How to Best Use Your Health Savings Account

Investing in an HSA has great tax benefits—if the insurance coverage makes sense.

Roger Young, CFP®
Thought Leadership Director

KEY INSIGHTS

- Health savings accounts (HSAs) are rightfully viewed by financial planners as a powerful retirement savings tool with unmatched tax benefits—if used properly.
- Savers should consider a range of short- and long-term strategies with HSAs and avoid situations where they can be suboptimal or even harmful.
- Eligibility for an HSA requires a high-deductible health plan, so individuals need to evaluate health coverage factors before seeking the tax benefits of an HSA.

TABLE OF CONTENTS

Since 2004, individuals enrolled in high-deductible health plans (HDHPs) have been able to fund health savings accounts (HSAs). A Mercer survey showed that over 80% of large employers nationally offered HSA-eligible health plans in 2022.[1] As more employers offer these plans, HSA usage has grown steadily to approximately 36 million accounts and $116 billion in assets.[2] We expect that HSAs will be a growing part of the health care landscape.

In an HDHP, the insured is responsible for a significant portion of health expenses up front before the insurance company pays. However, HDHPs must also include a limit on participants' out-of-pocket expenses. Premiums on these plans are generally lower than more traditional, lower-deductible policies. See Figure 1 for current IRS parameters on HDHPs and HSAs.

(Fig. 1) Key HSA facts (2024)[3]

	Individual	Family
Eligibility	Under 65 and enrolled in HDHP	
Minimum deductible for HDHP	$1,600	$3,200
Maximum out-of-pocket expense for HDHP	$8,050	$16,100
HSA annual contribution limits	$4,150	$8,300
HSA per-person catch-up contribution limit (age 55)	$1,000	$1,000

[1] Mercer National Survey of Employer-Sponsored Health Plans, 2022. Includes employers with 500 or more employees.
[2] https://www.devenir.com/research/2023-midyear-devenir-hsa-research-report/
[3] IRS Revenue Procedure 2022–24.

> HSAs offer a 'triple-tax benefit': tax deduction, tax-deferred growth, and tax-free qualified distributions. This essentially combines the benefits of Roth and pretax strategies in an IRA.
>
> — **Roger Young, CFP®**
> *Thought Leadership Director*

The HSA is structured with significant tax incentives to choose an HDHP and save or invest for health costs. Proponents of HSAs often refer to a "triple-tax benefit": tax deduction, tax-deferred growth, and tax-free qualified distributions. This essentially combines the benefits of Roth and pretax strategies in an individual retirement account (IRA). In addition, the funds can be used before retirement for qualified medical expenses—without tax or penalty. If used before age 65 for other purposes, however, a 20% penalty is assessed. Figure 2 compares HSAs with other tax-advantaged savings vehicles.

A key consideration in the evaluation of HSAs is the definition of a "qualified medical expense." In general, expenses that would qualify for a federal income tax deduction are considered qualified. (As you might expect, you can't double-dip and count them both as qualified for your HSA and as itemized deductions.) Some insurance premiums are qualified: Medicare, long-term care, COBRA, and coverage while you're unemployed. However, one significant medical premium is not qualified: Medicare supplement insurance, also referred to as Medigap. Hybrid life insurance/long-term care policies are usually considered life insurance and, therefore, aren't qualified.

A helpful feature of HSAs is that qualified medical expenses from prior years can be used to take qualified distributions. The expenses need to have occurred after you established the HSA and cannot have been otherwise reimbursed

(Fig. 2) HSA tax benefits vs. Roth and pretax retirement accounts

Tax rules are federal, unless otherwise noted. Green text represents features of the HSA that are better than the Roth account, pretax IRA, or both. Red text represents relative weaknesses of the HSA.

	Health savings account	Roth (IRA, unless noted)	Pretax (deductible IRA, unless noted)
Impact of contributions on taxable income—federal	**Deductible/excluded**	Not deductible	Deductible
Impact of contributions on taxable income—FICA	**Generally excluded**	Included	Included
Maximum individual contribution/catch-up contribution	**$4,150**/$1,000	$7,000/$1,000	$7,000/$1,000
Maximum retirement plan (e.g., 401(k)) contribution/catch-up contribution	N/A	$23,000/$7,500	$23,000/$7,500
Age for catch-up eligibility	**55**	50	50
Income limitations to participate	**No**	Yes for IRA; no for retirement plan	Possible income limitations on deductibility for IRAs
Federal tax on account earnings	Deferred	Deferred	Deferred
Ending age for early distribution penalties	**65**	59½	59½
Penalty for early distribution	**20%**	10%	10%
Early distributions not subject to penalty	**Qualified medical expenses**	Contributions (and limited other penalty exclusions)	Limited penalty exclusions
Taxation of distributions in retirement (post-penalty age)	**Qualified medical expenses: tax-free;** others at ordinary rate	Tax-free for qualified distributions	Ordinary rate
Required minimum distributions (RMDs)	**None**	None (for original owner)	Begin at age 73*
Tax treatment for surviving spouse	Ongoing HSA treatment	Ongoing tax-free (but now with RMD)	Ongoing tax deferral (with RMD)
Tax treatment for other heirs	**Value immediately subject to ordinary income tax**	Ongoing tax-free (but now with RMD)	Ongoing tax deferral (with RMD)

