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The retirement benefits of a health savings account

Jim Miller, Savvy Senior columnist

Dear Savvy Senior: What can you tell me about health savings accounts? I've been reading that they are a great investment that can help with growing health care costs when I retire. — Planning Ahead

Dear Planning: It's true! A health savings account is a fantastic financial tool that can help you build up a tax-free stash of money for medical expenses now and after you retire – but there's a catch. To get one, you must have a high-deductible health insurance policy.

How they work

Health savings accounts (or HSAs) have become increasingly popular over the past few years as health care costs continue to skyrocket, and because more and more Americans have gotten high-deductible health plans.

The benefit of a HSA is the triple tax advantage that it offers: Your HSA contributions can be deducted pretax from your paycheck, lowering your taxable income; the money in the account grows tax-free; and if you use the money for eligible medical expenses, withdrawals are tax-free.

And if you change jobs, the HSA moves with you.

To qualify, you must have a health insurance policy with a deductible of at least $1,350 for an individual or $2,700 for a family.

This year (2018), you can contribute up to $3,450 if you have single health insurance coverage, or up to $6,900 for family coverage. Next year (2019) you can contribute slightly more — up to $3,500 for single coverage or up to $7,000 for family coverage. And people age 55 and older can put away an extra $1,000 each year. But you cannot make contributions after you sign up for Medicare.

The money can be used for out-of-pocket medical expenses, including deductibles, co-payments, Medicare premiums, prescription drugs, vision and dental care and other expenses (see IRS.gov/pub/irs pdf/p502.pdf, page 5, for a complete list) either now or when you retire for yourself and your spouse as well as your tax dependents.

And unlike a flexible spending account, an HSA doesn't require you to use the money by the end of the year. Rather, HSA funds roll over year to year and continue to grow tax-free in your HSA account for later use. In fact, you'll get a bigger tax benefit if you use other cash for current medical expenses and keep the HSA money growing for the long term.

Be sure to hold on to your receipts for medical expenses after you open your HSA, even if you pay those bills with cash, so you can claim the expenses later. There's no time limit for withdrawing the money tax-free for eligible medical expenses you incurred anytime after you opened the account.

But be aware that if you do use your HSA funds for non-medical expenses, you'll be required to pay taxes on the withdrawal, plus a 20 percent penalty. The penalty, however, is waived for those 65 and older, but you'll still pay ordinary income tax on withdraws not used for eligible expenses.

How to open a HSA

You should first check with your employer to see if they offer a HSA, and if they will contribute to it. If not, you can open an HSA through many banks, brokerage firms and other financial institutions, as long as you have a qualified high-deductible health insurance policy.

If you plan to keep the money growing for the future, look for an HSA administrator that offers a portfolio of mutual funds for long-term investing and has low fees. HealthEquity, OptumBank, The HSA Authority and Bank of America are the top ranked HSA providers for long-term investing according to the investment research firm Morningstar. To search for providers, visit HSAsearch.com.

After setting up your HSA plan, adding money is pretty straightforward. Most plans let you do online transfers from your bank, send checks directly, or set up a payroll deduction if offered by your employer. And to access your HSA funds many plans provide a debit card, some offer a checkbook and most allow for reimbursement.