

## USING HEALTH SAVINGS ACCOUNTS AS A RETIREMENT VEHICLE

Over the last decade, many investors have begun to realize that their employer sponsored retirement plan assets (whether they be part of a defined contribution plan or a defined benefit plan) may not be enough to support their income needs in retirement. Many investors who are maximizing contributions under their employer-sponsored 401(k) plans and IRAs are seeking additional options for tax-deferred savings. For some, the solution may be right under their noses — health savings accounts (HSAs).

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More and more, employers are offering high-deductible health plans (HDHPs). Over half of companies surveyed by the Healthcare Trends Institute in 2016 reported offering this option in 2015, up from 39% in 2014 and 28% in 2013. That trend is predicted to continue. The presence of an HDHP opens the door for more HSA participation.

When first introduced in 2003, HSAs were designed to help individuals covered by HDHPs pay for qualified medical expenses and save for similar future expenses on a tax-free basis. However, HSAs have the potential to be a very powerful retirement savings vehicle as well. Many retirees face increased medical expenses during retirement, so the need for additional assets to pay these growing expenses becomes even more important. Initially, HSA accounts were established at banks and other savings institutions for current health care and medical expenses. Generally, the HSA assets were either left as cash or invested in CDs with minimal returns. At first they were not considered for long-term investment purposes. Over time, however, account owners sought investments that would yield greater returns. Now, practically all investments found in an IRA or retirement plan are available in an HSA. In addition to CDs, individuals can invest their HSA dollars in money market options, mutual funds or even self-directed brokerage accounts (subject to the limitations of the HSA provider).

HSAs combine several of the tax benefits associated with employer-sponsored retirement plans and traditional and Roth IRAs: contributions are tax deductible (regardless of income), earnings grow tax-deferred, and qualified distributions are exempt from federal tax and penalty. Although nonqualified distributions would be taxable, any penalty is waived upon reaching age 65.

Freedom of investment choice and portability between employers enable HSA owners to potentially accumulate a larger account balance to use for medical expenses (or nonmedical expenses) in retirement. As with any invested asset, there is always the risk of loss due to market performance.

### HSA eligibility

Among other things, HSA eligibility is contingent upon coverage by an HDHP. As the cost of medical coverage continues to rise, more and more employers are turning to HDHPs as a more cost-efficient way to provide medical coverage to their employees. In 2016, 19% of firms offering health benefits offered HDHPs with HSAs. The percentage was 9% in 2011.<sup>1</sup> Over four out of five HSAs (85%) have been opened since 2011.<sup>2</sup> Consequently, this shift in medical coverage offerings is contributing to the growth of HSAs.

For 2017, HDHPs have a minimum annual deductible of \$1,300 and a maximum out-of-pocket expense of \$6,550 for single coverage (\$2,600 and \$13,100, respectively, for family coverage).

<sup>1</sup> Kaiser Family Foundation, 2016 Employer Health Benefits Survey

<sup>2</sup> Employee Benefit Research Institute, Issue Brief, November 29, 2016.

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Besides HDHP coverage, other HSA eligibility criteria include:

- No coverage by any other non-HDHP
- No enrollment in Medicare
- Cannot be claimed as a dependent on someone else's tax return

### HSA contributions

While the contribution limits for HSAs are not as high as they are for 401(k) plans, it is still possible to accumulate large HSA balances over time. The Employee Benefits Research Institute (EBRI) estimates a person contributing for 20 years to an HSA could save between \$118,000 and \$193,000, and those who contribute to an HSA for 40 years could save up to \$360,000 or more (This assumes a 2.5% rate of return and no withdrawals).

One of the many great features of the HSA is that contributions can come from individuals, employers or a combination of both. The maximum that can be contributed each year depends on the type of HDHP coverage (i.e., self-only vs. family). For 2017, the contribution limit for family coverage is \$6,750 (\$3,400 for self-only coverage). In addition, similar to IRAs and qualified retirement plans, HSAs also allow for catch-up contributions. For 2017, HSA-eligible individuals who attain age 55 or older before the end of the year are allowed to contribute an additional \$1,000.