*The SECURE 2.0 Act of 2022 changes the required minimum distribution (RMD) age to 73 for individuals who turn age 72 on or after January 1, 2023. The new law also provides that the RMD age will change again to 75 in 2033.

> If you're in a position to [invest the HSA for the long term], it can help cover a significant expense in retirement.
>
> — **Roger Young, CFP®**
> *Thought Leadership Director*

or used for itemized deductions.[4] This feature adds to the flexibility of HSAs if you can keep good documentation of medical expenses and tax returns. (Keep in mind that may be a much longer time than you would ordinarily keep those records.)

It is also important to distinguish HSAs from other tax-favored health plans: flexible spending arrangements (FSAs) and health reimbursement arrangements (HRAs). Like HSAs, these other plans feature contributions that are excluded from gross income and tax-free withdrawals for qualified medical expenses. However, there are key differences:[5]

- FSAs have a lower contribution limit and are generally "use it or lose it." For 2024, only $640 of unused amounts at year-end may typically be carried over to the next year, if permitted by the employer; other unused amounts are forfeited.
- HRAs are funded solely through employer contributions, not employee salary deferrals. Unlike HSAs, they are generally not portable to another employer or convertible to cash.

Health Savings Account Best Practices

First, let's evaluate how the HSA can be used, assuming an HDHP is available and cost-effective in your situation. (We will come back to the issue of whether the HDHP makes sense.) Most of the possible outcomes are positive, but there are some situations to avoid. We'll start with the good ones.

Good: Contribute the amount of medical expenses you expect to incur in a year, and use it as needed. You get two of the three HSA tax benefits: deductible contribution and tax-free withdrawal. In this case, you would keep the balance in cash (or something similar), so you wouldn't really get the third benefit of tax-deferred investment earnings. Essentially, you get a deduction for your medical expenses without having to itemize or exceed the minimum threshold. If you don't use an HSA (or other tax-advantaged account), you can only deduct medical expenses that exceed a percentage of your adjusted gross income.

If you have trouble estimating your medical expenses for the year, consider contributing enough to cover a single sudden expense before meeting your deductible.[6]

Better: Contribute more than your expected medical expenses, building the account to completely cover one or more years of maximum out-of-pocket costs. Build the cushion by only drawing on the account for large or unusual medical expenses, not the routine ones. This reduces the financial risk of a major health issue. While most of this balance should be in cash, you can start investing the longer-term portion, which puts you on the path to the "best" scenario below.

Best: Contribute at or near the maximum, and invest most of it for the long term. By long term, we mean investments such as stocks, bonds, and funds that contain those securities as opposed to cash and equivalents. This strategy provides the full triple-tax benefit. If you're in a position to use this strategy, it can help cover a significant expense in retirement. And in addition to the benefits already mentioned, using tax-free distributions instead of tax-deferred accounts may prevent you from jumping to a higher tax bracket or incurring higher Medicare premiums.

Conversely, here are some HSA situations with negative consequences that can be avoided.

Very Bad: Using the account before age 65 for nonqualified expenses. As noted in Figure 2, this results in ordinary tax on

[4] Internal Revenue Bulletin 2004–33 Notice 2004–50, Health Savings Accounts—Additional Qs&As, Answer 39, August 16, 2004.
[5] IRS Publication 969.
[6] If you have a choice between low- and high-deductible plans, you could instead contribute an amount that helps you evaluate whether you made the right choice. See the Appendix beginning on page 11 for further information.

> The HSA should not be considered your emergency fund.
>
> **— Roger Young, CFP®**
> *Thought Leadership Director*

the withdrawal plus a 20% penalty. This penalty is worse than early withdrawal penalties from retirement accounts, so drawing on the HSA for nonmedical spending should be a last resort. Since it's logistically easy to take money out of your HSA (compared with a retirement account), you need to be careful to avoid this temptation. The HSA should not be considered your emergency fund.

