

IRA OR HSA, WHICH SHOULD I FUND FIRST?



Traditional IRAs have been around since 1974. They provide workers an opportunity to save for retirement on a pre-tax and tax deferred basis depending on your income and whether or not your employer offers a workplace retirement plan.

Health Savings Accounts (HSAs) have only been around since 2003 but have rapidly been gaining popularity over the past decade. An HSA also allows you to save money on a pre-tax basis, and any growth in the account is tax-free provided it is used for healthcare expenses.

Despite some similarities between the two savings vehicles, the HSA may actually offer more flexibility to workers before and during retirement.

First, let's look at some of the similarities and differences between the two accounts, then walk through an example of why it may make more sense to fund an HSA instead of an IRA.

IRA

- Contributions may be tax deductible depending on your income and whether or not you are a member of a company sponsored retirement plan.
- Distributions incur a 10% penalty if taken before age 59.5, unless you meet a few specific exceptions.
- Distributions after 59.5 are taxed as ordinary income.
- Maximum annual funding amounts: \$6,000 for those under age 50, \$7,000 for those 50 and over
- You can also make non-deductible contributions to IRAs that would result in your account having basis, but that is a conversation for another day.

HSA

- You must meet the requirement of having a High Deductible Health Care Plan to be eligible to contribute to an HSA. "High Deductible" means a \$1,400 deductible for individuals or \$2,800 for a family plan for calendar year 2020.
- All contributions are tax deductible if you qualify as HSA-eligible.
- Distributions made for healthcare expenses are tax free at any time.
- Distributions made for purposes other than healthcare before age 65 carry a 20% penalty on top of being taxed as ordinary income.
- HSA funds can be invested once you hit a certain dollar amount depending on your plan.
- Maximum Fund Amount: \$3,350 for an Individual and \$7,100 for a family

Both

Both plans grow tax deferred, meaning you don't pay any taxes on the growth from year to year.

Now let's walk through an example.

Let's assume a family has an extra \$5,000 to save in 2020 and they are trying to decide which plan makes more sense. Funding an IRA may result in a \$5,000 tax deduction depending on their income and if they have a workplace retirement plan. The IRA would grow tax deferred and could be accessed without a penalty at age 59.5. A 10% penalty is added on top of the taxes if accessed before 59.5. If the family chose to fund the HSA they would get a \$5,000 tax deduction as well, and the funds would also grow tax deferred. The big difference is that the HSA funds can be used for healthcare expenses at any time without a penalty. If the family has an emergency healthcare situation it is much easier to access the HSA than it would be the IRA.

Let's assume that neither account is touched until retirement at age 65. Assuming they are invested the same, the accounts would have the same balance when the family retires. Due to the option for tax-free healthcare distributions, the HSA now adds a lot more value to the family's financial situation. Both the IRA and HSA would be taxed as ordinary income if they are used for everyday living expenses, but any distribution from the HSA for a doctor's visit or other specific healthcare related expenses would come out tax free. This could be a huge benefit over the course of your retirement.

Final Thoughts & Recommendations

Now that you know the additional benefits that HSAs provide, consider maxing out your HSA before funding an IRA. For many workers funding your HSA should come second only to getting your company match through your retirement plan. Once you get your company match, consider putting any extra savings toward your HSA. The ultimate goal would be to fund your HSA and then pay your medical expenses out of pocket throughout the year with any additional cash flow. This would allow your HSA savings to grow more if you can avoid taking distributions over time.

Schwab recently began offering an HSAB account that allows you to move your HSA funds over to a Schwab account that can be invested similar to an IRA. Most HSA plans have a limited investment lineup similar to a 401k, while the HSAB provides an unlimited investment lineup.

If you have any questions about your eligibility for an HSA or about opening an HSAB please contact us at landmark-info@wealthenhancement.com