But less than one-half (45%) of HSA owners contributed to their accounts in 2015, and only 47% received employer contributions.<sup>3</sup> This may indicate that owners of newer HSAs are not aware of the tax advantages HSAs can provide.

Similar to traditional IRAs, contributions made by individuals to their HSAs are tax deductible. But unlike IRAs, you can deduct your HSA contribution regardless of your income for the year. Contributions can be made by the owner of the HSA or any other person on behalf of the HSA owner. And contributions to a traditional or Roth IRA, or an employer sponsored 401(k) plan, do not affect one's ability to contribute to an HSA. For example, it would be possible for an HSA-eligible individual, age 56, to maximize contributions to an IRA in the amount of \$6,500, contribute the maximum deferral of \$24,000 to a 401(k) plan, plus make a tax

deductible contribution of \$6,750 to an HSA (assuming family HDHP coverage) for a total combined contribution of \$37,250 for 2017. The individual would not be able to deduct the IRA contribution unless income limits are met.

Employer contributions are not deductible; however, amounts contributed by the employer are generally not included in an employee's gross income. Amounts the HSA owner or other individuals are able to contribute will be reduced by any employer contribution to the HSA for the year. Employers generally allocate contributions based on health coverage (self-only vs. family). If a variety of health insurance options are offered through an employer, one factor in considering which plan might be most beneficial is whether or not an employer contribution is available. Receiving an employer contribution to an HSA plus an employer match or profit sharing contribution within a 401(k) plan is a great way for employees to maximize retirement savings potential.

### HSA distributions

There is no specific time limit on when an HSA owner must use the assets of the HSA. The ability to carry over the balance enables the account to continue to grow year after year. This, coupled with tax-deferred growth opportunities, makes it possible to accumulate large balances in an HSA for use in retirement.

The tax treatment of HSA distributions depends on the reason for withdrawal. If an HSA distribution is tied to a qualified medical expense, any contributions plus interest distributed are free from IRS penalty and exempt from federal tax. If the HSA distribution is not related to qualified medical expenses, the distribution is subject to federal tax as ordinary income and also subject to an IRS penalty of 20% (unless the owner is age 65, disabled or the distribution is due to death).

Remember, there is no time limit for using the HSA dollars for qualified medical expenses. Therefore, if a qualified medical expense is incurred in one year but paid out of pocket, this expense can be reimbursed from an HSA at any point in the future without being assessed the 20% penalty.

<sup>3</sup> Employee Benefit Research Institute, Issue Brief, November 29, 2016.

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### HSA distribution example

Lisa, who has HSA-eligible HDHP coverage, makes the maximum HSA contribution each year. From 2009 through 2017, Lisa incurs a total of \$10,000 in qualified medical expenses, all of which she elected to pay out of pocket. In 2021, at the age of 59, Lisa is in need of \$10,000. She has a large 401(k) balance; however, she is still working, and the plan does not allow for in-service distributions. She also has a large IRA balance, but any distribution she takes prior to reaching age 59½ will be subject to an IRS early withdrawal penalty of 10%, because she doesn't qualify for the medical expense or any other penalty exception. Because she kept the receipts from her previously unreimbursed qualified medical expenses incurred between 2009 and 2017 and none of the medical expenses were taken as an itemized deduction at any time between 2009 and 2017, she can elect to take a qualified distribution from her HSA now without being assessed the 20% HSA withdrawal penalty.

The unmatched tax benefits of the HSA make this savings vehicle ideal not only for accumulating assets to pay for current qualified medical expenses but also for accumulating assets to use for other purposes (including qualified medical expenses) in retirement. Investors who are eligible for an HSA but are not maximizing contributions or are not contributing at all, may be missing out.

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