Suboptimal: Dying with a significant unused balance and leaving the account to a non-spouse beneficiary. This isn't as bad as the "very bad" example above because, upon death, the balance is not subject to the 20% penalty. It does, however, incur ordinary tax for your beneficiary. In a sense, this is like a Traditional (pretax) IRA, except instead of having the option to distribute the account over a number of years, your HSA beneficiary has to claim all of the taxable income in one year.

This scenario is especially undesirable if your beneficiary has a higher tax rate than you did when you contributed. In this case, it would have been better to use a Roth account or even a taxable account with gains free of tax due to the step-up in basis.

Leaving a balance to your spouse is a different story—it becomes his or her HSA, which is fine. Then, the outcome depends on whether the surviving spouse uses the account effectively or leaves a balance to other beneficiaries.

Fair: Using the HSA for nonqualified expenses after age 65. This results in ordinary tax but does not incur the 20% penalty. Like the previous "suboptimal" example, it's similar to using a Traditional IRA. This isn't the preferred way to use the HSA, but it does not leave a big tax bill for your heirs in a single year after you die.

If you won't be able to spend all of your HSA for medical expenses, you have a choice between this scenario (spending it on other things) and leaving it to a beneficiary (as noted previously). If your heirs are in a lower tax bracket than you, the "suboptimal" strategy of leaving it unused could actually be better. But remember that a large HSA inheritance could bump someone into a higher bracket for that year.

Prioritizing HSA Contributions

There are many competing priorities for the money we're able to save. While HSAs are a great way to save, we need to consider how they fit into an overall plan.

First, because of the steep penalty for nonqualified expenses, building your emergency fund and paying off high-interest debt (credit cards) should take priority. This keeps you away from the "very bad" outcome of a 20% penalty.

Next, consider the "good" strategy described previously. That approach is an expense management tactic rather than an investment decision. If you're likely to incur those medical expenses at some point, you should get the tax benefit.

Now, the next question may be whether to invest in the HSA or your company retirement plan. If the 401(k) offers a company match, you generally want to get that match first. The HSA has a more limited purpose than a retirement plan, and the company match is an automatic benefit you usually don't want to leave on the table. While the HSA could theoretically look more valuable than the match,[7] it seems unlikely you will get the full triple-tax benefit of the HSA if you're in a position where you have to choose between the two.

After getting the employer match, the next decision is when to consider the "better" strategy. Because it's important to begin investing for the long term as early as possible, we recommend that you achieve a solid retirement savings rate before using the "better" strategy. You don't necessarily have to get to the 15% savings rate we recommend before

[7] Geisler, Greg; 2016. "Could a Health Savings Account Be Better Than an Employer-Matched 401(k)?" *Journal of Financial Planning* 29 (1): 40–48.

starting to invest in the HSA, but you should be making meaningful progress.

At this point, you may also be weighing HSA long-term investments against saving for your children's future college costs, a home purchase, or other goals. The HSA is more tax-advantaged than the typical vehicles for those goals (such as 529 plans and taxable accounts). However, it is reasonable to forgo the HSA tax benefits to achieve important, nearer-term objectives. Again, you don't want to fund those other goals with the HSA because of the 20% penalty.

When you're on track for other goals and able to save the recommended 15% for retirement, you should include the "best" strategy described previously as part of your retirement savings.

High-Deductible vs. Low-Deductible Plans

Now that we've covered the basics of HSAs and how they can fit into your financial plan, let's take a step back. According to Mercer, 88% of large employers with HDHPs also offer lower-deductible options (LDHPs). (See note 1 on page 1.) Since only HDHPs are eligible for HSAs, you need to make this decision first. However, that analysis should reflect the value of the HSA tax benefit versus other alternatives.

The first step is to estimate your annual health care expenses (before the impact of insurance plan rules). This is obviously challenging because your usage of health care services can vary widely year to year. As a baseline, you can start with the expenses you incurred in previous years and adjust for any known changes.

Using that estimate, calculate your costs under the different plans offered. In addition to providing legally required examples, your employer may offer an online tool to compare the plans based on your situation. If not, the Appendix beginning on page 11 shows how to estimate your costs (with some simplifying assumptions). The key factors are typically annual premiums, deductibles, coinsurance percentages, and out-of-pocket maximums.

For example, the Appendix shows a choice where the high-deductible plan has a $1,400 lower annual premium and a $3,200 deductible versus $1,000 for the low-deductible plan. Coinsurance percentages are 20% and 10%, respectively. In that situation, if you incur $2,556 of medical expenses, your total cost will be the same under the two plans. If you expect less than $2,556 of expenses, the high-deductible plan is better; otherwise, the low-deductible plan is preferable.

