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Notes

AT A GLANCE

Lifetime Accumulations and Tax Savings from HSA Contributions, *By Paul Fronstin, Ph.D., EBRI*

- 2014 marks the 10-year anniversary of the introduction of health savings accounts (HSAs), created by Congress in 2003. HSAs provide account owners a triple tax preference. Contributions to an HSA reduce taxable income. Earnings on the assets in the HSA build up tax free, and distributions from the HSA for qualified expenses are not subject to taxation.
- A person contributing for 40 years to an HSA could save up to $360,000 if the rate of return was 2.5 percent, $600,000 if the rate of return was 5 percent, and nearly $1.1 million if the rate of return was 7.5 percent, and if there were no withdrawals.
- In order to maximize the savings in an HSA to cover health care expenses in retirement, HSA owners will need to pay the medical expenses they incur prior to retirement on an after-tax basis using money not contributed to their HSA. Many individuals may not have the means to both save in an HSA and pay their out-of-pocket health care expenses. Also, HSA balances may not be sufficient to pay all medical expenses in retirement even if maximum contributions are made for 40 years.

Lifetime Accumulations and Tax Savings from HSA Contributions

By Paul Fronstin, Ph.D., Employee Benefit Research Institute

Introduction

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA) included a provision to allow individuals with certain high-deductible health plans to open and fund a health savings account (HSA) starting in 2004. Hence, 2014 marks the 10-year anniversary of the introduction of HSAs. In 2013, enrollment in HSA-eligible health plans was estimated to range from 15.5 million to 20.4 million policyholders and their dependents.[1] Nearly 11 million accounts holding $19.3 billion in assets as of Dec. 31, 2013 were also estimated.[2]

The number of HSA-eligible enrollees will differ from the number of accounts for various reasons. The number of enrollees is composed of the policyholder and any covered dependents and will generally be higher than the number of accounts because one account is usually associated with a family. However, over time, the number of accounts can grow relative to the number of enrollees because when an individual or family is no longer covered by an HSA-eligible plan, they are allowed to keep the HSA open.

HSAs provide account owners a triple tax advantage. Contributions to an HSA reduce taxable income. Earnings on the assets in the HSA build up tax free. And distributions from the HSA for qualified expenses are not subject to taxation. Because of this triple tax preference, some individuals might find using an HSA as a savings vehicle for health care expenses in retirement more advantageous from a tax perspective than saving in a 401(k) plan or other retirement savings plan.

This paper examines the amount of money an individual could accumulate in an HSA over his or her lifetime. It also examines lifetime tax savings from HSA contributions. Limitations of an HSA are also discussed.

What is an HSA?

An HSA is a tax-exempt trust or custodial account that an individual can open and use to pay his or her health care expenses. Contributions to the account are deductible from taxable income. Distributions for qualified medical expenses are not counted as taxable income. Tax-free distributions are also allowed for certain premiums. Any interest or other capital earnings from the account build up tax free as well. As a result of this triple-tax advantage, some individuals may find it advantageous to use an HSA as a savings vehicle not only for here-and-now medical needs but for health care expenses in retirement.

Eligibility

In order to qualify for tax-free contributions to an HSA, the individual must be covered by a health plan that has an annual deductible of not less than $1,250 for self-only coverage and $2,500 for family coverage. Certain preventive services can be covered in full and are not subject to the deductible. The out-of-pocket maximum may not exceed $6,350 for self-only coverage and $12,700 for family coverage, with the deductible counting toward this limit. The minimum allowable deductible and maximum out-of-pocket limit are indexed to inflation. See Figure 1 for historical statutory HSA limits.

To be eligible for an HSA, an individual may not be enrolled in other health coverage, such as a spouse's plan, unless that plan is also an HSA-eligible health plan. However, individuals are allowed to have supplemental coverage without a high deductible for such things as vision care, dental care, specific diseases, and insurance that pays a fixed amount per day (or other period) for hospitalization. Individuals enrolled in Medicare are not eligible to make HSA contributions, although they are able to withdraw money from the HSA for qualified medical expenses and certain premiums.[3]

Contributions

Both individuals and employers are allowed to contribute to an HSA. Contributions are excluded from taxable income if made by the employer and deductible from taxable income if made by the individual account owner. The maximum annual contribution is $3,300 for individual coverage and $6,550 for family coverage.

