

HSAs and the power of tax-free growth

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- Health Savings Accounts (HSAs) are investment vehicles that offer a unique triple tax advantage and allow you to keep funds invested over many years.
- HSA assets can be used (free of income tax) for several healthcare costs in retirement, even some not covered by Medicare, such as qualified long-term care costs.
- Even though HSAs have low annual contribution limits, maximizing HSA contributions each year (and investing in a growth-oriented strategy) might give many families enough to cover the bulk of their out-of-pocket healthcare expenses in retirement.

Healthcare costs are rising rapidly, which means it's becoming increasingly important to build healthcare costs into your retirement plan. Based on data in our report, "[Healthcare in retirement](#)," we estimate that most retirees will need to save between USD 300,000 and USD 600,000 at the age of 65 to cover their lifetime healthcare expenses. In addition to these healthcare costs, retirees must account for the potential of requiring long-term care (LTC) in the future, which can be incredibly costly in some instances.

Thankfully, there's a savings vehicle with powerful features that can make it easier to save for future health-related expenses: Health Savings Accounts (HSAs). These accounts are available to individuals or families covered by qualified high deductible health plans (HDHPs), and typically provide investment options similar to a 401(k).

These accounts are one of the most tax-friendly investment vehicles available to investors because they are triple tax-advantaged: no tax on contributions, growth, or distributions (as long as these funds are spent on qualified medical costs). Removing this tax drag can mean thousands of dollars of tax savings on healthcare costs.

HSAs offer a triple tax advantage:

1. **Pre-tax** contributions, similar to a Traditional IRA or 401(k) contribution.
2. **Tax-free** investment earnings.
3. **Tax-free** distributions when they are used to cover qualified medical expenses.

Near-term spending or tax-free growth?

Most Americans are spending more than they are saving in their HSAs. [Only 24% of assets contributed to HSAs in 2019 were carried forward into 2020](#). While individuals do have the option of using HSA dollars during their working years, similar to Flexible Spending Accounts (FSAs), HSA savings are not subject to a "use it or lose it" time horizon. FSA dollars must be earmarked for near-term spending, whereas unspent dollars in an HSA can be carried forward for many years. That's an important feature because the benefits of tax-free growth compound over time.

In addition to leaving your savings in your HSA until the funds are needed in retirement, we also recommend utilizing the investment feature in order to reap the full benefits of your HSA. [As of 30 June 2020, only 5% of accounts invested a portion of their HSA dollars](#). That means 95% of HSAs were held entirely in cash or the account's money market fund. That could be a huge missed opportunity, because the cumulative effect of HSA's triple tax advantage is remarkable.

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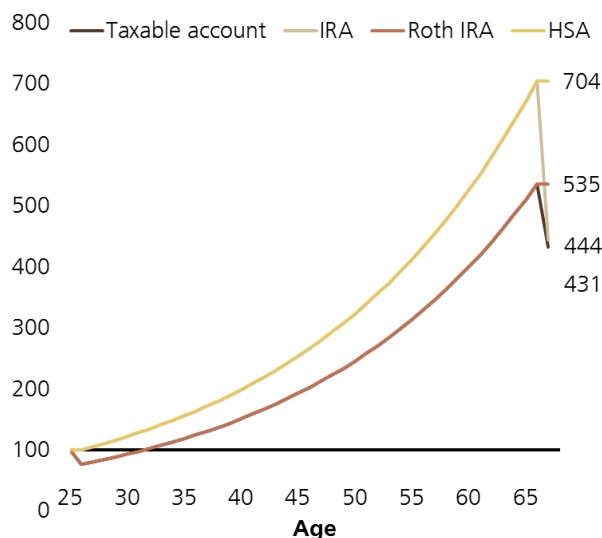
For example, let's look at the scenario illustrated in Fig. 1 where an individual invests USD 100 of her salary in different investment vehicles at age 25, assuming a 5% annual growth rate.

- **After-tax dollars in a taxable account.** Assuming an income tax rate of 24% at age 25—and that it's possible to minimize ordinary income and short-term capital gains taxes as the capital grows—USD 100 of her salary invested at age 25 would grow to pay for around **USD 431 of medical expenses** (or any other spending) in her first year of retirement at age 65.
- **Pre-tax IRA contribution.** Although not taxed when the contribution is made, the distribution is taxed as ordinary income. Assuming a 37% income tax rate on distributions, USD 100 of her salary invested at age 25 could pay for approximately **USD 444 of medical expenses** (or any other spending) in her first year of retirement at age 65.
- **After-tax Roth IRA contribution.** Qualified distributions are tax-free, but contributions are taxed at ordinary income tax rates. Assuming an income tax rate of 24%, the USD 100 contribution of her salary at age 25 would pay for **USD 535 of medical expenses** (or any other spending) during her first year of retirement at age 65.
- **HSA contribution.** With tax-free contributions, growth, and distributions, USD 100 of her salary contributed at age 25 would be able to pay for **USD 704 of qualified medical expenses** during her first year of retirement at age 65.