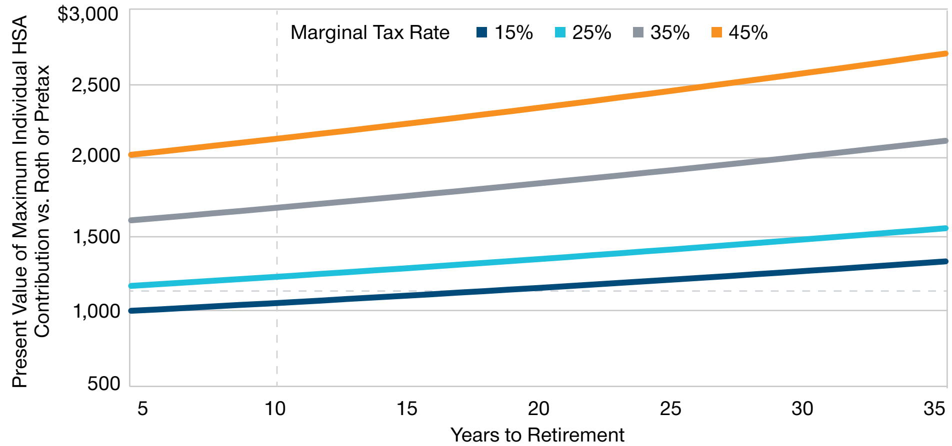
If you are not in a position where long-term investments in an HSA make sense, this is probably where your analysis ends. Many people have access to an FSA with their low-deductible plan. In that case, in the short term, you get similar tax benefits with an FSA and HSA: tax-deductible contributions and no taxes when used for medical expenses. As previously noted, the FSA has more limitations, including allowable contribution amounts, portability, and the ability to carry forward balances. However, those differences might not sway the decision if you expect significant medical costs.

If you are able to invest long term using the HSA, that adds a significant tax benefit to consider. Suppose you could shift some of your retirement contributions away from your 401(k) and use the HSA instead. As we've discussed, the HSA has better tax benefits than Roth and pretax retirement savings if the HSA is ultimately used for qualified medical expenses. We can estimate the after-tax future value of these different types of contributions at retirement age based on assumed return rates, number of years, and tax rates. Then, to help with the HDHP/LDHP decision today, we discount those values—essentially converting them to present-day values. Figure 3 shows

> If you are able to invest long term using the HSA, the additional tax benefit could make a high-deductible health plan more appealing.
>
> **— Roger Young, CFP®**
> *Thought Leadership Director*

(Fig. 3) Incremental value of an HSA contribution

Present value of HSA contributions vs. other tax-advantaged savings at different marginal tax rates (federal plus state).



Assumes 5% return, 4% discount rate, marginal FICA tax rate of 7.65% for the 15% marginal tax rate line, 1.45% for the other lines, and $4,150 HSA contribution. Notes on assumptions: The values are based on holding the investment until retirement, not longer. Analysis assumes tax rates remain the same from now until retirement (which makes Roth and pretax options equivalent). The employer does not match contributions (or the match has already been maximized). Does not reflect any potential reduction in eventual Social Security benefits for the 15% line.

the present value of a single $4,150 HSA contribution, less than the value of making an equivalent contribution to a Roth or pretax plan.[8] (By "equivalent," we mean the net after-tax impact on your paycheck is the same.)

For example, suppose your combined federal and state marginal tax rate is 25% and you are 10 years from retirement. Using Figure 3 (highlighted by dotted lines), contributing $4,150 to an HSA adds an incremental value of approximately $1,200 in today's dollars versus using a Roth or pretax plan.[9] As a reminder, that assumes you intend to hold the investments until retirement.

Armed with that knowledge, your decision on an LDHP versus an HDHP may change. For example, if you estimated that the LDHP would cost you $700 less based on your projected expenses, the additional $1,200 tax benefit means a high-deductible plan with an HSA may make sense.

Remember, medical expenses are hard to estimate. You should consider a range of possibilities up to the out-of-pocket maximum when making this decision.

Estimating and Funding Health Care Expenses in Retirement

Deciding how to use an HSA also depends on health insurance and expenses during retirement, which can be very complex. This paper is not intended to explain the full range of options or coverage rules. (For

[8] Calculations and assumptions by T. Rowe Price. Uses formulas based on: Geisler, Greg; 2016. "Could a Health Savings Account Be Better Than an Employer-Matched 401(k)?" *Journal of Financial Planning* 29 (1): 40–48.