Individuals who have reached age 55 and are not yet enrolled in Medicare may make catch-up contributions. In 2014, a $1,000 catch-up contribution is allowed. The catch-up contribution is not indexed to inflation.

Distributions

Distributions from an HSA can be made at any time. An individual need not be covered by a high-deductible health plan to withdraw money from the HSA. Distributions are excluded from taxable income if they are used to pay for qualified medical expenses as defined under Internal Revenue Code (IRC) Sec. 213(d). Distributions for premiums for coverage under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), long-term care insurance, health insurance while receiving unemployment compensation, and insurance while eligible for Medicare other than for Medigap, are also tax free.

Distributions for nonqualified medical expenses are subject to regular income tax as well as a 20 percent penalty (increased from 10 percent in 2010 as a result of the Patient Protection and Affordable Care Act of 2010 (PPACA)). Penalties are waived if the owner of the HSA dies, becomes disabled, or is eligible for Medicare.

Potential HSA Accumulations

An individual who saves in an HSA for 10 years could accumulate between $53,000 and $68,000, depending on the rate of return realized and on the contribution rates assumed (Figure 2), while saving for 20 years could wind up with between $118,000 and $193,000. After saving for 40 years, you could have $360,000 if the realized rate of return were 2.5 percent, $600,000 if it were 5 percent, and nearly $1.1 million if it were 7.5 percent.

Assumptions

A number of assumptions were made to generate the potential savings in an HSA outlined above:

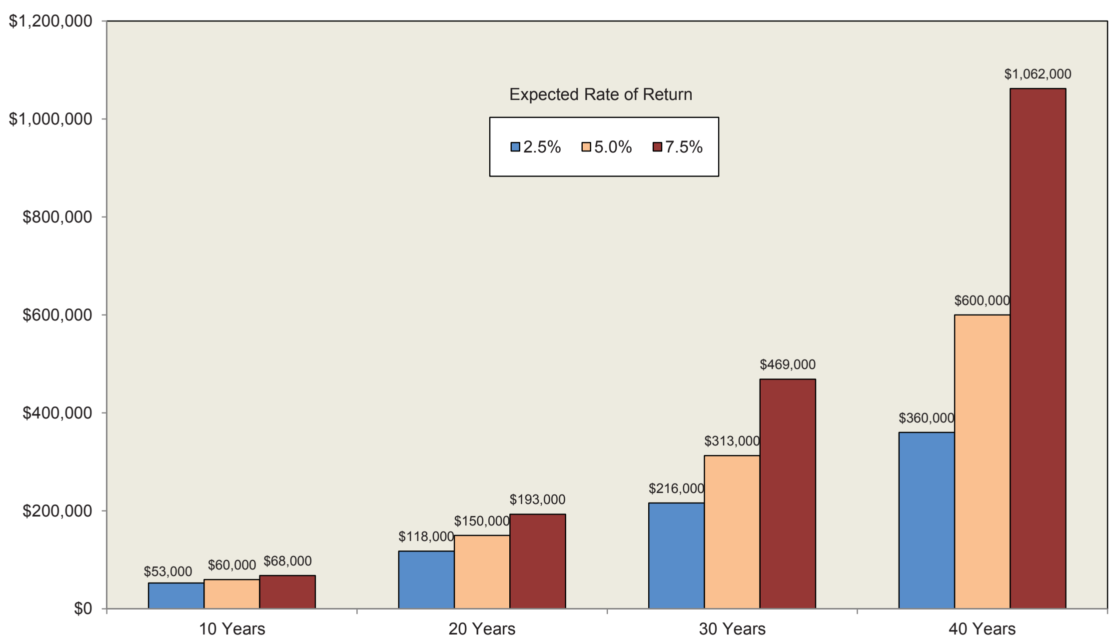
- It was assumed that the maximum contribution was made each year. Contributions were assumed to have been made monthly, where the monthly contribution was one-twelfth of the maximum annual contribution. The maximum contribution thresholds were increased 2.5 percent each year, which was the average annual increase in the maximum contribution limit from 2004 to 2013.
- Individuals eligible to make catch-up contributions (those ages 55 and older) were assumed to have made those contributions. Despite the fact that certain Medicare-eligible individuals are allowed to make catch-up contributions, it was assumed that only individuals ages 55–64 made them. As a result, in the 10-year savings estimates, catch-up contributions were assumed to have been made in each of the years. In the 20-, 30-, and 40-year savings estimates, catch-up contributions were assumed to have been made during the final 10-year period. In other words, the 10-year savings estimates represent the amount a 55-year-old could save by the time he or she reached age 65. The 20-year savings estimates represent the amount a 45-year-old could save by the time he or she reached age 65. The 30-year savings estimates represent the amount a 35-year-old could save by the time he or she reached age 65. And the 40-year savings estimates represent the maximum amount a 25-year-old could save by the time he or she reached age 65. The maximum catch-up contribution was not indexed to inflation.