Even ignoring state and local income taxes, she'd have to save USD 32 more of her salary in the Roth IRA, USD 59 more in the pre-tax IRA, or USD 63 more in the taxable account, just to get the same purchasing power at age 65 as she would with the HSA. Put simply, the unique and powerful features of HSAs make it easier to save for the increasingly expensive costs of healthcare in retirement.

Fig. 1: The triple tax advantage makes it easier to save for retirement healthcare costs

Hypothetical illustration, USD 100 of salary saved in various account types, 5% annual growth, and spent on qualified medical expenses.



Source: UBS. Assumes 24% tax on contributions, 37% tax on distributions, and 23.8% tax on capital gains, where applicable.

To get the most out of your HSA, we suggest funding your pre-retirement healthcare expenses with other assets. Most investors, who will have significant healthcare spending in retirement, should consider funding their taxable savings accounts to cover their pre-retirement healthcare expenses and avoid interrupting the compound growth potential of their tax-exempt HSAs.

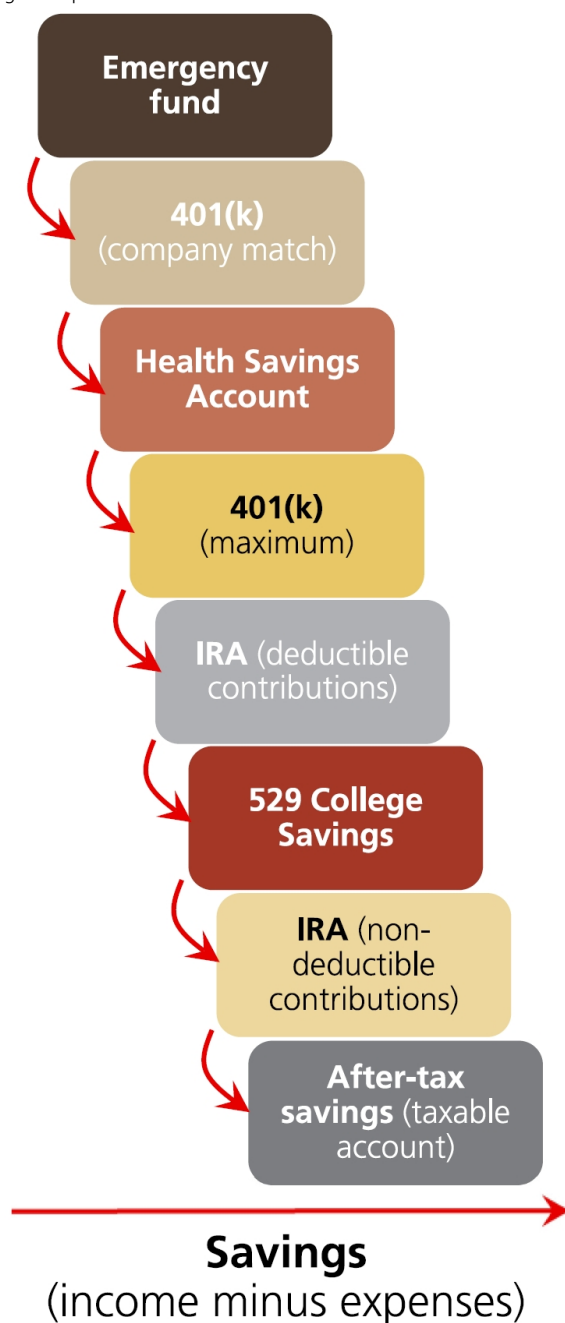
If you do not have after-tax resources to tap for near-term healthcare spending, we recommend keeping enough money in your HSA's money market fund to cover your current year's deductible and invest the excess assets in something with greater growth potential. Tapping your HSA isn't a last resort (we'd recommend doing so before, for example, taking on credit card debt), but it's a very costly option when you consider the foregone growth potential of each dollar taken out.

Should I be saving in my 401(k) or my HSA?

Try to avoid picking one account over the other. Your retirement accounts like 401(k)s and IRAs can, and should, be used simultaneously with your HSA—think of them as supplements to one another.

Fig. 2: The "savings waterfall"

A framework for prioritizing savings and investing accounts by after-tax growth potential.



Source: UBS. For illustration purposes only.

Ideally, investors should max out contributions to all applicable tax-advantaged vehicles in order to generate the greatest after-tax wealth. However, that isn't always feasible. So, if you're trying to determine where you should put your next dollar to work for you, we've identified the investment vehicles with the greatest impact based on after-tax return potential in our "savings waterfall."