[9] If you are already maximizing your retirement plan contributions, then the comparison would be between the HSA and savings using a taxable account. The timing and rate of taxation for a taxable account depend on many factors. However, using a taxable account cannot be more tax-favorable than a Roth account (assuming qualified distributions). Therefore, in this circumstance, the incremental value of the HSA investment is at least as large as the amounts in Figure 3 (given all of the other assumptions).

example, we won't address details on Medicaid, employer-based retiree coverage, or the many exceptions to general rules around Medicare.) However, we can summarize ranges of costs for many people.

Upon eligibility for Medicare at age 65, a person's medical expenses can include:

- Medicare Part A (hospital) premiums (but most people get this free)
- Medicare Part B (medical insurance) premiums
- Medicare Part D (drug coverage) premiums
- Medicare Part C (Medicare Advantage) premiums
- Medicare Supplement Insurance (Medigap) premiums
- Out-of-pocket expenses such as deductibles, coinsurance, and items not covered by insurance
- Long-term care expenses

T. Rowe Price studied health care costs in retirement[10] and reached a few key conclusions:

- It helps to think in terms of annual expenses, rather than a lifetime lump sum
- Separating premiums from out-of-pocket costs can make it easier to plan for expenses
- Expenses can vary widely based on the type of insurance coverage chosen

Our study found that most individuals over 65 pay less than $3,000 per year in medical insurance premiums if they don't purchase Medigap policies. However, Medicare Part B premiums can be significantly higher—up to around $7,000—for people with higher income levels. Income adjustments for Part D can add around $1,000 per year in the top bracket. While these premium adjustments only affect around 7% of Medicare enrollees,[11] they are important to consider, especially for people in a position to aggressively fund an HSA. Figure 4 shows the range of Medicare Part B premiums.

On average, only about one-quarter of retirees' health care costs (excluding long-term care) are out-of-pocket expenses. As you would expect, these expenses vary more widely than premiums. Around 25% of older Americans pay less than $300 in out-of-pocket health expenses, whereas the top 10% of spenders incur over $3,800. Interestingly, having a Medigap policy does not dramatically change the variability—perhaps because those policies are selected by people who need or want to consume more medical services.

(Fig. 4) Annualized standard Medicare Part B premiums in 2024, based on modified adjusted gross income (MAGI) in 2022[12]

Individual MAGI	Married filing jointly MAGI	Annual Part B premium (per person)
$103,000 or less	$206,000 or less	$2,096
Above $103,000 up to $129,000	Above $206,000 up to $258,000	$2,935
Above $129,000 up to $161,000	Above $258,000 up to $322,000	$4,193
Above $161,000 up to $193,000	Above $322,000 up to $386,000	$5,450
Above $193,000 up to $500,000	Above $386,000 up to $750,000	$6,708
$500,000 or above	$750,000 or above	$7,128

[10] Banerjee, Sudipto. "A New Way to Calculate Retirement Health Care Costs," T. Rowe Price white paper, March 2024.
[11] https://www.cms.gov/newsroom/fact-sheets/2023-medicare-parts-b-premiums-and-deductibles-2023-medicare-part-d-income-related-monthly
[12] Source: Medicare.gov.

> A high-income retiree with Medigap coverage can spend $13,000 per year on medical expenses, even without long-term care.
>
> **— Roger Young, CFP®**
> *Thought Leadership Director*

In total, typical (middle 50%) annual health care expenses, excluding long-term care, range from $2,400 to $5,100 per year for retirees without Medigap. (See Figure 5.) However, a retiree in the highest Medicare premium bracket, with a Medigap policy and top-quartile out-of-pocket expenses, could incur around $13,000 per year.

It's worth noting again that these are rough estimates, with a wide range of possibilities. In preparing for retirement, individuals should consider many factors—state of residence, overall health level, family history, prescription drug requirements, medical specialists needed, and others.

HSA Contributions Based on Potential Qualified Medical Expenses

Now that we have a rough idea of medical expenses in retirement, we can evaluate how an HSA can help cover those expenses. Figure 6 shows the estimated annualized withdrawals you could take from an HSA under different circumstances.

Comparing these numbers with Figure 5, some observations can help guide decisions. First, if you're starting to fund an HSA at age 50 or later, you have a pretty good chance to use the account entirely for qualified medical expenses over a 20-year period. There is little downside to fully funding the account if you are able.

If you maximize contributions continuously starting at a younger age, you could end up with more in the account than you will spend on qualified medical expenses in retirement. Preretirement qualified expenses that you haven't already used for itemized deductions or HSA distributions reduce this potential excess. Remember, however, that you can't count non-Medicare insurance premiums as qualified expenses, and you need to keep good records of your expenses for a long time.