Figure 1
Statutory HSA* Limits, 2004–2014

	Minimum Deductible		Maximum Contribution		Maximum Out-of-Pocket Limit		Per-Person Catch-Up Contribution Limit
	Individual	Family	Individual	Family	Individual	Family	
2004	$1,000	$2,000	$2,600	$5,150	$5,000	$10,000	$500
2005	1,000	2,000	2,600	5,150	5,000	10,000	600
2006	1,050	2,100	2,700	5,450	5,250	10,500	700
2007	1,100	2,200	2,850	5,650	5,500	11,000	800
2008	1,100	2,200	2,900	5,800	5,600	11,200	900
2009	1,150	2,300	3,000	5,950	5,800	11,600	1,000
2010	1,200	2,400	3,050	6,150	5,950	11,900	1,000
2011	1,200	2,400	3,050	6,150	5,950	11,900	1,000
2012	1,200	2,400	3,100	6,250	6,050	12,100	1,000
2013	1,250	2,500	3,250	6,450	6,250	12,500	1,000
2014	1,250	2,500	3,300	6,550	6,350	12,700	1,000

Source: http://www.treasury.gov/resource-center/faqs/taxes/pages/health-savings-accounts.aspx
* Health savings accounts.

Figure 2
Potential Savings in a Health Savings Account, by Years Saved and Expected Rate of Return



Source: Author estimates based on assumptions in text.

- The savings estimates did not include any money rolled over from a medical savings account (MSA) that was established prior to 2007.[4]
- It was assumed that there were no distributions made from the HSA to pay for any health care claims or services received while covered by the HSA-eligible plan.
- Expected rates of return were calculated as the rate of return on the prior-year balance and one-half the rate of return on current-year contributions. One-half of the rate of return was used on current-year contributions to approximate rates of return compounded on a monthly basis on contributions that are made monthly. Individuals who contribute the maximum all at once in January of each year will save more than individuals contributing monthly.
- In reality, expected rates of return will vary over time, and with account balance. During the early years of an account, individuals will likely receive low rates of return, as the funds will typically be invested in only a money market fund. Once an individual reaches a minimum balance, usually in the range of $2,000–$3,000, he or she will be able to invest the account balance above that range in an investment account, perhaps earning a higher return on the investment. However, as an individual reaches retirement age, he or she might move the funds back into safer investments, yielding a lower expected rate of return. For simplicity, expected rates of return in this analysis were assumed to be constant over the entire time period examined in this study. Three rates of return were examined for illustrative purposes: 2.5 percent, 5 percent, and 7.5 percent.
- The account was assumed to incur no direct fees.

