HSAs: A retirement saving tool?

Lula Tadesse: The rapid growth of health savings accounts, or HSAs, in recent years has created more opportunities for individuals to save for retirement and other long-term goals. Indeed, since HSAs were introduced in 2003, HSA assets have grown from $2 billion to about $37 billion in 2016.

Hello, and welcome to Vanguard's Investment Commentary Podcast series. I'm Lula Tadesse.

In this month's episode, which we're recording on September 19, 2017, we're going to discuss HSAs: what they are, why you should consider them, and how to use them effectively.

Joining us today are Andy Clarke and Jonathan Kahler of Vanguard's Investment Strategy Group. They recently coauthored a paper for our *Financial Planning Perspective* series titled *HSAs: An off-label prescription for retirement saving*.

Andy and Jonathan, thanks for joining us, and welcome.

Andy Clarke: Thanks very much, Lula. Good to be here.

Jonathan Kahler: Thanks for inviting us.

Lula Tadesse: Andy, perhaps you can start us off. Can you briefly explain what health savings accounts are and why they're becoming more popular?

Andy Clarke: Yes. HSAs are a special tax-advantaged vehicle that people can use to save for medical expenses. In 2017, an individual or his or her employer can contribute as much as $3,400 to this account. For a family, it's $6,750. The key is that these accounts must be paired with a high-deductible health plan.

Lula Tadesse: So if you're not in a high-deductible health plan, you can't sign up for an HSA?

Andy Clarke: That's right, and that's something to think about during open enrollment season. If you do have a choice between, say, a high-deductible health plan and a traditional insurance plan such as a PPO, you might want to look at the special advantages of opening an HSA in making that decision.

Jonathan Kahler: Yeah, Andy, and I can use myself as an example here. For years, I've had the option to choose either the high-deductible plan or a more traditional preferred provider plan.

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Meet the speakers

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And just looking at the difference in the premiums and the deductible—it seemed like a wash. I didn't really look too much into it. But once I did some more research, and looked at the tax advantages that come with participation with the health savings account, that really pushed the numbers in favor of using the high-deductible plan, for my family anyway.

Lula Tadesse: And they seem to have a lot of tax advantages. How do the tax advantages of the HSAs compare with tax advantages of other familiar savings vehicles, such as 401(k) plans and IRAs?

Jonathan Kahler: Yeah, the tax treatment is what really makes these accounts stand out. And if we compare it to other savings vehicles that we have at our disposal—you know, mainly a traditional IRA or 401(k), or a Roth IRA, or Roth contributions to a 401(k)—what we're really looking at is when we want to pay those taxes.

So do we want to pay the taxes now and contribute to the Roth—let those assets grow tax-deferred, and not have to worry about taxes in the future—or would you rather have the tax deduction in the current year, and use the traditional IRA or 401(k)? And that's basically an assumption of what my tax rate is going to be in the future versus what it is now.

With the HSA, you really don't need to make that assumption. You're going to get the tax benefit on both ends, so you'll get the deduction going into the account. As an added bonus, it's also exempt from FICA taxes, so your Social Security tax and Medicare tax. So if you're under that Social Security taxable wage base, there's an additional benefit there. And then most states have favorable tax treatment as well.

Andy Clarke: As Jonathan mentioned earlier, when we look at different tax-advantaged vehicles, we're usually deciding whether to pay taxes now or later. With an HSA, you can conceivably pay taxes never.

Lula Tadesse: Now this is a health savings account. For advisors out there who are not used to delving into the health insurance coverage of their clients, why does it make sense for them to view HSAs as a retirement savings tool?

Jonathan Kahler: Most advisors are really good at having conversations around an investor's income and assets. They may not be getting into details of benefit plans. But there really is an opportunity to use the HSA as an additional vehicle strategically for long-term savings and additional tax savings.

So it's really something that can add a lot of value for clients, especially since it's not necessarily an obvious use of the account.

Clients we know have a lot of anxiety around health care expenses in retirement, whether that's figuring out the details of Medicare or worrying about potential for large custodial care expenses down the road. So having an account that is dedicated to a health care purpose can also be really helpful to clients.

Andy Clarke: Yeah. I think as we try to explain in our research piece, even though it's labeled a health savings account, this account is really another tool that you can use in a broader financial planning conversation.

Lula Tadesse: And health care is one of the biggest expenses for retirees.

Jonathan Kahler: Absolutely.

Lula Tadesse: So it makes sense. How should advisors help their clients prioritize their contributions to HSAs versus 401(k)s and other retirement plans?