To address the possibility of amassing too much in your HSA, you could scale back your contributions accordingly, especially if you have other financial goals to fund. Alternatively, you could start contributing aggressively since you have time to make course corrections. If you do, be sure to reevaluate the situation periodically, including the following factors:

- Whether you expect to face income-related Medicare premium adjustments
- Your health and family history (which could affect typical costs and life expectancy but, perhaps, in opposite directions)

(Fig. 5) Estimated annual health care expenses, excluding long-term care

For individuals age 65 and above.

	Medicare Parts A, B, and D	Medicare Advantage with drug coverage
25th Percentile	$2,800	$2,400
50th Percentile	$3,500	$3,100
75th Percentile	$5,100	$4,500
90th Percentile	$8,300	$7,000

Note: These would generally be considered qualified medical expenses for HSA withdrawals. However, additional premiums for Medigap plans (estimated at approximately $2,400 to $3,000) would not be qualified. Source: T. Rowe Price estimates based on projected 2024 Medicare premiums and data from the Health and Retirement Study (HRS). All costs are rounded to the nearest hundred.

Long-Term Care

You will notice that long-term care (LTC) expenses are excluded from the analysis of health care expenses in retirement. LTC can range from in-home assistance to assisted living environments to full nursing home care. Custodial care is not covered by Medicare, and Medicaid only comes into play after most of a person's resources are exhausted.

While long-term care should not be ignored, these costs are even more difficult to estimate than ongoing medical costs. Many people will have no long-term care expenses. Others will have some LTC needs but for a limited period (such as the final months of life). Some people will require multiple years of extensive nursing care, which is a major financial risk. In general, because HSAs are not estate-friendly, we do not recommend building an HSA balance large enough to cover multiple years of LTC.

Another option for LTC expenses is to purchase insurance using your HSA. There is a segment of "mass affluent" people who theoretically benefit from shifting this risk to an insurer. (People at the lower end of wealth can't justify or afford the expense, and high-net-worth individuals can successfully self-fund.) Unfortunately, the premiums for LTC insurance have risen sharply, and many companies have gotten out of the business. Given the current state of this insurance market, we would be cautious about purchasing a long-term care policy. As noted previously, hybrid policies that avoid some drawbacks of traditional LTC insurance are really life insurance, which would not be a qualified medical expense.

- Your likelihood of needing long-term care and whether family members may be potential caregivers
- Your likelihood of continued HSA eligibility
- Preretirement qualified medical expenses (out of pocket) that you haven't used yet for HSA distributions or itemized deductions
- Health care expense trends and legislative developments
- How well your HSA investments have performed
- Your tax bracket (and expected bracket of your heirs, if possible)

Contribution Strategy Example

To help illustrate how someone might choose an appropriate HSA contribution level, consider Jane, a successful, single (and hypothetical) 35-year-old. She earns a low-six-figure salary and expects that she will face income-related Medicare premium adjustments when she retires. Therefore, she assumes she'll have above-average qualified medical expenses in retirement of around $5,000 per year (in today's dollars).

Jane thinks the assumptions in Figure 6 look reasonable—retiring at age 65; living to, at least, age 85; and earning HSA investment returns a little above health care inflation. The middle column of that table tells her that if she continually contributes the maximum to her HSA ($4,150, adjusted for inflation), the account hypothetically could cover $9,422 of qualified medical expenses annually for 20 years (circled in Figure 6).

With this in mind, Jane needs to decide whether to fully fund her HSA (and possibly make course corrections in the future) or choose an amount intended to cover her expected expenses. Jane has always worked for large companies and thinks there's a reasonable chance that she will continue to be eligible for an HSA. She also has other financial goals, so she'd prefer to fund those goals rather than potentially overinvest in her HSA. Since $5,000 is 53% of $9,422, she contributes 53% of the maximum, or around $2,200 per year, to the HSA. She invests it for the long term since the intent is to use the funds

(Fig. 6) Hypothetical annual withdrawals from an HSA

Over a 20-year period from age 65 to 85 (in today's dollars), funded by continuous maximum HSA contributions (currently $4,150).

Starting age of contributions	Investment return, net of health care inflation 1%	2%	3%
30	$8,731	$11,611	$15,496
35	7,290	**9,422**	12,193
40	5,919	7,439	9,344
45	4,615	5,643	6,887
50	3,374	4,016	4,767
55	2,193	2,543	2,938
60	1,069	1,209	1,361

Assumptions: Amounts are in today's dollars. Maximum individual contributions ($4,150 in 2024) are made to an HSA until age 65, with no catch-up contributions. Investment returns range from 1% to 3% above the health care inflation rate until retirement, then drop by one percentage point after age 65. Withdrawals are for qualified medical expenses over a 20-year period. Note: Numbers in green are lower than the estimated median expenses in Figure 5. Numbers in red are higher than the estimated 90th percentile expenses in Figure 5. The bold circled number refers to the example that follows.

