HSAs Bring Special Opportunities for High Income Earners

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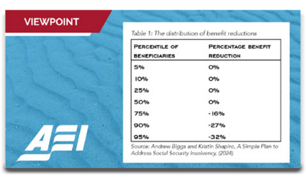

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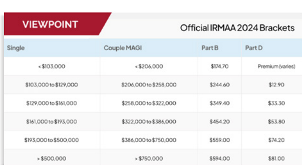

Social Security for the Rich
by Andrew L. May

The Social Security Cliff Is Coming
by Andrew L. May

The Health Savings Account (HSA) was created to give ordinary workers a way to accumulate modest funds to meet very high deductibles increasingly found in employer-sponsored health insurance. HSAs have uniquely attractive tax treatment, better than the tax treatment of any other employment related savings vehicle for reasons we'll discuss.

Like so much else in financial planning, HSAs can create enormous and unintended opportunities for high income people, especially if they 1) start early, 2) never spend from the account and 3) are meticulous about documenting health care spending throughout life. This article will shamelessly describe how high income individuals can maximize the value of this highly tax-favored opportunity.

How did we get here?

Let's remember where the HSA came from and how it came to offer such benefits. Health insurance is unique. Paying for health benefits is tax deductible for the employer but the value of the benefits is not taxable to the employee. This is bizarre. Your cash wages are taxable to you. But if your employer pays for health insurance that miraculously exempts the payment from taxes. There's deep history here, going back to World War II when providing health benefits was seen as a way of evading price controls.

The War Labor Board ruled in 1943 that the wage freeze in effect nationally did not apply to fringe benefits. A loophole you could drive a truck through. Soon employers were widely providing health insurance tied to employment. In 1954, the Revenue Act confirmed that employer paid health benefits were not taxable as employee income. The rest is history.

In a health plan with minimal employee payment responsibility, incentives to economize are absent. Benefit designers recognized that increasing employee responsibility for health expenses might cause more careful spending. In 2001 the High Deductible Health Plan (HDHP) was born. But it came with a problem: the lower income folks who need health insurance the most could not afford the deductible, avoiding necessary health care spending or going into debt. George W. Bush's signature legislation, the so-called Medicare Prescription Drug Bill, included a provision creating the Health Savings Account, designed to make HDHPs more palatable to ordinary employees. The HSA drafted behind the well-established tax treatment of health benefits: deductible for the employer but non-taxable to the recipient.

Let's quantify the opportunity and define the restrictions.

Over time, the amount that employees can place in their HSA has grown. For 2024, a person with "family coverage" under his or her health plan at work can put $8,300 into the HSA, pretax. Needless to say, middle class people mostly don't have $8,300 per year to fund the account, but young partners at big law firms certainly do (to give one example) and they absolutely should. The funds go into an account that, after some accumulation, can be invested just like a 401K. Consider the potential: If a 35 year old puts in $8300 per year for 30 years and earns just 5% on the money, the account balance will be $900 thousand at age 65. And there's no obligation to pull money out then. There will be no more contributions to the HSA once Medicare is your insurance, but the balance in the account can continue to grow. At 5%, it will reach over $1.7 million at age 80. Money that is taken out of the account is not taxed as long as it is used for approved health care items. You object: no one has $900 thousand in health care spending, much less several million. But you might over the course of a lifetime. There is no time limit on the accumulated health care spending as long as you keep the receipts and can validate the spending. And the spending grows in retirement. Medicare Part B and Part D premiums can be paid for out of HSA funds. Remember, my wealthy friend, your Part B premiums are going to be very large under the Income-Related Monthly Adjustment Amount (IRMAA). You are likely to find that you have plenty of health care spending, by the time you are very old, to allow you to pull all the money out of the HSA tax free. If not, there is no real problem, the withdrawal will simply be taxable. But think how cool it will be to pull over $1 million out of the account at age 80, untaxed (!) based on family health care spending when you were perhaps 40 years younger. What a party you could throw!

If you die with a large balance still in the account, your spouse can withdraw just as you can, but it stops there. If both spouses die and money remains in the account it will be subject to ordinary income tax. So at the first death, the heat is on to pull out the money based on documented health care spending.

Nothing else works this way, pretax going in, untaxed coming out. The amounts involved can be fairly large, certainly worth your attention if you are methodical about it.

Where should a high income person prioritize HSA contributions among her savings alternatives?

Any contributions to retirement accounts that are heavily matched should come ahead of the HSA. The HSA is next, better than unmatched 401K contributions, with a couple of caveats. First, withdrawals before age 65 for non-healthcare spending come with a 20% income tax penalty. 401k withdrawals get a 10% penalty and that stops at age 59.5. But you can take money from your HSA at any age as long as you spend it on health care – with no penalty and no tax, dramatically better than 401k withdrawals. Another caveat, some HSA plans seem to have minimal investment opportunities even for substantial funds. You should, at a minimum, be able to direct the balance to a very low cost index fund that mirrors the broad stock market.

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