Saving for healthcare in retirement: Strategies for employees

Suzanne Taranto
Marcella Giorgou

Milliman

For a significant portion of U.S. retirees, medical coverage depends on Medicare and the retirees' personal savings. According to the Kaiser Family Foundation's 2024 Employer Health Benefits Survey, only 24% of employers currently provide subsidized health coverage in retirement.[1] On top of that, according to Milliman, the average healthy 65-year-old can expect to spend up to $281,000 (male) or $320,000 (female)[2] on healthcare costs in retirement, which translates to $188,000 (or $207,000 for a female) needed in savings today.

For employees who are looking for strategies to begin saving for retiree healthcare costs—and the employers that are supporting them—this paper offers a number of effective methods to save for healthcare costs not covered by federal programs such as Medicare. It also provides options for employers that support these strategies. To note, "healthcare costs" in the context of this article refers to medical and prescription drug costs in retirement; custodial healthcare needs, such as long-term care, nursing homes, home health aides, etc., are typically an additional health-related cost beyond the following discussion.

MEDICARE COVERAGE BASICS

If employer-sponsored coverage is not available, retirees who are over age 65 rely on Medicare. Original Medicare (aka Medicare fee-for-service) provides coverage for hospitalization (Part A), other medical expenses (Part B), and prescription drugs (Part D), but does not cover the entire cost. Generally, Medicare Part A and Part B cover around 80% of hospital and medical costs (including the Part B monthly premium), and Part D covers 70%–80% of prescription drug costs.

To fill the gap between what Medicare covers and what healthcare costs, 89% of retirees with Medicare rely on supplemental coverage[5]—this includes both those with and without employer-provided supplemental coverage. There are various programs available, including traditional Medicare plus Medicare supplemental coverage or Medicare Advantage coverage. (See Appendix B for more information on these programs, as well as the distribution of their use among Medicare beneficiaries.) Retirees can shop for coverage on Medicare.gov, which provides details on the available options and costs (which can be customized for individual healthcare needs) and many beneficiaries work with a broker or agent to help them find coverage. Retirees can generally use employer-sponsored account-based plans to help cover these expenses.

The basics: Employer-sponsored healthcare programs for retirees

The majority of the U.S. working population (72% of private industry workers and 89% of state and local government workers as of March 2024 per the Bureau of Labor Statistics[3]) receive medical coverage from their employer. These employees are often provided with tax-effective opportunities to save for healthcare expenses through flexible spending accounts (FSAs), health savings accounts (HSAs), or other vehicles. (See Appendix A for details on FSAs and HSAs.)

Those who retire or leave the workforce before age 65 may get their medical coverage through the Affordable Care Act exchanges or purchase a non-ACA individual/family policy, a working spouse's employer-sponsored plan, or employer-provided retiree medical coverage (in fact, about 91% of the 24% of employers who provide retiree coverage offer it prior to Medicare eligibility[4]).

Employers that provide coverage in retirement generally use one of two strategies:

1. Sponsorship of a traditional group health plan
2. An account (such as a health reimbursement account, or HRA) that provides tax-effective funding to retirees to buy individual medical coverage

Each strategy has advantages and disadvantages, and the value to the retiree will depend on the level of subsidy in each program.

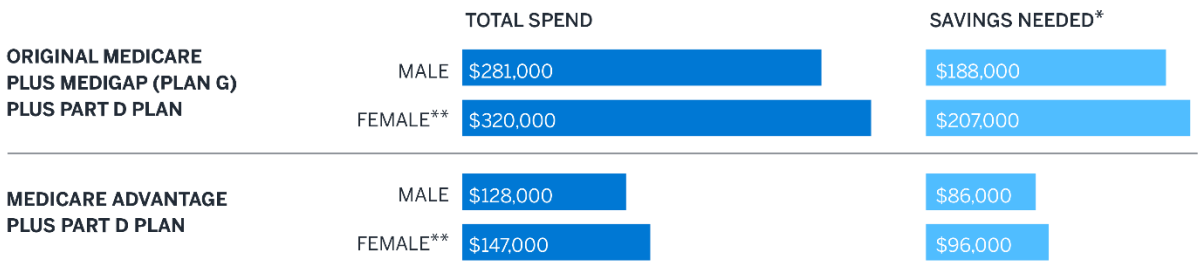
TRADITIONAL GROUP HEALTH PLAN	ACCOUNT-BASED PLAN (HRA)
Provides a program of benefits with limited design options	Provide annual funding or build an accumulated account
Employer takes on the majority of the risk of higher medical utilization	Used to purchase plans on the individual market that meet retiree's specific needs

How much savings is needed and the financial risk to the employee depends on the level of subsidy in each program, as well as the employer's ability to sustain the ongoing cost of the plans. HRAs are also described in Appendix A.

