical expenses not covered by Medicare, such as hearing aids and most dental care. In some cases, maintenance and personal care services, such as assistance with disabilities, can also be covered if they meet stringent qualifications.

The tax-free withdrawal feature of HSAs can be a particularly important income source in retirement. When traditional IRAs and 401(k) plan accounts are used to pay large spikes in expenses, such as for medical costs, there may be financial implications beyond the need to pay taxes on the withdrawal. The increase in taxable income can lead to higher Medicare premiums, more Social Security benefits taxed, and raising your tax bracket.[7] HSA money can be taken out for past paid qualified health care expenses and used for anything, such as unplanned home repairs, a vacation, or a new car, as long as receipts for the qualified expenses are retained.

Roth IRA plans and Roth 401(k) plans, like HSAs, do allow for withdrawals without tax ramifications. However, contributions are made after-tax, and withdrawal of earnings prior to age 59½ can carry penalties and/or be taxed.[8]

After taking advantage of any 401(k) employer match, you may want to consider contributing to an HSA

Example

Melissa, age 40, first contributes 6% of her salary to her employer's 401(k) plan, taking full advantage of a 50% match.[9] She then invests the full $3,400 into her HSA that she is allowed in 2017. Although she incurs $2,000 of medical expenses throughout the year, she chooses to pay them from a different, taxable account. By letting the full $3,400 grow tax-free, she could have $15,000 available at age 65 to withdraw and spend, all tax-free on qualified medical expenses. If she continues to contribute $3,400 each year, she could have a total of $187,000 at age 65—the estimate of her total health care costs.[10] She could then withdraw $2,000 at any point in time based on the expenses she incurred when she was 40, assuming she kept the receipts for those expenses.

[6] For those with drug expenses at the 90th percentile throughout retirement and who want a 90% chance of having enough money saved for health care expenses in retirement by age 65. Source: EBRI Notes, January 31, 2017, *Savings Medicare Beneficiaries Need for Health Expenses: Some Couples Could Need as Much as $350,000,* Employee Benefit Research Institute.

[7] Ask your advisor for PNC's article *Roth, Traditional, or Both: Considerations to Weigh* for more details on the effect of large withdrawals from traditional accounts.

[8] Roth contributions may be withdrawn at any time without taxes or penalties (subject to plan rules if a Roth 401(k)). Earnings may be withdrawn tax-free and penalty-free once the account has been open for at least five years and you reach age 59 1/2, become totally disabled, or die.

[9] The most common match in 401(k) plans is 50 cents for each $1 contributed, up to 6% of salary. Source: Ashlea Ebeling, "Beware These 401(k) Match Traps," *Forbes.com*, May 26, 2017. Accessed August 28, 2017, https://www.forbes.com/sites/ashleaebeling/2017/05/26/beware-these-401k-match-traps/#6cea8069391c.

[10] Assumes a 6% rate of return.

How you manage HSA withdrawals evolves over your lifetime.

because it provides tax benefits that are superior to both Roth and traditional accounts. Though HSAs can only be applied to qualified medical benefits to receive tax-free withdrawals, we believe planning for medical costs is an important part of retirement planning.

Managing Withdrawals

How you manage HSA withdrawals evolves over your lifetime. For example, two important withdrawal considerations are the balance in the HSA and marital status. Upon death, HSA accounts pass to the living spouse and retain all tax features.

However, when HSAs pass to nonspousal beneficiaries, the balance becomes taxable income to the beneficiary for the year of the HSA owner's death. It may make sense in certain circumstances for a single person to spend down the HSA—recognizing that if there are qualified medical expenses in the year of your death, the HSA may be used to pay for those expenses before going to the nonspouse beneficiary.

On the other hand, if you are in a lower income tax bracket than a nonspouse beneficiary, you may consider naming your estate as the beneficiary of your HSA, primarily because its value will be included in your final tax return and will be taxed at your lower income tax rate versus the nonspouse beneficiary's higher income tax rate.

An HSA provides a unique combination of tax benefits not available with any other account. Through careful planning, you can create a pool of money to help manage health care expenses in your retirement years.

Balancing When to Withdraw

The decision when to use HSA money and when to seek other resources requires a well-planned, evolving strategy. Below are some considerations to discuss with your advisor:

- marital status;
- balance in the account;
- your tax rate versus nonspouse beneficiary's tax rate; and
- impact of unplanned expenses during retirement.

For more information, please contact your PNC advisor.