Potential Lifetime Tax Savings

As mentioned above, HSAs provide account owners a triple tax advantage. Contributions reduce taxable income. Earnings on the account build up tax free. And distributions for qualified expenses from the account are not subject to taxation. The tax treatment is different from a traditional retirement savings plan, such as a 401(k) or individual retirement account (IRA), where contributions reduce taxable income but distributions of original pre-tax and employee contributions are taxed along with subsequent investment returns and also different from a Roth 401(k) or Roth IRA, where contributions are taxed but the account growth and distributions are not so long as certain holding periods are attained. As a result, some individuals might find using an HSA as a savings vehicle for health care expenses in retirement more advantageous from a tax perspective than saving in a 401(k) plan or other retirement savings plan.[5]

Federal Income Tax Savings

Figure 3 shows potential federal income tax savings over 40 years of saving in an HSA by tax bracket and expected rate of return. Tax savings are highly dependent on an individual's tax bracket. The higher an individual's tax bracket, the larger the tax savings for the same lifetime contributions to an HSA and rate of return on the account. Similarly, the higher the expected rate of return, the larger the tax savings from the same lifetime contributions and tax bracket.

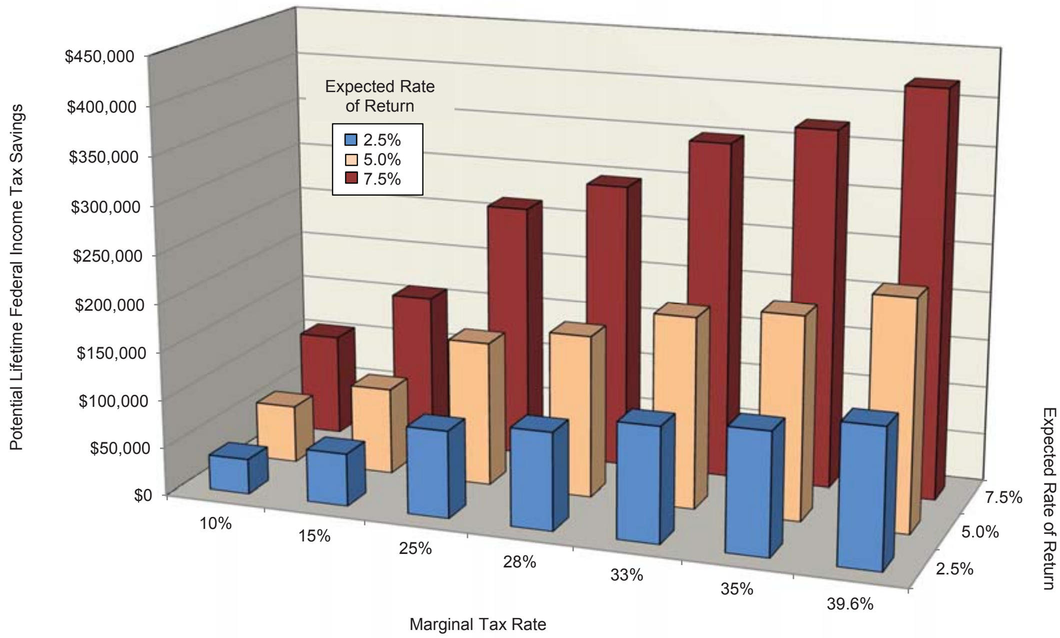
An individual earning 2.5 percent on his or her HSA would save about $36,000 in federal income tax over 40 years if he or she were in the 10 percent tax bracket, while an individual in the 39.6 percent tax bracket would save about $143,000. By comparison, an individual earning 7.5 percent on his or her HSA would save about $106,000 in federal income tax over 40 years if in the 10 percent tax bracket, and about $420,000 if in the 39.6 percent bracket.

Payroll Tax Savings

Potential savings from payroll tax (Social Security and Medicare paid under the Federal Insurance Contributions Act (FICA)) are shown in Figure 4. Two payroll tax rates are shown: 1.45 percent and 7.65 percent. Individuals below the maximum taxable wage base for Social Security would save 7.65 percent on their HSA contributions, but those above the wage base ($117,000 in 2014) would only save 1.45 percent on their HSA contributions.