> There is little downside to fully funding an HSA if you are starting after age 50. If you're younger, determining how much to contribute takes more analysis.
>
> **— Roger Young, CFP®**
> *Thought Leadership Director*

in retirement. (Additional amounts could be contributed to cover preretirement qualified expenses.)

So far, our examples have focused on single people, for simplicity. It is important to note that medical costs incurred by a spouse or dependents are considered qualified expenses. This could justify a larger HSA contribution for one spouse, especially when a dual-income household is covered under one medical plan. For example, suppose Jane is married, her husband earns a similar salary, and they have family coverage in the HDHP at Jane's employer. Combined, they may still face Medicare income-related premium increases, so their qualified medical expenses in retirement might be twice as much as Jane's alone. Since we estimated Jane's target contribution around $2,200 if she were single, a $4,400 annual contribution could make sense for their family. Fortunately, that's within the $8,300 limit for a family plan.

Beyond Health Care: Investment and Drawdown Strategy

Once you've started contributing to a health savings plan, you need to manage it. This includes an investment strategy. After you turn 65 and can withdraw the funds penalty-free, you also need a drawdown strategy.

As noted in the section describing a range of overall strategies, there is a difference between short-term expense management and long-term investment. Your HSA can include a combination of both. For expenses you might incur in the next few years (including a reserve for out-of-pocket maximums), keeping your account in cash or a similar short-term option is the appropriate strategy.

For money you plan to invest for the long term, your investment allocation could be similar to a retirement portfolio. In general, that should be a diversified mix, with an emphasis on equities early in your career. Because earnings in an HSA are tax-free if used properly, you want investments with high potential returns. As with a Roth account, you may want to be more aggressive in an HSA than in a pretax account.

Unlike a Roth account, however, you will ideally exhaust your HSA assets before you die. (See the "suboptimal" outcome on page 4.) That leads into both the drawdown strategy and investment approach in retirement.

To reduce the risk of having a sizable balance in your HSA when you pass away, you may want to prioritize taking qualified distributions from that account in early and mid-retirement. This is especially true if you have Roth assets, since you can use the Roth account to continue receiving tax-free growth. And, as noted, the Roth account is better for the estate.

However, you may also be choosing between drawing on your HSA and your pretax retirement account. After you turn 73, that pretax account will have required minimum distributions (RMDs). If those RMDs could push you into a higher tax bracket, draw down the IRA and/or retirement plan account first to reduce the RMD.

Because you can defer qualified medical expenses to future years for HSA distributions, this gives you additional tax planning flexibility. Consult with a tax advisor or financial planner on an integrated plan. Just remember that you want to ultimately use the HSA for qualified expenses, and you need good documentation.

Since your time horizon for the HSA is shorter than for a retirement account, it should be more conservative approaching and during retirement. Combined with the previous advice about starting out more aggressively, that means the HSA allocation to equities should be decreased fairly rapidly as retirement approaches. The need to adjust equity exposure suggests that an active asset management approach is

> An HSA is less estate-friendly than a retirement account, so ideally, you will exhaust your HSA assets before you die.
>
> **— Roger Young, CFP®**
> *Thought Leadership Director*

likely appropriate. Multi-asset products may be useful to help adjust the asset allocation, but they should be reviewed periodically, especially as the time horizon shortens.

It's also worth spending a moment to consider account fees. Because most HSA assets today are in cash, rather than investments, the fee structure may look more like a bank account than an investment account. These accounts often include some combination of fixed monthly charges, fees based on a percentage of assets, and costs per transaction. In total, this may work out to a higher percentage on assets than in a typical retirement account (which usually has larger balances).

If you're using the HSA appropriately, the tax benefit should outweigh the costs unless you're making very small contributions. That doesn't even include potential investment gains. However, if your HSA has a significantly higher expense ratio than your retirement asset accounts, that would be another reason to avoid investing more than necessary to cover expected qualified medical expenses.

