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Use HSA to supplement 401(k) savings

401(k) ADVISER
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With life expectancy stretching into the 90s for many, funding a health savings account to supplement your other retirement savings makes a lot of sense.

Rapidly rising health care costs are making it increasingly difficult for people to afford to retire. So if you're not familiar with how an HSA works, it's time you learn more about one of the most powerful savings and retirement planning tools around.

An HSA allows you to pay for out-of-pocket medical, dental and vision expenses with tax free money. It's the "triple crown" of tax shelters, providing an up-front tax deduction for your contribution, no taxes on any earnings and the tax free withdrawal of all you've accumulated when you use the money to pay for qualified medical expenses.

To contrast, a traditional 401(k) account gives you a tax deduction up-front and tax deferred compounding of your earnings, but you owe taxes on your savings when they are withdrawn. A Roth 401(k) account provides tax free accumulation and tax free withdrawal upon retirement, but you don't get an up-front tax deduction.

To be eligible to contribute to an HSA, you must also participate in a high deductible health plan. A health plan is considered high deductible if it requires an individual to pay at least the first $1,300 in annual health care expenses out-of-pocket or $2,600 for family coverage.

In 2016, the maximum you can contribute to an HSA is $3,350 if covered by an individual health plan and $6,750 for a family health plan. If you're 55 or older, you and your spouse can each contribute an additional $1,000. You may withdraw any portion of the funds you accumulate in your HSA at any time to pay qualified medical expenses.

Be advised that money withdrawn from an HSA for non-medical expenses is subject to a 20% penalty tax and ordinary income tax. After you reach age 65, the penalty tax disappears and any money withdrawn that is not used for medical expenses is simply subject to ordinary income tax.

Importantly, unlike a flexible spending account (FSA), your HSA is not a "use it or lose it" program. If you don't spend all the money you save for the year, it stays in your account. This feature encourages you to become a smarter consumer of health care products and services, and can lead to the accumulation of significant wealth over time. Contrast this with an FSA, which can encourage you to be wasteful with your health care savings because any amount you don't spend by year end is forfeited.

While a 401(k) plan is available only if your employer offers one to you, an HSA is not necessarily tied to your employer. As long as your health plan meets the high deductible requirements, you can open an HSA anywhere. Most banks can offer you an HSA, so it is a good idea to shop around to compare investment flexibility and costs.

Depending on the HSA provider you select, the money you deposit in an HSA can be invested in a conservative money market account or diversified for a longer-term time horizon into an array of stock or bond mutual funds. Generally, it's a good idea to keep at least one year of potential out-of-pocket medical expenses invested conservatively.

If your health is good and your HSA grows in value, you should diversify your HSA savings into longer-term investment vehicles because when you reach retirement age, you're allowed to continue using your HSA to cover out-of-pocket qualified medical expenses. HSAs have no mandatory required distribution rule at age 70½.

As attractive as an HSA is, it still doesn't surpass the appeal of a 401(k) plan with a matching feature. A matching contribution is free money you collect only when you voluntarily participate in your employer's 401(k) plan. Be sure to save enough in your employer's retirement plan to maximize its matching dollars before you consider investing additional savings into an HSA.

Also, if you expect to incur some significant medical expenses in the next 12 months, and coming up with a high deductible would be problematic, then a high deductible plan with an HSA may not be for you. So be sure to consider your overall health and health care spending history before enrolling.

While HSAs have been around for a little more than a decade, they remain widely misunderstood and dramatically underutilized. Regardless of your age, with increases in health care costs running way ahead of inflation, it's time to learn more. Talk with your employer's HR department or refer to websites such as http://www.obamacarefacts.com/health-insurance/health-savings-account-hsa/. Taking a close look at your personal situation and doing some additional research on this powerful savings tool should help you determine if an HSA makes sense for you.

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