Figure 3

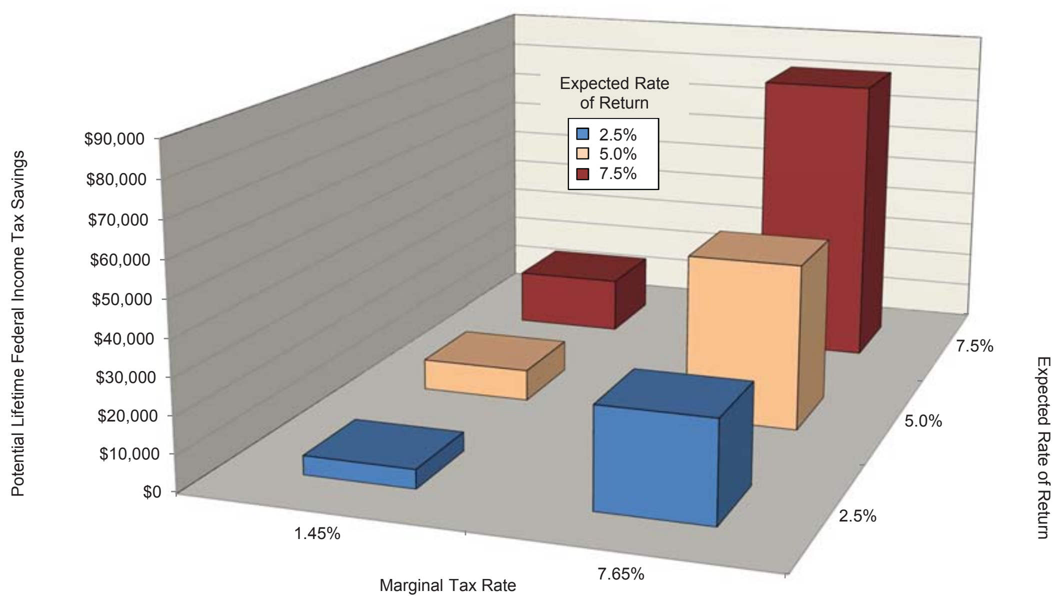
Potential Lifetime Federal Income Tax Savings From Contributing to an HSA* for 40 Years, by Expected Rate of Return and Marginal Tax Rate



Source: Author's calculations.
* Health Savings Account.

Figure 4

Potential Lifetime FICA[a] Tax Savings From Contributing to HSA[b] for 40 Years, by Expected Rate of Return and Marginal Tax Rate



Source: Author's calculations.
[a] Federal Insurance Contribution Amount.
[b] Health savings account.

FICA savings phase down from 7.65 percent to 1.45 percent in the 28 percent tax bracket for single filers; the 25 percent tax bracket for individuals filing joint returns, qualifying widows, and heads of household; and the 33 percent tax bracket for married individuals filing separately. As a result, higher-income individuals (those assumed to be above the Social Security wage base every year for 40 years) would save between about $5,000 and $15,000 in FICA taxes over 40 years, depending on the rate of return. Lower-income individuals (those assumed to be below the Social Security wage base every year for 40 years) would save about $28,000 in FICA taxes over 40 years at a 2.5 percent rate of return, and about $81,000 at a 7.5 percent rate of return.

For tax-savings purposes, it was assumed that all contributions to the HSA were made by the individual, but that they were made through payroll deduction, so that FICA tax savings applied. Individual contributions made outside of payroll deduction (contributions made directly to an HSA) are not subject to and do not therefore benefit from the FICA exclusion. In addition, there is an additional 0.9 percent Medicare tax that must be paid when income subject to FICA is above $200,000 for individuals and $250,000 for couples. FICA savings for individuals incurring the additional Medicare tax were not calculated in this report.

To the degree that individuals make contributions to an HSA through payroll deduction, employers also save on their portion of the FICA tax. Any direct employer contributions to an HSA are also excluded from the employer's payroll tax base. In contrast, individual and employer contributions to a 401(k) plan do not reduce the employer's FICA tax.

State Income Tax

Savings from avoiding or deferring state income taxes were not estimated for this report. State tax rates vary widely. Furthermore, individuals in Alabama, New Jersey and California are unable to reduce their taxable state income by the HSA contributions. In addition, seven states—Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming—do not collect state income tax. Hence, residents in those states will not realize any state income tax savings from any HSA contributions.