Conclusion

Health savings accounts are a wonderful tool to help you prepare for a key expense in retirement. While there are many details to consider when using HSAs, here are the key points to remember:

- Due to the 20% penalty on early nonqualified withdrawals, the HSA should not be considered your emergency fund.
- By investing in your HSA and using it for qualified medical expenses in retirement, you get the triple-tax benefit: deductible contribution, tax-deferred growth, and tax-free distributions. This can be an important part of your retirement saving strategy.
- Most people should take advantage of the company retirement plan matching contribution before investing for the long term in an HSA.
- If you are committed to a long-term strategy with your HSA assets, that could motivate your decision to choose an HSA-eligible, high-deductible plan instead of a low-deductible plan.
- Leaving a large HSA balance to someone other than your spouse isn't ideal. Try to use the assets for qualified expenses in retirement. That entails estimating your medical expenses and planning the level of HSA contributions accordingly.
- There are many factors that affect your potential medical expenses. Review those factors periodically, especially if you're contributing aggressively to the HSA.
- To take advantage of tax-free earnings, invest your long-term HSA contributions in high-potential asset classes. But as retirement approaches, reduce the risk sharply to prepare for distributions soon after age 65 or 73.
- As you make key decisions—such as participating in an HSA, determining the right contribution level, investing the assets, and taking distributions—consider consulting with tax and financial planning professionals.

Appendix: Comparing Low-Deductible and High-Deductible Plans

In general, a high-deductible plan is preferable if you have relatively low medical expenses. However, calculating which plan is better for you may not be a back-of-the-envelope task. Some, but not all, employers provide online calculators to help with this decision.

In many health plans, the insured pays a deductible before the insurer incurs any costs. After the deductible, the

insured pays a percentage of costs called coinsurance. The deductible and coinsurance together represent out-of-pocket expenditures. After reaching a maximum out-of-pocket level, the insurer pays all costs. Total costs for the insured include out-of-pocket payments and premiums. An employer contribution to an HSA or HRA could be viewed as a reduction in the premium.

We can represent this mathematically. This model excludes complexities, such as different rules for in-network or out-of-network providers, different coinsurance levels for different services, and separate deductibles for the family and each family member.

This model also excludes any tax effects. For someone considering an HSA for short-term spending needs, this is realistic in many cases because a flexible spending arrangement might provide a similar tax benefit.

d = deductible ($)

c = coinsurance (%)

m = maximum out-of-pocket cost ($)

p = premium ($)

x = expenses incurred (in dollars, after any discounts negotiated between the plan and medical providers but before allocation between insurer and insured)

t = total cost to the insured ($) = p + minimum (x, m, d + c (x - d))

L = subscript to denote low-deductible plan

H = subscript to denote high-deductible plan

To determine whether the low-deductible or high-deductible plan is preferable, we look for a break-even point: the level of expenses (x) where total costs are equal for the two plans ($t_L = t_H$). This is somewhat complicated because the formula for t includes a minimum of different values. So let's assume that the difference in deductibles for the two plans is greater than the difference in premiums, which seems like a common plan design.* In this case, the breakeven is:

$x = (p_L - p_H)/(1 - c_L) + d_L$

You will notice that if there is no coinsurance, the break-even point is the difference in premiums plus the deductible in the low-deductible plan. Assuming the coinsurance percentage is relatively small, this is a helpful approximation or rule of thumb.

So in the Figure 7 example, if the employee expects to incur medical expenses below $2,556, the high-deductible plan is preferable. For higher expected expense levels, the low-deductible plan is better. Note that the break-even point is a little

(Fig. 7) High deductible vs. low deductible example

	Low deductible	High deductible	Difference
Deductible	**$1,000**	$3,200	-$2,200
Coinsurance	10%	20%	-10%
Maximum out-of-pocket cost	$4,000	$8,000	-$4,000
Annual premium	$6,000	$4,600	**$1,400**
Expenses incurred at break-even point	$2,556	$2,556	—
Out-of-pocket cost	$1,156	$2,556	-$1,400
Total cost to insured	$7,156	$7,156	—

* More precisely, this break-even point holds where $(d_H - d_L)(1 - c_L) > p_L - p_H$.

above the rule of thumb, which works out to $2,400. (That's from simply adding the bolded numbers in the example.)

In this example, suppose you chose the HDHP, contributed $2,556 to the HSA, and took withdrawals from the account for all qualified expenses (the "good" scenario on page 3). Then after a year, if you increased the balance from the prior year, that quickly verifies that the HDHP was the right decision for that year.

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

To learn more, please visit troweprice.com.

T. Rowe Price®

Important Information

This material is provided for general and educational purposes only and is not intended to provide legal, tax, or investment advice. This material does not provide fiduciary recommendations concerning investments, investment strategies, or account types; it is not individualized to the needs of any specific investor and is not intended to suggest that any particular investment action is appropriate for you, nor is it intended to serve as the primary basis for investment decision-making.

The views contained herein are those of the authors as of March 2024 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates.

All investments involve risk. All charts and tables are shown for illustrative purposes only.

T. Rowe Price Investment Services, Inc., Distributor.

CCON0144504
202403-3425903