How much do you need to save for healthcare costs in retirement?

The amount of savings needed at retirement to cover future medical expenses varies based on a number of factors, including how long a retiree will live, their health status, and how medical costs increase due to inflation. Figure 1, taken from Milliman's Retiree Health Cost Index[6], illustrates both the expected total spend and savings needed in 2024 dollars for a healthy 65-year-old retiree with Medicare coverage (assuming a 3% return on the savings and net of taxes).

FIGURE 1: 2024 COST OF HEALTHCARE IN RETIREMENT—RETIREE AGE 65 IN 2024



* This is the amount of savings (net of taxes) needed at age 65 to pay a retiree's remaining lifetime "total spend," assuming an investment return of 3.0% per year.

** Higher female costs are largely a result of a longer life expectancy compared to males.

Source: Retiree Health Cost Index, Milliman.

Amassing this level of funds typically requires saving over a career. Understanding how much an employee needs to save on an annual basis to cover healthcare costs will depend on how early the employee begins saving, what their investments earn over time, and whether the employee can pay for health benefits before or after income taxes.

Employer-provided retiree health coverage: What is the impact?

For employees who receive retiree health coverage from their employer, the value of those benefits would offset the amounts detailed in Figure 1. Estimating the future value of employer-provided coverage can be a challenge, since it also requires a prediction of how much medical costs will grow.

Considerations when estimating how much an employer may contribute toward healthcare costs include:

- The Retiree Health Cost study referenced in Figure 1 above assumes healthcare costs increase by 4.9% per year and that use of healthcare services increases with age. However, healthcare costs can vary year by year based on individual medical needs.
- Employers that provide retiree medical benefits through account-based plans (such as an HRA) typically use a formula to determine how much is contributed each year or how much is provided at retirement. An employee can calculate the future value of an account-based plan at retirement based on key personal data—age today, target retirement age, and how much the account is able to grow—to determine the lower amount needed.
- Employer benefits in the future (both group and account-based plans) can change from current levels.

Evaluating retiree healthcare savings vehicles

For employees who are beginning to save for their retiree medical costs, there are a number of different savings vehicles that can be effective. These include:

- 401(k) retirement savings plans (or similar arrangements such as 403(b) or 457 plans)
- HSAs
- Personal savings

Effective cost-saving vehicles should be evaluated based on how they perform with respect to five different criteria:

- Pretax deferrals—can contributions be made before taxes are paid?
- Ability to access investment options—can the funds be invested to earn additional income?
- Tax-free accumulation—are the funds taxed as they earn income?
- Tax-free distributions—are the funds taxed when they are used to pay for medical services?
- What restrictions/costs apply to the vehicle?

Note that we have not considered FSAs (as they do not roll over from year-to-year), Archer MSAs (for self-employed individuals), or Medicare Advantage MSA (Archer MSAs for Medicare members). In the following sections, we compare the three primary savings options and their tax implications for employees.

401(k) plan as a healthcare savings vehicle

Many people consider 401(k) plans as their primary vehicle for savings in retirement but, while generally true, a 401(k) plan's efficiency for medical expenses may not be as favorable as other options. When 401(k) contributions are made before tax, the account accumulates tax-deferred, and distributions are taxed.

Distributions are also subject to timing constraints (referred to as "minimum required distributions") that may require accessing the funds prior to when they are needed for medical expenses. For many people, the 401(k) is the only source of retirement income (outside of Social Security), putting other demands on these funds. Finally, there are annual limits to how much can be contributed ($23,500 in 2025, although catch-up contributions are permitted for anyone age 50 or over), effectively capping the amount that can be saved. Once funds have been distributed, any medical expense can be reimbursed. A beneficiary can inherit a 401(k) but will have certain distribution rules to comply with.

HSA as a healthcare savings vehicle

HSAs are designed specifically to fund medical expenses and are the most tax-efficient way to do so, as contributions, investment returns, and distributions are not taxed (as long as they are used for qualified medical expenses). The annual amount that can be saved is limited ($4,300 for single coverage and $8,550 for family coverage in 2025). Amounts contributed by employers count toward those limits, but the funds belong to the employee once contributed (no vesting).