The obvious starting point is allocating to your 401(k) to take advantage of your company's matching contribution (if there is one), since this is like getting an immediate 100% return (in a tax-advantaged account) on the matched dollars. But if your employer doesn't offer a 401(k) match, consider maxing out your HSA first since its features provide a greater after-tax return potential, all else being equal.

This rule of thumb won't work for everyone, but the savings waterfall illustration can be used as a guide. And, as you make and save more money, you will be able to allocate your savings further down the waterfall as it makes sense for your personal situation.

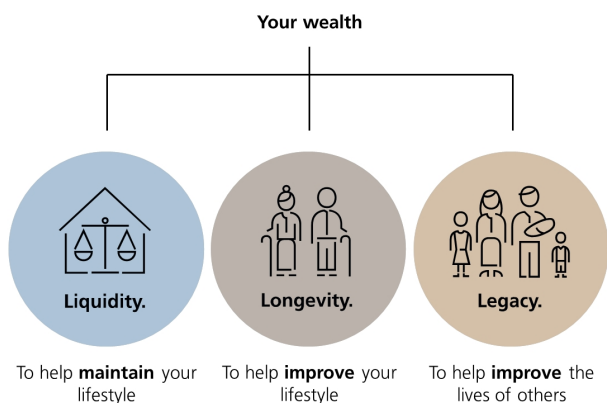
How much is too much?

As mentioned previously, we estimate that most retirees will need to save between USD 300,000 and USD 600,000 at the age of 65 to cover their healthcare expenses. For wealthier and healthier families, that number could be much higher (especially when accounting for the potential of needing LTC), but it's a good starting point. If your HSA balance is on pace to grow to more than that amount by the time you're 65, it may be getting toward the "fully funded" side. But, with a 2021 contribution limit of USD 3,600 for individuals, USD 7,200 for families, and a catch-up limit of USD 1,000 per individual age 55 and older, overfunding won't be a problem for most people.

Even still, it's important to note that HSAs differ from other qualified accounts. Unlike IRAs, HSAs do not have a Required Minimum Distribution (RMD), which is beneficial because it lets you keep the funds growing until you need them. However, HSAs only retain their tax-advantaged status when passing to the surviving spouse. That's why it's important for you to make sure your spouse is the beneficiary of your HSA. And then, when both partners pass away, the account beneficiary receives the fair market value of the HSA balance as taxable income—so these tax treatments for beneficiaries should be taken into consideration when deciding which accounts to pull from in retirement. This will help make sure the remaining wealth that will be passed on to your heirs can be transferred in a tax-efficient manner.

How should I invest my HSA?

As always, investment-related decisions should be made within the context of your overall situation. Our [Liquidity, Longevity, Legacy. \(3L\) framework](#)* can help guide you through this process by using your goals and objectives as the primary driving factor behind all financial decisions in your life.



*Timeframes may vary. Strategies are subject to individual client goals, objectives and suitability. This approach is not a promise or a guarantee that wealth, or any financial results, can or will be achieved.

One of the key advantages of this framework is that it acknowledges the link between risk and time horizon. Assets earmarked to be spent in the next few years can't "wait out" short-term volatility, so they need to be invested conservatively. Such assets, like cash, are well suited to meet short-term cash flow needs, but they typically offer low expected returns and lose purchasing power over the long term.

By contrast, those assets designated to meet spending goals that won't occur for decades have the inherent "patience" to wait out temporary market losses, so they can be invested more aggressively. Such investments, like stocks, might be volatile in the short term, but they provide long-term growth potential that's necessary to surpass inflation and to maintain purchasing power.

In the case of HSAs, due to their triple tax advantage and extremely long time horizon, these accounts are better aligned with the Longevity strategy—assets earmarked for retirement spending. Assuming an investor has the resources in their Liquidity strategy to fund planned near-term health spending and any unexpected healthcare costs, HSAs should be invested in a way that aligns with how the rest of the Longevity portfolio is allocated.

Bottom line

HSAs can be used to cover future healthcare costs in retirement. Their triple tax benefit makes it easier to save for healthcare costs in comparison to other retirement savings accounts. But, they should not be the primary source of funding for healthcare spending in retirement. Instead, HSAs should be used as a part of your overall retirement savings strategy.

If you're currently maxing out your 401(k) contributions, do the same to your HSA. If you aren't able to max out your 401(k) or HSA, contribute at least enough to your 401(k) to receive your entire employer match (if applicable) and then direct additional savings toward your HSA.

And, when feasible, fund pre-retirement healthcare expenses with after-tax dollars. This will allow the assets in your HSA to benefit from long-term tax-free growth and tax-free distributions on qualified expenses.

For details regarding what medical expenses are qualified for HSA distributions, along with other HSA-related information, please see [IRS Publication 969](#).

Appendix

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