Trade-Offs

Individuals with a goal of minimizing taxes and maximizing savings for health care expenses in retirement may choose to maximize contributions to an HSA before contributing to a 401(k) plan or other retirement savings vehicle. However, the potential loss of employer matching contributions to a 401(k) plan must also be weighed against any tax savings from shifting contributions from a 401(k) plan to an HSA. In addition, in order to maximize the savings in an HSA to cover health care expenses in retirement, HSA owners would need to pay the medical expenses they incur prior to retirement on an after-tax basis using money not contributed to their HSA. Many individuals may not have the means to both save in an HSA and pay their out-of-pocket health care expenses. There is already evidence that rising health care costs are resulting in reduced contributions to retirement savings plans, such as 401(k)s and IRAs (Fronstin and Helman, 2013).

Also, HSA balances may not be sufficient to pay all medical expenses in retirement even if maximum contributions were made. In prior work, EBRI has found that a married couple both age 55 in 2008 would need a combined $325,000–$654,000 by the time they reach age 65 in 2018 to have enough money to cover their premiums and out-of-pocket expenses 50 percent of the time, and $511,000–$1 million to have a 90 percent chance of having enough savings. EBRI also found that they would be able to save only about $118,000 in an HSA if they contributed the maximum amount each year for 10 years, including catch-up contributions (Fronstin, 2008).

Additionally, HSA balances may not be sufficient to cover insurance premiums and out-of-pocket expenses, especially if health care costs increase faster than the inflation adjustments that allow higher maximum contributions into an HSA in the future. The data indicate that individuals will need to supplement any HSA savings with other substantial savings accounts or sources of income to pay for all of their expected health care costs in retirement.

References

Fronstin, Paul. "Saving for Health Care Expenses in Retirement: The Use of Health Savings Accounts." *EBRI Notes,* Vol. 29, (Employee Benefit Research Institute, August 2008).

Fronstin, Paul, and Ruth Helman. "2013 Health and Voluntary Workplace Benefits Survey: Nearly 90% of Workers Satisfied With Their Own Health Plan, But 55% Give Low Ratings to Health Care System." *EBRI Notes*, Vol. 34 (Employee Benefit Research Institute, September 2013).

Endnotes

[1] America's Health Insurance Plans (AHIP) found that 15.5 million people were enrolled in an HSA-eligible plan in January 2013 (See www.aahp.org/hsa2013/). The EBRI/Greenwald & Associates Consumer Engagement in Health Care Survey (CEHCS) estimated that 20.4 million people were enrolled in an HSA-eligible plan in August 2013 (see http://www.ebri.org/pdf/EBRI_IB_012-13.No393.CEHCS.pdf). The actual number likely falls somewhere in between. The AHIP census was based on 91 companies. Some insurers may not have reported HSA-eligible enrollment numbers to AHIP, which would have meant that the AHIP census underestimated HSA-eligible enrollment. The CEHCS may have overestimated the percentage of individuals in an HSA-eligible plan, as it was based on self-reported eligibility status.

[2] See www.devenir.com/research/year-end-2013-devenir-hsa-research-report/

[3] Among Medicare enrollees, only those ages 65 and older are allowed to pay insurance premiums from an HSA. A Medicare enrollee under age 65 cannot use an HSA to pay insurance premiums.

[4] Prior to HSAs, medical savings accounts (MSAs) were authorized as a demonstration project under the Health Insurance Portability and Accountability Act of 1996 (HIPAA). Workers were eligible to set up an MSA if employed at a firm with 50 or fewer employees. The self-employed were also eligible. Both were required to be covered by a high-deductible health plan in order to contribute to an MSA. When the MMA created HSAs, existing MSAs were grandfathered, but as of Dec. 31, 2007, no new MSAs could be opened. However, individuals with MSAs were allowed to transfer account balances to an HSA.

[5] Individuals may also have more flexibility with regard to the timing of distributions as compared to traditional 401(k) plans and IRAs. There are mandatory distributions required from 401(k)s and IRAs starting when an individual reaches age 70-½. There are no such distribution requirements for HSAs.

Notes

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