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Jonathan Kahler: That's a really good question. And I think it's going to depend somewhat on the client. So if you have maybe a wealthier client that is already maxing out their 401(k) and taking advantage of tax-advantaged accounts that they have at their disposal, the HSA is just another option for them to save more, and save more in a tax-favored way.

If you are more savings-constrained, and kind of deciding between using one account versus another—that's where it can get a little bit more complicated. We would say that you definitely want to take advantage of any employer match that you have for a 401(k). Generally, that's going to be the most advantageous use of your savings.

Once you have that and have contributed enough to get the maximum employer match, that's when we would say to take a close look at the HSA and, if possible, contribute really as much as you can to that. Because you can generally assume that you're never going to pay taxes on these savings at a later date, you can really look at your tax savings in the current year and calculate the incentive that you get for contributing to that kind of account.

So, for example, if you have a 40% marginal tax rate that would otherwise be applicable, any dollar that you contribute to the health savings account would give you an immediate tax benefit of 40 cents. So looking at it that way, it can kind of help you understand what that benefit is and maybe allow you to understand what your savings capacity is for other accounts as well.

Andy Clarke: You have 40% plus state taxes and potentially payroll taxes in some situations.

Jonathan Kahler: Right.

Lula Tadesse: So it's worth running the numbers and advisors can help their clients do that.

Jonathan Kahler: Yeah, absolutely.

Lula Tadesse: So are all HSAs created equal, Andy?

Andy Clarke: No, and I'm sure it'll shock you to hear Vanguard say this, but you should focus on the costs of different HSA custodians. You should focus on the costs, but also the investment options. And you want to look at choosing an HSA custodian depending on how you plan to use the account.

So if you plan to use the HSA as sort of a short-term transactional account almost like a medical checking account, you want to make sure that there aren't big monthly maintenance fees that are chipping away at your money.

If you're planning to use it as a long-term investment account, you don't want the maintenance fees, but you also want to make sure that you have access to low-cost investment options that will allow your money to compound to the greatest extent over the long term.

Lula Tadesse: Do you have a choice as to where to invest that money?

Andy Clarke: That's one of the really neat things about these accounts. Suppose your employer directs your contributions, and whatever contributions the employer makes, to an HSA custodian with bad funds and high costs. Once a year you have the option to roll those funds over into an HSA with better options.

Lula Tadesse: So once you open an HSA and select your investments, what is the best way to make the most of it?

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Andy Clarke: Well, you know, one thing you want to look at is how you're going to invest the money in the HSA, and that takes us back to the purpose for it. So if it's going to be more of a short-term savings account, you want to make sure that money is in a secure low-risk vehicle, such as a money market fund or other savings option.

If you're planning to use this for long-term retirement savings, you want to make sure that you have the option to invest that money in a way that's consistent with your other long-term savings.

Jonathan Kahler: I think that use may also change over time, depending on the individual.

So if you have a few years where you're lucky enough not to incur medical expenses or just have the flexibility to save more without pulling money out, then you may look at it as an emergency fund; you know, you've got those receipts set aside, maybe you've got a shoebox that you put all your medical receipts in.

So whatever the unexpected expense might be that comes up—whether it's home repairs or something of that nature—you've got those receipts that are banked away and you're able to use that HSA as an emergency fund in that capacity. Or, maybe, that you're able to just use it as long-term savings, and you're saving those receipts to justify withdrawals in retirement for any other expenses.

Lula Tadesse: In your paper, you talk about investors' perceptions and behaviors when it comes to HSAs. What are some of these perceptions and behaviors, and how should advisors frame these conversations with their clients?

Jonathan Kahler: Yeah, I think the name can kind of cause some difficulty with perceptions. So if you look at HSA, it stands for "health savings account." So that can trip up an investor sometimes; they see this as primarily a health savings vehicle or that transactional health spending vehicle.

What we would like to see is for advisors to really look at this as another tool for long-term savings, and look at the treatment of the contributions, those tax benefits, the flexibility with how it can be used, and really assess how that can fit into a more comprehensive plan with other account types—whether it's traditional IRA, Roth IRA, 529, whatever meets those investor's goals.

Lula Tadesse: That sounds like a good note on which to wrap up our talk on HSAs. Andy and Jonathan, thanks again for being with us today.

Andy Clarke: You're welcome. Thanks for having us.

Jonathan Kahler: Thank you.

Lula Tadesse: And thank you for joining us for this Vanguard Investment Commentary Podcast. To learn more about today's topic, download *HSAs: An off-label prescription for retirement savings*, from our website, vanguard.com.

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