HSAs are only available when paired with a high-deductible health plan (HDHP), which generally requires higher employee cost sharing than other medical plan options. An employee can use the HSA to save for medical expenses in retirement, but will at the same time need to fund their current out-of-pocket medical costs (which can be higher as a result of the HDHP plan, and potentially more challenging, particularly for lower-wage workers).

HSAs typically offer participant-directed investment options for accounts above a certain threshold. HSA contributions cannot be made after Medicare eligibility, so savings must occur during the working career (or, if retired earlier than Medicare eligibility, on an after-tax basis when paired with a HDHP). Most HSAs provide a debit card to pay for medical costs as they occur or allow automatic direct payments for monthly premiums. A beneficiary can inherit an HSA, but the favorable tax status only remains for a surviving spouse.

Personal savings and other options

Personal savings are also an important retirement savings strategy. As employees earn income, they can save their after-tax pay in any number of savings vehicles, from investments to a standard savings account, and use these funds for medical (or any other) expenses. Unlike an HSA, most accumulated personal savings are subject to both income (or capital gains) tax and FICA tax. Further, since employees are typically in a higher tax bracket during their working career compared to when they are retired, employees are likely to pay a higher income tax rate on personal savings than they would when withdrawing a 401(k) benefit. Personal savings can also be inherited and will be subject to inheritance tax rules.

There are other tax efficient strategies that couple with personal savings like variable life insurance (which takes post-tax money but can be withdrawn without taxes) that are not discussed in detail here but that individuals could consider.

Figure 2 summarizes the key features and requirements of the 401(k), HSA, and personal savings options.

FIGURE 2: COMPARING KEY FEATURES OF RETIREMENT HEALTHCARE SAVINGS OPTIONS

	401(K) PLANS*	HSAS	PERSONAL SAVINGS
Deferrals avoid			
Income tax	Yes	Yes	No
FICA tax	No	Yes	No
Tax-free accumulation**	Yes	Yes	Depends on investments, but generally no
Investment options for individual	Yes (based on options offered by the plan)	Yes (based on options offered by the plan and once balance is above a threshold)	Yes
Tax-free distributions for health expenses	No	Yes	Yes (already paid)
Restrictions/costs	Annual contribution limits May be needed for retirement income Must take distribution and then pay expenses—no direct link Minimum required distribution timing	Annual contribution limits (lower if employer contributes) Must be paired with an HDHP while accumulating—need other source to fund expenses Only use for qualified health expenses	Tax rate as active employee higher than in retirement (less tax efficient) May be needed for retirement income Must take distribution and then pay expenses—no direct link

*Roth 401(k)s allow contributions to be made on a post-tax basis with withdrawals in retirement tax-free.

**Tax treatment on the state level varies. For example, California and New Jersey tax both contributions and earnings.

Conclusion

Employees who anticipate being responsible for some or all of their medical expenses in retirement should consider their future needs and the potential opportunities to save for those needs during employment. While 401(k) plans are widely known as effective retirement savings vehicles, employees who have access to HSAs should consider using them to not only save for current medical expenses but to maximize the funding (based on their ability to do so), as they may be the most efficient option to cover medical expenses in retirement. Additionally, employees who have access to an employer-provided retiree health plan need to learn more about the value of those benefits and consider how they may affect savings needed for healthcare in retirement.

