The Benefits of Health Savings Accounts - Transcript

Tom Mullooly: Welcome to the Mullooly Asset Management podcast. This is episode number 261. I'm your co-host, Tom Mullooly, and with me this week is Tim Mullooly.

Tim Mullooly: Hey, everybody? Filling in for Brendan this week. We have three really good articles that we wanted to talk about. The first one was from MarketWatch, and it's super important topic that really can't be talked about enough. The title read, 5 key tax questions when you're responsible for a loved one's estate. Estate planning and being an executor and those responsibilities is not something people like to talk about, because it means a loved one has passed away, but it's something that's very important.

Tom Mullooly: We've written about this and we've actually done a video or two on it and we've discussed it in podcasts as well. This is something that I'll begin by saying, we deal with this on just about a weekly basis here in the office. And most folks who are the executor for an estate or have a loved one who's passed away, this may only happen once or twice in their lifetime. It's something that they don't normally do. So the article was good, but it was very surface level. We're not going to get into an in-depth discussion here. But we wanted to talk about some of the points that they raised in the article. Like, what are an executors responsibilities?

Tim Mullooly: Yeah. First, they went over how you even get to who is the executor, which sometimes isn't necessarily clear. I mean, the most straightforward way is it's named in the persons will. This is a good reminder to everyone out there to have a will, because if not, it goes to probate and that goes to the state.

Tom Mullooly: And the state has to appoint an executor or an administrator to handle the decedents estate. It's a big deal. I think sometimes folks get cute with their estate planning or writing their will and they'll name two children, or worse, three children.

Tim Mullooly: Well, I don't want to pick a favorite. So I'm just going to name all three of them.

Tom Mullooly: That's a huge mistake. Yeah. Because all three have to sign off on everything that happens with the estate. You could have one of them that lives out of the area. You could have someone who has different ideas than you. And you may just not agree or get along. Even worse. That's not the way to pull a family together. That's often how a family gets torn apart. We're serious when we say that.

Tim Mullooly: Absolutely. They went on to say the basic responsibilities of an executor are to first identify what the estate's assets are. What needs to be distributed? Pay off any debts that are outstanding.

Tom Mullooly: I want to hit the pause button on this because everybody it seems when they're doing this for the first time, they're like, okay, I know he's got a visa bill. I know he's got some hospital bills. I know he's got this, that and the other thing. A lot of folks, executors are surprised when eight months later, a bill shows up in the mailbox. Or something's gone to collections because it was overlooked or not paid. Some of these bills, we had a client who had a bill for the

ride, the ambulance ride to the hospital that showed up 14 months later. 14 months later. It happens. Don't be in a hurry to say, the estate it's done, we're just going to distribute the assets.

Tim Mullooly: Right. And that is the last step or the last responsibility that they hit on for the executor, was just distribute the remainder of the assets. One thing that they did mention after that was that the executor is also responsible for filing any necessary tax returns. I feel like that's something that gets glossed over. Most people think, I just need to read the will and distribute everything the way that the person said, easy.

Tom Mullooly: Not so. Not only will you have, in some cases an estate tax return, you'll have a state estate tax return. And then, if your loved one passed away at any time during the year, they're probably going to have to file an income tax return for federal and state.

Tim Mullooly: Yeah. Unless they weren't working and had no money coming in. If they earned income during that year, they had any sort of income coming in, you're going to have to file for that year.

Tom Mullooly: There's a lot to go on. Some states are pretty straightforward and they can be wrapped up in three to six months. We've had some states that have hung around for two years. It happens. So this is not something that's going to get resolved quickly. Right. So Tim, what were some of the other points that were raised in the MarketWatch article?

Tim Mullooly: The next point that they wanted to talk about were the inherited assets and how you determine the cost basis of those assets.

Tom Mullooly: We run into a lot of situations where someone's getting sick or they're actually in the hospital or death is closing in. And they feel the need to raise money, because they don't know how much things are going to cost or they want to help everybody kind of smooth the process. So they want to sell assets, which can be a terrible decision. And unfortunately, I think without the help of an advisor, folks wind up doing this and not knowing the consequences.

