

To *SAVE* or To *SPEND*: That's the *HSA* Question

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What does the “S” in HSA stand for? The simple answer—based on Section 223 of the Internal Revenue Code that gave it life—is that an HSA is a Health Savings Account. The more complicated answer is that an HSA should be used at various times for saving and spending.

S is for Saving

First, let's look at the savings side of the equation.

The cost of medical coverage during retirement is something that most do not take into account. That is a mistake. Fidelity Investments' annual health care cost survey had some startling news: A married couple turning 65 this year will require \$215,000 in savings to meet their medical costs. That's because Medicare does not cover everything. There are deductibles, copayments and excluded benefits. Parts B (medical insurance) and D (prescription drug coverage) carry monthly premiums.

From what sources will people derive those savings? Traditional savings vehicles like pensions, 401(k)s, and IRAs are usually spent on living expenses. An HSA is fit for the purpose when it comes to saving for medical expenses during retirement. It is portable and not subject to the use-or-lose rules of a more traditional FSA.

After changes to the law that became effective this year, HSA participants can contribute up to the annual statutory maximum. In 2008, that will be \$2,900 for those with self-only high-deductible health plan coverage, \$5,800 for those with family HDHP coverage. These amounts are indexed to inflation and change every year. In addition, HSA participants who are age 55 or older at any time during 2008 can contribute another \$900 to their HSAs. In 2009 and thereafter, these catch-up contributions will be \$1,000 per year.

HSA contributions can be made on a pre-tax basis through a cafeteria plan, or on a tax-deductible basis if made with after-tax dollars. Employer HSA contributions are also tax-free as long as they comply with certain requirements. HSA funds can be invested in mutual funds or other investments that are available through the HSA trustee. Balances grow tax-free—not tax-deferred, like a 401(k) or IRA—and distributions are tax-free as well, as long as they are used for eligible medical expenses.

Here is an example of an HSA as a savings account. Assume a 40-year-old employee has family HDHP coverage. She cannot afford to save the maximum (\$5,800 in 2008) but resolves to save \$4,000 per year until she turns 65, given the fact that her insurance will cost \$200 less per month. With a modest five percent rate of return, her resolution to treat the HSA as a savings account will net her over \$200,000 to spend on medical coverage when she retires.

It would appear that many HSA participants are getting the message. By the end of 2006—only the third year of existence for HSAs—the accounts totaled more than \$5 billion in assets, according to estimates by Information Strategies Inc.





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S is for Spending

Now let's look at the other side of the equation: HSAs as spending accounts. In a way, electing an HSA is akin to reaching the proverbial fork in the road. Down one path is the general-purpose FSA, which one can use to reimburse eligible expenses on a pre-tax basis. This path has the advantages of uniform coverage and grace periods (if applicable) but the disadvantages of the use-or-lose rule.

Another path awaits: the general purpose Health Reimbursement Arrangement (HRA). It has the advantage of employer funding and carry-overs/spend-downs (if applicable) but the disadvantage of no uniform coverage. The HRA and FSA paths can merge in some cases. In other words, some employers offer both.

The final path is the HSA. This path cannot intersect with a general-purpose HRA or FSA. (It is compatible with a limited-purpose or post-deductible HRA or FSA.) And you must have a companion along the HSA path: the HDHP. The HDHP companion is typically less expensive than its non-HDHP counterpart so you can bank the monthly premium savings in your HSA.

In this light, the HSA serves the same purpose as the HRA and FSA—namely, as a spending account. Everyone has out-of-pocket expenses that they want to pay for with pre-tax money. HSAs can meet that purpose.

From a spending-account perspective, the HSA path enjoys many advantages. There are no plan-substantiation requirements. HSA participants merely retain receipts to support their tax filing. While HSAs have no uniform coverage, recently issued proposed regulations allow employers to accelerate funding of employer contributions. You can change HSA elections at least once per month throughout the year (election changes are available in limited cases for FSAs).

An HSA can be great in an emergency. If you lose your job and need to pay for COBRA, which can be expensive, you can use your HSA money. If you are collecting unemployment compensation and want health coverage, you can use your HSA money.

S is for Synchronization

So where is the happy medium? A prudent approach would be to consider an HSA primarily as a savings account but realize that it may need to be used from time to time to cover out-of-pocket expenses. The more you can keep in your account, the more it will grow. Grab a shoe box and mark "HSA" on the top. Start the habit of depositing every medical expense receipt. On a rainy day, you can be reimbursed for those expenses, even if the distribution occurs years after the expenses were incurred.

Let's revisit our hypothetical employee above. If her family averages \$1,500 in reimbursements from age 40 to age 55 then \$1,000 thereafter (when the children have grown up), what do you think the HSA account balance will be at age 65? Believe it or not, it will still be more than \$140,000.

HSAs are not necessarily a cure-all for everyone. They do address a need that more traditional reimbursement accounts do not. And they are owned not by the employer, but by you. When it comes to an HSA, you can take it with you. And chances are that you intend to stick around for awhile. ■



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