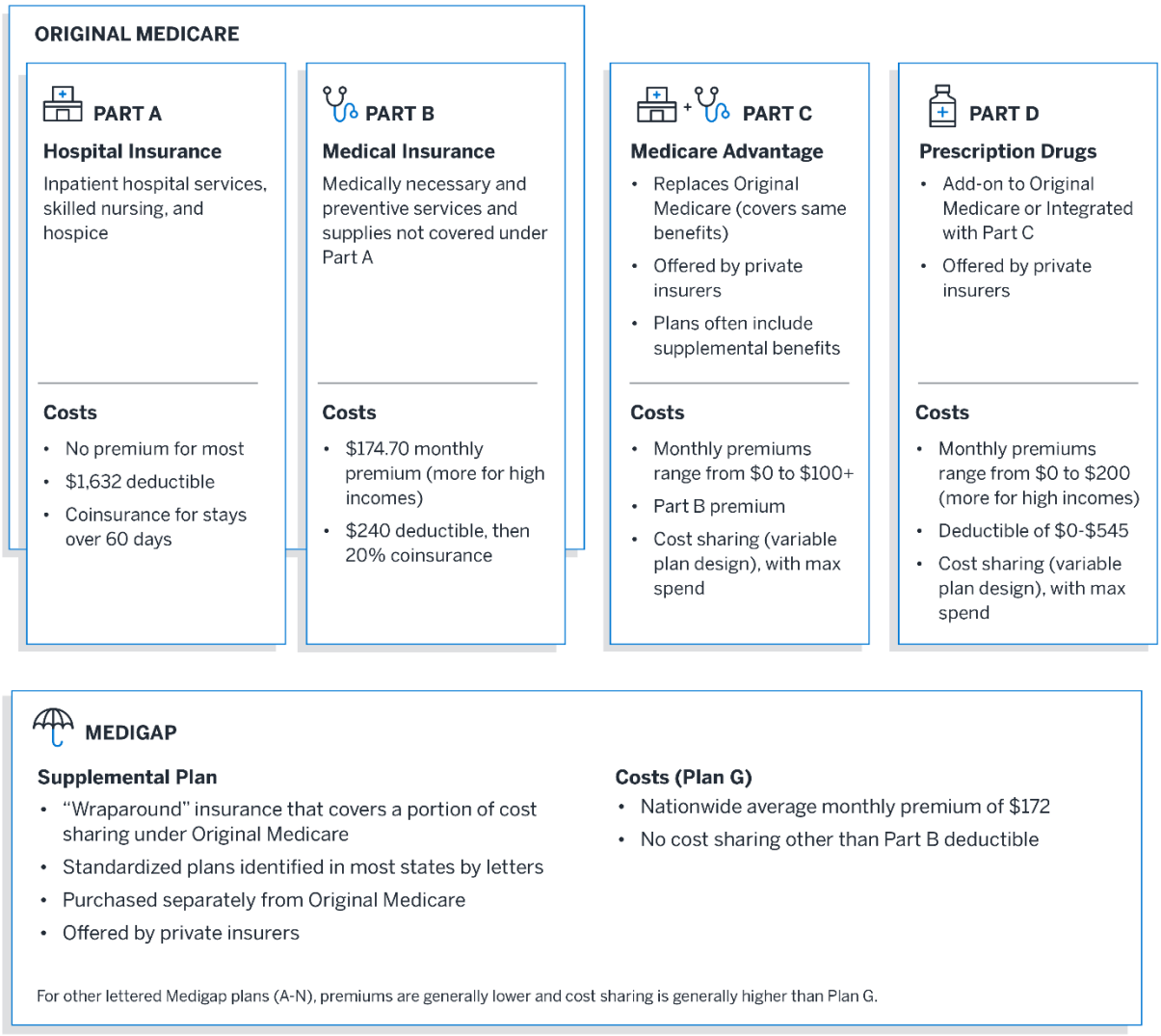
Appendix A—FSA, HSA, and HRA Basics

FIGURE 3: FSA, HSAS, AND HRA BASICS FOR ACTIVE EMPLOYEES

	HSA	FSA	HRA
ELIGIBILITY	Enrolled in a qualified HDHP, not enrolled in any disqualifying coverage, not anyone's tax dependent. General-purpose FSA and HRA are both disqualifying coverage (unless post-deductible). The HDHP is qualified if it complies with minimum deductible and maximum out-of-pocket limits (set annually by regulations).	Must be a common-law employee (or former employee) of the employer. Subject to employer's plan eligibility provisions. Eligibility not precluded because of enrollment in other coverage. If not limited in purpose to vision or dental, all employees eligible for the FSA must also be eligible for non-excepted group health plan coverage (major medical).	Must be a common-law employee (or former employee) of the employer. Subject to employer's plan eligibility provisions. Eligibility not precluded because of enrollment in other coverage. If not limited in purpose to vision or dental, must be integrated with a group health plan. Therefore, all individuals eligible for HRA reimbursement (including spouse and dependents) must also be enrolled in major medical.
CONTRIBUTION SOURCE	Employer or employee.	Employer or employee.	Employer only.
CONTRIBUTION MAXIMUM	Set annually by regulations. Affected by number of months eligible out of the year, level of coverage enrolled in (single or family), and age (whether 55 or older). Employer contributions count toward the maximum.	Set annually by regulations. Employer contributions do not count toward the maximum unless employees can receive amounts as cash or other taxable benefit. Employer contributions must be limited to match or $500.	Employer determines.
AVAILABILITY OF FUNDS	Funds are available to use once actually contributed, not before. Employer generally cannot remove funds once contributed.	Subject to uniform availability requirement. Entire election must be available upon first day of plan year (before the entire election is actually contributed).	Funds are available as determined by the employer. Employer can make the full amount available annually or on a pro rata basis (e.g., monthly or quarterly).
PLAN DESIGN AND WITHDRAWAL RULES	Employee owns account, therefore employer cannot limit eligible expenses beyond what the tax code permits.	Regulations permit reimbursement of any IRC 213(d) medical expense except for insurance premiums, but employer can further limit.	Regulations permit reimbursement of any IRC 213(d) medical expense; employer can further limit.
INDIVIDUALS WITH ELIGIBLE EXPENSES	HSA holder, spouse, and tax dependents (as defined by §152). Individuals do not have to be eligible to contribute to an HSA in order to have eligible expenses.	Employee, spouse, employee's child who has not attained age 27, and tax dependent. Subject to plan eligibility requirements.	Employee, spouse, employee's child who has not attained age 27, and tax dependents. Subject to plan eligibility requirements. Unless limited purpose, individuals must be enrolled in the integrated coverage in order to have eligible expenses.