Tim Mullooly: When a person who is sick passes away, their assets distributed to whoever is inheriting it, the cost basis gets adjusted not from the day that the person who passed away purchased it, but to the date of death. Which is extremely significant if those stocks or funds had huge capital gains. Like you were saying, if that person before they pass away, chooses to sell those investments or give them to their loved ones before they pass away, they're giving them the initial cost basis, and they're foregoing that stepped up cost basis they should have had if they had just waited until they passed away.

Tom Mullooly: So let's use some numbers to kind of paint this picture. Suppose someone put money into an investment years ago, they invested say $30,000. And over time, this has now grown to $100,000. If the person on their deathbed decides, I need to help my family, so I'm going to sell this so they have cash to pay for my funeral or whatever, they have now recognized $100,000 transaction with a $70,000 capital gain built into it.

Tim Mullooly: Whereas if they were to have not realized that gain, then they would have passed it along to the beneficiaries or whoever was inheriting the assets. Those people could sell it for $100,000 but not have the $70,000 worth of gains. It would only have the amount of gains that accumulated from the date of death to when they sold it, which that could be a couple weeks, a month. So that's significantly less in capital gains.

Tom Mullooly: Sure, it wipes the slate clean and gives people an opportunity to say, okay, if I need to change the investments or reallocate, I can do this without any kind of tax implications. So they also in the article referred to selling a principal residence. This is something I think lot of folks just overlook.

Tim Mullooly: So what they were talking about is if your spouse passes away and you sell, you can sell your house, take the joint filing exclusion for the gains up to $500,000. But it has to be within the first two years of the date of death. And that's an important, they made that distinction in the article. It's not the calendar year, two years of the calendar year, it's two years from the date of death. So today's June 14, 2019, if someone passes away, they can sell ... They can have this exclusion until June 14th of 2021. Not the end of 2021. Not December 31st, 2021.

Tom Mullooly: Right. There's a big difference and knowing these dates is important because they do trip up as we've learned overtime and clients have learned, you got to know these rules, they really do matter. Then the article went on to talk about required minimum distribution rules for inherited retirement accounts.

Tim Mullooly: One thing that I wanted to point out is that they used it a lot in these last couple paragraphs. It was dreaded. The dreaded RMDs of an inherited IRA.

Tom Mullooly: Is it dreaded.

Tim Mullooly: Why? Why are they dreaded? What's so bad about it? Tell me, tell me what's bad about it. Oh, my gosh, you have to take money. It's free money that you didn't work for and someone is giving to you. God forbid.

Tom Mullooly: They go on to say that beneficiaries really can't ignore these rules. And the way the rules are structured now is that the beneficiary of a retirement account can roll the money over from the decedent's retirement account into their own IRA. It's now set up as a beneficiary IRA, depending on whether the decedent was taking money out already as Required Minimum Distribution, RMDs, or if they had not begun taking their Required Minimum Distribution is going to help in calculating what your Required Minimum Distribution will be.

You will have to take money out even if you're under 59 and a half right, you will need to take money out of these Required Minimum Distributions. Now, having said that, that's actually on the table as a potential chopping block issue with this bill that's going through Congress. Where they're talking about potentially getting rid of stretch IRAs, which would be in my opinion, the loss of a very important planning tool.

Tim Mullooly: I just don't understand why everyone has such a big problem with these RMDs coming from the inherited IRAs. I mean, most times it's based off of the beneficiaries life expectancy, so you're not going to be getting that much per year anyway in your RMDs unless the account is worth like millions of dollars.

Tom Mullooly: I saw an example where a 25-year-old inherits a million dollar retirement account. The Required Minimum Distribution is about 16 or $17,000 a year. Not a deal breaker.

Tim Mullooly: Yeah. For someone in their 20s, in their mid-20s, that is a good chunk of change for them, which will help. Again, it's not a bad thing. You can't use 16 or 17 extra thousand dollars a year?

