

Learn about the lesser-known benefits of owning a Health Savings Account (HSA) to help fund your retirement.

THE HIDDEN POWER OF HSAS: TAX-FREE SAVINGS FOR HEALTH CARE AND RETIREMENT

Feb. 3, 2026

Key Takeaways:

- **An HSA offers triple tax benefits.** Contributions go in tax-free, grow tax-free and can be withdrawn tax-free for qualified medical expenses.
- **Your HSA is yours to keep — for life.** The balance rolls over each year, can be invested for growth and remains with you even if you change jobs or retire.
- **HSAs can support both today and tomorrow.** You can use funds for current medical costs — or save receipts and reimburse yourself later to create tax-free emergency or retirement cash flow.

Overview

A health savings account, often referred to as an HSA, is a savings vehicle that can be paired with a high-deductible health insurance plan (HDHP). It is designed to help you pay for out-of-pocket medical expenses with tax-free income.¹

At first glance, paying for a high-deductible health insurance plan may not seem as advantageous as other health insurance options. And using it as a retirement savings vehicle may not seem as obvious as using an employer-sponsored plan (such as a 401(k) or 403(b)) or IRA. But an HSA can be a valuable tool for saving for retirement, reducing taxes and paying for medical expenses, both now and in your later years.

How an HSA Works

The benefit of selecting an HDHP for your medical insurance is a lower premium. The drawback? You generally have a much higher deductible. This means you end up covering more of your medical expenses out of pocket until you've met the higher deductible each year.



To offset this, many HDHPs permit the plan member to open and contribute to an HSA. The money saved can then be used to cover out-of-pocket expenses related to their medical care.

For those whose HSA is associated with an employer-sponsored HDHP, both the employee and the employer may contribute to the HSA. Note that their combined contributions may not exceed the annual limit, which is adjusted each year for inflation.

One of the perks of an HSA is that all the money contributed belongs to the account owner. Unlike an employer-sponsored flexible spending account (FSA), the employee doesn't have to "use it or lose it" by the end of the year. Moreover, the account belongs to the employee even when they leave the company. They cannot continue contributing to the HSA unless or until enrolled in another HDHP, but the balance can continue growing and they may use the funds to pay for eligible expenses.²

HSA Investment Options

The HSA is not administered by the HDHP insurer. It must be opened separately at a financial institution, such as a bank. The custodians that offer health savings accounts typically also enable the account owner to invest a portion of the balance once it reaches a certain threshold. Typically, the account owner must retain a minimum balance in the HSA (usually \$1,000 to \$2,500) before transferring assets to an investment account. The owner can transfer money between the savings and investment accounts as needed.³

The invested portion of an HSA is administered by a brokerage firm. As such, there is generally a wide range of investment options, such as mutual funds and individual securities. Be aware that principal and performance returns in the invested component of a health savings account will fluctuate and, when redeemed, may be worth more or less than their original cost. The invested assets are not FDIC-insured or guaranteed by the bank that administers the health savings account.

As with other types of investments, it is important to review the associated costs, such as investment expenses and account fees, which can reduce returns over time.

Tax Benefits of an HSA

An HSA offers yet another opportunity to diversify your tax liability during retirement. While pension, traditional IRA and 401(k) benefits will be taxed when distributed during retirement, money drawn from an HSA and a Roth IRA will not. The latter two also do not mandate required minimum distributions as you age, so interest can continue compounding tax-free.



Note that all contributions made to a health savings account are tax-free. Also, the interest earned on invested HSA funds grows tax-free, and withdrawals used to pay for qualified medical expenses are not taxed. If the money is used for nonmedical expenses, the account owner must pay income taxes on those specific amounts and may be subject to an early withdrawal penalty. However, the penalty fee goes away once the account owner reaches age 65.

If you were to instead invest those funds in a 401(k) plan or traditional IRA, you would pay income taxes on both the contributions and earnings when withdrawn, even the money used for health care expenses. If you put that money in a Roth IRA, your earnings would be tax-free, but your contributions wouldn't be tax deductible. The HSA is the only investment vehicle that avoids taxes altogether when used to pay for qualified health care expenses.⁴

	Taxed when contributed	Taxed when withdrawn
401 (k)	No	Yes
Traditional IRA	No	Yes
Roth IRA	Yes	No
HSA	No	No

Using an HSA as an Emergency Savings Fund

With so many demands on our money, it's difficult to prioritize savings efforts. One of the most important recommendations is to have a liquid emergency savings account funded with at least three to six months' worth of income. This is where an HSA can work double duty.

The way to do this is to pay for out-of-pocket medical expenses with current income and leave the money you've saved and invested in a health savings account to continue growing. However, save the receipts you receive for all eligible purchases. You are permitted to "reimburse" yourself for paying those expenses via your tax-advantaged HSA funds. There are no time limits for when money in an HSA must be used or distributed for reimbursement.

This means you can withdraw money as needed from that account to pay emergency expenses by pairing the amounts withdrawn with receipts already paid for. Not only will those distributions be both tax- and penalty-free, but the additional bonus is that any unused money in your HSA nest egg can continue growing tax-free as well.



Your HSA funds can be used for doctors' visits, medical procedures, glasses, lab fees, dental care, prescriptions and medical equipment. You can also cover over-the-counter purchases, such as⁵

- Facial cleansers, toners and moisturizers
- Over-the-counter acne treatments
- Sunscreen, sunburn creams and ointments
- Lip balms for sun protection and chapped lips
- Sleep aids and CPAP machines
- Nighttime mouthguards
- Sports mouthguards
- Heating pads, creams and patches
- Feminine care products
- Pregnancy kits

Many of these items are things we buy every day without thinking about using HSA funds to pay for them. You need only track those qualifying expenses and keep the receipts to enable your HSA to work as a tax-free emergency savings account.

Health Care Savings for Retirement

Because a health savings account is “portable,” you can keep it as long as you want, even if it’s provided by an employer. If you continue health coverage under an HDHP after leaving employment, you may continue contributing to the account. Even when you may no longer contribute, the invested balance is yours and continues to grow tax deferred.

One note: Contributions to an HSA must stop once the individual has enrolled in Medicare. However, they can still access funds to pay for medical expenses.⁶

Once you’ve retired, you have many options for using this money. After age 65, HSA distributions can be made for any reason, although funds not used to pay for qualifying medical expenses will be taxed at the owner’s ordinary income tax rate, which is sometimes lower in retirement. Obviously, the most effective use is to pay for health-related expenses, and you’re likely to have more of these during retirement.

If you delay using your health savings account until retirement, you’ll have ready money to tap for those out-of-pocket expenses on an as-needed basis. You also won’t have to pay income taxes on withdrawals, and the funds that remain invested in the account may continue to grow tax deferred. With saved receipts, you’ll still be able to tap the HSA for tax-free emergency funds.



Final Thoughts

By maximizing annual contributions and investing assets for growth, the HSA can help create a tax-free means of paying for health care expenses. At the same time, it can be an effective retirement savings option. As with any investment vehicle, it's important to keep in mind that HSAs are exposed to market fluctuations and are not guaranteed to grow.

While most financial professionals do not directly offer health savings accounts, they can advise you on how to invest funds saved there, particularly within the context of your overall asset allocation strategy.

Sources

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