CARRYOVER/ROLLOVER	Account is owned by employee, therefore it is portable from employer to employer. No forfeiture from year to year.	Subject to the use-or-lose rule (used for expenses during coverage period or forfeited). $660 carryover for 2025 Plan Year into 2026 Plan Year, or 2½-month grace period permitted (not both).	Employer may allow carryover to subsequent plan year. No transfer to other employer or HSA.
COBRA	Continued coverage under the HDHP must be offered. Employer does not have to continue making contributions to employee's HSA.	Only required where the account is "underspent" (healthcare FSA benefit still available is greater than the COBRA premium due for the remainder of the year). If required at all, only to the end of the current plan year.	Must be offered. If individual elects COBRA for the HRA, they will have access to unspent HRA balance as well as any monthly or annual accruals that active employees get. COBRA premium should be blended (the same for all qualified beneficiaries regardless of account balance).

Appendix B—Medicare Coverage and Supplemental Plans

FIGURE 4: COMPONENTS OF MEDICARE COVERAGE (2024) AND SUPPLEMENTAL PLANS



Source: Retiree Health Cost Index, Milliman. https://www.milliman.com/en/insight/retiree-health-cost-index-2024

ENDNOTES

1. Claxton, G., Rae, M., Winger, A., Wager, E., Byers, E., Kerns, J., Shmavonian, G., & Damico, A. (October 9, 2024). Figure 11.1. 2024 Employer Health Benefits Survey. KFF. Retrieved on March 13, 2025 from https://www.kff.org/report-section/ehbs-2024-section-11-retiree-health-benefits/#figure111.
2. Schmidt, R., Walters, E. (May 14, 2024). 2024 Milliman Retiree Health Cost Index. Milliman. Retrieved on March 11, 2025 from https://www.milliman.com/en/insight/retiree-health-cost-index-2024.
3. Bureau of Labor Statistics, U.S. Department of Labor (September 19, 2024). Employee Benefits in the United States—March 2024. Retrieved March 1, 2025, from https://www.bls.gov/news.release/pdf/ebs2.pdf.
4. Claxton, G., Rae, M., Winger, A., Wager, E., Byers, E., Kerns, J., Shmavonian, G., & Damico, A. (October 9, 2024). Figure 11.4. 2024 Employer Health Benefits Survey. KFF. Retrieved on March 13, 2025 from https://www.kff.org/report-section/ehbs-2024-section-11-retiree-health-benefits/#figure114.
5. Ochieng, N., Cubanski, J., & Neuman, T. (September 23, 2024). A snapshot of sources of coverage among Medicare beneficiaries. KFF. Retrieved March 11, 2025, from https://www.kff.org/medicare/issue-brief/a-snapshot-of-sources-of-coverage-among-medicare-beneficiaries/#AppendixTable1.
6. Schmidt, R. Op. Cit.

CONTACT

Suzanne Taranto
suzanne.taranto@milliman.com

Marcella Giorgou
marcella.giorgou@milliman.com