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Tom Mullooly: So, Tim, I want to move on to the article that was in the Wall Street Journal about your mutual fund and ETF fees might still very more than they should. And they talked about how you may own a mutual fund or ETF in a different account, whether it's a personal account, IRA, 401(k) at work, and have basically the same investments, but different levels of fees. They quoted a labor lawyer who talked about how in her 401(k) at work, she owned an S&P 500 Fund, and the fund charges were 61 basis points or 0.61%.

I think part of the problem with understanding fees is that our industry tends to talk in basis points, when most of the world talks about percentages. So this particular example, she was in a S&P 500 Index fund at work and their annual charge was 0.06%. Or a little more than a half of percent. You could invest in an S&P 500 ETF and sometimes see three or four basis points. 0.03 or poi 0.04%. The problem though is, where is it? In this case, it's sitting inside of her 401(k) account. Now, those accounts are not free. I know, from our plan here at Mullooly Asset Management, there's costs involved with these plans. You have to pay for them some way.

Tim Mullooly: They said how that labor lawyer was like, I did my research, and I know that there are S&P 500 funds out there for three, four basis points, and I'm paying 60 basis points. Why is that? Like, that shouldn't be. Well, it's within this 401(k) like you're saying, Tom, 401(k) aren't free. Someone needs to pay to run the 401(k), do all the backend office stuff that the employees don't see. Otherwise, the company would have to do it themselves. They don't know how to do it.

These fund companies still need to make money in some way. And these 401(k)s aren't free. So the labor lawyer who had a problem with paying that much. I mean, like they said in the article, no one is forcing you to invest in your 401(k). If you're really that unhappy about the 60 basis points spread that you have to pay for your 401(k), you can open your own account and do it yourself.

Tom Mullooly: I thought it was interesting how they did, it was almost like a sidebar article where they compared different S&P 500 Index funds and what they offered. So they talked about the Schwab S&P 500 Index, which is two basis points. Then they talked about the Rydex S&P 500 mutual fund that charges 2.3%.

That's 233 basis points for their Class C shares. And then they also mentioned principal financial as just ... These are just examples and certainly not recommendations. But they're a large cap S&P 500 Index fund. Again, Class C has a expense ratio of 1.3%. That's 130 basis points. And that actually shows up in the returns.

Just looking over the last 12 months, and this is right in the article in the Wall Street Journal, the Fidelity 500 Index fund over the last 12 months through April returned 13.4. The principles version of the S&P 500 returned 12.02. So you can see the difference there, the fee coming out. The Rydex fund total return over the last 12 months was 10.6. So you can see how overtime fees will erode your gains. Sometimes it happens immediately when you are in these high cost funds. But they're paying for back office costs, they're paying for record keeping when you see them inside a workplace retirement account.

Tim Mullooly: I think it's important to remember that and just remember where these funds are being held, and that you have the option to go and do it yourself. If you're really not happy with the options within your plan, or like they said in the article, you can go talk about or go talk to your HR person and see if they're willing to at least review the options within your plan. But all of those numbers that you write-off the returns, I mean, the lowest one there was 10 point something percent. Is that really that bad? I mean, obviously there is difference. If you're paying 2% in fees versus .3%, yeah, you're going to have it 2 or 3% difference in returns. Still 10% is not something to complain too much about.

Tom Mullooly: I was working at Morgan Stanley in 1999, and we had a lot of these dot-com funds. Not a lot. But there was basically a couple of these that were pure dot-com funds, and they posted returns 70, 80 90% in the calendar year. Nobody cared what the fees were in that year. But get yourself into a year where the return on your investment is 2 or 3%, fees will really matter at that point.

Hey, I want to just take a moment or two and talk about health savings accounts. This was another article that will link to in the show notes. The article goes on to talk about while most ... The basic Medicare plan is free for most people over 65. It only covers part of your health care needs. And it talked about, you may want to consider putting money into a health savings account.

