

To Save or to Spend: That's the HSA Question

by Rich Glass, JD

What does the S in HSA stand for? Based on Section 223 of the Internal Revenue Code that gave it life, S stands for "savings" in a Health Savings Account (HSA). But an HSA should be used at various times for saving and spending.

S is for Saving

Let's look at the savings side of the equation. Most of us don't take the cost of medical coverage into account during retirement. That is a mistake. Fidelity Investments' annual healthcare cost survey revealed some startling news: a married couple turning 65 this year will need \$215,000 in savings to meet their medical costs. That's because Medicare does not cover everything. There are deductibles, co-payments, and excluded benefits. Parts B (medical insurance) and Part D (prescription drug coverage) carry monthly premiums.

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

After changes to the law, 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 (HDHP) coverage and \$5,800 for those with family HDHP coverage. These amounts, which are indexed to inflation, change every year. In addition, HSA participants who are 55 or older any time during 2008 can contribute another \$900 to their HSAs. These catch-up contributions will be \$1,000 a year in 2009 and thereafter.

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 available through the HSA trustee. Balances grow tax-free – not tax-deferred, like a 401(k) or IRA. Distributions are also tax-free as long as they

are used for eligible medical expenses.

Here is an example of an HSA for a 40-year-old employee who has family coverage under a high deductible health plan: She cannot afford to save the maximum of \$5,800 in 2008, but she resolves to save \$4,000 a year until she turns 65 since her insurance will cost \$200 less a month. With a modest 5% 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.

Many HSA participants seem to be getting the message. These accounts totaled more than \$5 billion in assets by the end of 2006, which was only the third year of existence for HSAs, according to estimates by Information Strategies Inc.

S is for Spending

Let's look at the other side of the equation with HSAs as spending accounts. Choosing an HSA is like reaching a fork in the road. Down one path is the general-purpose health FSA, which can reimburse eligible expenses on a pre-tax basis. This path offers uniform coverage and grace periods, if applicable, but has the disadvantages of the use it-or-lose it rule.

Another path awaits: the general purpose health reimbursement arrangement (HRA). It offers employer funding and carryovers/spend-downs, if applicable, but it has the disadvantage of no uniform coverage. The HRA and health FSA paths can merge in some cases. In other words, some employers offer both.

The HSA is an alternative route to the fork in the road. This path cannot intersect with a general-purpose HRA or health FSA. It is compatible with a limited-purpose or post-deductible HRA or health FSA. You must have a companion along the HSA path: the HDHP. Since it is usually less expensive than the non-HDHP counterpart is, you can bank the monthly premium savings in your HSA.

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

The HSA path has advantages from a spending account perspective. There are no plan substantiation requirements. HSA participants retain receipts to support their tax filings. HSAs aren't subject to the uniform coverage requirements of Health FSAs. However, employers are now permitted to accelerate funding of employer contributions, based on proposed regulations recently issued by the IRS and based on earlier IRS guidance.

A person can use their HSA money if they lose their job and need to pay for COBRA, which can be expensive. They can also use their HSA money if they are collecting unemployment compensation and want health coverage.

S is for Synchronization

So where is the happy medium? It would be prudent to consider an HSA primarily as a savings account, which may need to be used to cover out-of-pocket expenses from time to time. The more a person can keep in their account, the more it will grow. Here is an exercise for your client's employees: Grab a shoebox and mark HSA on the top. Get in the habit of depositing every medical expense receipt. On a rainy day, they can be reimbursed for those expenses, even if the distribution occurs years later after the expenses were incurred.

Let's revisit our hypothetical employee above. Suppose her family averages \$1,500 in reimbursements from age 40 to age 55 and \$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.

While HSAs are not 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 the employee. □

Rich Glass is chief compliance officer for In-finisource, Inc, a benefits educator and administrator serving more than 15,000 clients nationwide in the areas of COBRA, HIPAA and Flexible Benefits, including HSAs. He's a licensed attorney with more than 14 years of legal expertise, specializing in benefits, Human Resources, and regulatory compliance issues.