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Triple Tax Benefit – Health Savings Accounts

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What does a triple tax benefit look like? It is an account that is funded with pre-tax dollars, has tax-deferred investment growth and provides the opportunity for tax-free withdrawals. These generous tax features have earned the health savings account, or HSA, a reputation for being "dollar for dollar the greatest wealth building vehicle currently permitted within the tax code."

Health savings accounts first came on the scene in December of 2003 when President George W. Bush signed into law the Medicare Prescription Drug, Improvement and Modernization Act. Provisions of the act provide consumers of high deductible health insurance plans the ability to set aside pre-tax dollars to pay qualified medical expenses. The maximum annual funding amounts have grown slightly over time and are different depending upon who is insured. In 2019 a single person can contribute up to $3,500, a family can contribute $7,000 and if the insured is over the age 55, an additional $1,000 contribution is permitted.

Most HSA owners use their account to pay medical expenses at the point of service, and therefore, keep their HSA dollars invested in liquid interest bearing investments similar to a savings account or money market fund. These low risk, liquid investments are appropriate in instances when the HSA contributions are required in order to pay current medical expenses. In this scenario the HSA balance is typically small as is the applicable interest rate. The small amount of interest earned is sheltered from taxes, but the biggest benefit in this scenario is the ability to pay medical expenses with pre-tax dollars.

The HSA cash flow scenario described above is the most common reality among HSA owners, but it is not reflective of everyone's circumstances. If current medical expenses can be met using other resources, the dollars held in the HSA can remain intact and continue to grow on a tax deferred basis. Account balances will carry forward from one year to the next and increase as annual contributions are made and investment growth is achieved. Similar to an IRA, an HSA can hold several different types of investments. If the HSA dollars are part of a longer-term strategy, investment liquidity and safety can be take a back seat to investments that provide better long-term growth potential. Yes, you can invest your HSA dollars into equities, including low-cost index based vehicles.

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To date, the cumulative opportunity set for early adopters of health savings accounts has been substantial. Since their advent, a single person could have contributed a total of $49,500, a family $98,850 and an additional $14,500 could have been saved if the insured was over the age of 55 when first introduced back in 2004. Remember, these are pre-tax dollars. More specifically, payroll contributions are made prior to the assessment of payroll taxes and non-payroll contributions are deductible against income when taxes are filed. Saving that occurs on a pre-tax basis is a powerful incentive. Assuming a hypothetical tax rate of 25%, a single person would need to have earned $66,000 and saved the net of tax amount to match the $49,500. A family subject to the same 25% tax rate would have to earn $131,800 to match their pre-tax savings of $98,850.

Investing HSA dollars in equity investments provides an opportunity for growth beyond that of a typical savings account or money market fund. The growth is tax deferred which only enhances the compounding power. To further demonstrate the since inception opportunity set, please reference the table below. It assumes maximum annual funding at the individual, family and single individual over age 55 levels. The rolling balances further assume the funds have been invested into a S&P500 index fund. For 2019, I only included the annual contributions.

Year	S&P 500 Return	Individual	Family	Single Over 55
2004	10.90%	$ 2,883	$ 5,711	$ 3,438
2005	4.90%	$ 5,805	$ 11,498	$ 7,016
2006	15.80%	$ 9,848	$ 19,626	$ 12,061
2007	5.50%	$ 13,397	$ 26,667	$ 16,575
2008	-37.00%	$ 10,267	$ 20,454	$ 12,836
2009	26.46%	$ 16,777	$ 33,390	$ 21,291
2010	15.06%	$ 22,813	$ 45,495	$ 29,158
2011	2.11%	$ 26,409	$ 52,735	$ 33,909
2012	16.00%	$ 34,230	$ 68,422	$ 44,090
2013	32.39%	$ 49,620	$ 99,124	$ 63,997
2014	13.69%	$ 60,165	$120,140	$ 77,647
2015	1.38%	$ 64,392	$128,540	$ 83,129
2016	11.96%	$ 75,844	$151,471	$ 97,941
2017	21.82%	$ 96,535	$192,745	$ 124,672
2018	-4.38%	$ 95,605	$190,900	$ 123,466
2019	TBD	$ 99,105	$197,900	$ 124,466

The data indicate that a single person who has saved the maximum annual amount and invested their HSA dollars into a S&P500 fund would have contributed a total of $49,500 and would maintain a projected account balance of approximately $99,105. Similarly, a family would have contributed $98,850 and would maintain a projected account balance of approximately $197,900. A single person over age 55 in 2004 would could have contributed a total of $64,000 and maintain a projected account balance of approximately $124,466. All of the growth, dividends, interest and capital gains, was sheltered from taxes over the course of 15-plus years. In each of the above examples the percentage of principal vs. gain is roughly half; half funded with principal dollars that were never taxed and half investment growth that has also never been taxed.

HSA balances are always available for tax-free withdrawal when used to pay qualified medical expenses. The definition of a qualified medical expense is broad and the list of examples is long so there is no shortage of potential qualified expenses. If an HSA owner is over age 65, withdrawals for non-medical reasons are permitted on a penalty-free basis but the withdrawals are subject to income tax. This is the same tax treatment associated with an IRA withdrawal for someone who is over the age of 59 ½. If you think that future medical expenses are inevitable, I could argue the merits of funding an HSA prior to funding an IRA. The account also provides for a beneficiary designation. If a spouse inherits an HSA the account will continue as if it were their own.

The triple tax benefits of this account (pre-tax contributions, tax deferred growth, potentially tax free withdrawals) coupled with the exponential compounding power of the equity markets make it a clear winner for consumers of high deductible health insurance plans. If you would like to learn more about how an HSA account could fit into your overall wealth management plan, please contact a member of Greenleaf Trust's client centric team.