Now, there's a lot of confusion because over the last 20 years, we've seen Flexible Spending Accounts, which are basically you get an allowance each year to spend on things like eyeglasses and dental coverage and things that aren't covered in your plan. That's a Flexible Spending Account. You have to use it each year. Use it or lose it. But a health savings account is something that you can have if you're in a high deductible insurance plan. These things are actually pretty good.

Tim Mullooly: Yeah, they are. It's exactly what the name implies. It's a savings account that you can use for qualified medical expenses. They, in the article outlined what most of those qualified expenses would be. It covers pretty much everything that you would need on a yearly basis. I mean, there are some exceptions, but there's a lot of things that you can use these accounts for. One of the big bonuses that they said about this account, type of account, is that it's triple-tax-free or something, I think was the phrase?

Tom Mullooly: That's right. They call it triple-tax-free because the money can be deposited into the plan on a pre-tax basis. So that's first. Then the earnings grow without any taxes, so that second. And then if you're using the money down the road for health expenses, the money comes out of the plan tax-free. It really is a good deal. Individuals can contribute up to $3,500 right now in 2019. Married couples can contribute up to $7,000 per year.

If you're over the age of 55, you can also make a $1,000 catch up provision which we're doing this year. I'm contributing $8,000 this year to my health savings account. I started it here a couple of years ago. If you don't need to lay out money, if you're relatively healthy, and you can pay your costs out of pocket, this money can accrue.

Tim Mullooly: That's the huge catch, I think, in my opinion. Like a 401(k) or an IRA, you can also invest the money in the account and let it grow.

Tom Mullooly: I have to admit, that took a little bit of digging for me because I set up an account online with a bank in Wisconsin. We were getting 1% interest when I started this. And then I read through the plan documents and I found that you could actually open a self-directed brokerage option through this at TD Ameritrade. So my health savings account is now invested in an account at TD Ameritrade. It sounds kind of like a circuitous loop, but we send the money to the bank in Wisconsin, and then we have to manually transfer the money over to TD Ameritrade. It eventually gets there and it gets invested. But it is possible.

Tim Mullooly: It's outlined as a health savings account that you can use for medical expenses. So in my mind, I'm like, that's so risky to invest the money that you're putting into the account for medical expenses. What happens if you put money into the account, the market plummets, it's invested, you have less money than you thought you were going to have. And then you get sick and you need the money and you don't have as much as you thought you were going to have. For someone who really needs this money for medical coverage, I would hesitate to actually invest the money in that account.

Tom Mullooly: Right. These are really ideally they're perfect for young healthy people who have the ability to sock some extra money away, and can let it compound for some time. You can't use money that's sitting in a health savings account to pay the premiums. You can use it for medical expenses, but you can't use the money to pay for premiums. That's a big catch. I think a lot of people miss that part. But you also have to be a participant in a high deductible health plan.

So that means that you have to be paying, I think it's $1,300.

Tim Mullooly: It is over a thousand dollars. Yeah.

Tom Mullooly: So you have to have a plan that has a deductible of at least 1,350 if you're single or $2,700 deductible if your plan covers two or more people. So that's a big deal. Basically, the way they do it is they set you up with a debit card. And so you can just swipe it when you're buying things that may not be covered under your health insurance plan. Hearing aids, some dental work, eyeglasses, and who knows, maybe this one day will pay for the MRI. Don't really know, but it's good to have it and this money continues to compound. I fully anticipate that by the time I'm ready for Medicare, it's going to cover less and less than what it covers even today. It's just the way things are.

Tim Mullooly: So I think these accounts are really good. I just err on the side of caution when you're investing it. I mean, you can't predict when you're going to get sick. But just keep that in mind, like, this money is for medical expenses. So don't go all out, pedal to the metal, aggressive, aggressive, risky investing if you are nervous about being able to cover medical expenses.

Tom Mullooly: So this is going to wrap up Episode 261. We appreciate your tuning in and listening to us and we will catch you on the next episode.