

## HEALTH SAVINGS ACCOUNTS

As the cost of health insurance and medical expenses continues to rise, many who pay for their own health insurance (self-employed, retired, unemployed) find themselves looking for ways to reduce the cost of insurance premiums. At the same time, many who receive insurance from their employer find that their plans include high deductibles as a way of keeping costs down, or they are offered a choice of plans with different levels of deductibles and required contributions.

While some may view high deductible plans as being inferior to plans with little or no out of pocket expenses, many believe that they are actually beneficial and required to effectively manage our health care system and skyrocketing costs. The idea is that by having some skin in the game, plan participants may be more judicious in their allocation of healthcare spending, as opposed to the potential for excessive use of services when there is no cost incurred by the participant.

Health Savings Accounts were created in an effort to ease some of the pain associated with higher out-of-pocket expenses, as well as to provide additional incentives for savings and judicious spending.

### What is a Health Savings Account?

A Health Savings Account (HSA) is an account established for an individual and intended to pay for qualifying medical expenses incurred by that individual, his/her spouse, and his/her dependents. Money in an HSA may generally be invested similar to the way that money in an IRA is invested (stocks, bonds, mutual funds, etc...) and allowed to grow tax-deferred, although it may depend on who administers the account...HSAs provided by the insurance company may have more restrictive investment options.

Investment gains inside the HSA are tax-deferred, and distributions used for qualified medical expenses are tax-free. Although distributions not related to medical expenses are subject to income taxes and a 10% penalty if taken before age 65, distributions after age 65 are not subject to the 10% penalty.

### Who is eligible to create an HSA?

HSAs are available to individuals under age 65 who are covered by a "high deductible" health insurance plan, and who have no other health plan. *In general*, a "high deductible" plan is a health insurance plan with that meets the following requirements:

- An annual deductible of at least \$1,100 for individual coverage, or \$2,200 for family coverage.
- Maximum out-of-pocket expenses with respect to allowed costs, *including the deductible*, cannot exceed \$5,600 for individual coverage and \$11,200 for family coverage. Out of pocket expenses include deductibles, co-payments, and any coinsurance amounts (premium payments are not included).

**Note:** The best way to determine if your health insurance plan qualifies as a "high deductible plan" that would allow you to create an HSA is to contact the plan provider.

### Who can contribute to an HSA?

Contributions to an HSA may be made by (1) the individual, (2) his/her employer, or (3) both. Contributions made by the individual are tax deductible, and contributions made by the employer are excluded from income.

### **What are the limits on HSA contributions?**

The maximum annual contribution to an HSA is \$2,850 for an eligible individual with self-only coverage, or \$5,650 for an eligible individual with family coverage. These amounts are increased annually to account for cost-of-living-increases.

For individuals who will be age 55 by the end of the taxable year, the annual contribution limit is increased by \$900 in 2008, and \$1,000 in 2009 and thereafter.

Note: If the employee is not yet age 55, but his/her spouse is, it is possible to open the HSA under the spouse's name in order to take advantage of these higher contributions.

### **Full-year contributions for part-year account holders**

For purposes of computing the annual contribution amount, an individual who is eligible during the last month of a taxable year is treated as having been eligible for all prior months during the taxable year. As a result, the individual is allowed to make contributions for months before he/she was enrolled in a high deductible health plan.

If the individual does not remain eligible for a full year, a portion of HSA contributions is includible in gross income and is subject to a 10% additional tax (with exceptions for death and disability).

### **How are distributions from an HSA taxed?**

Distributions from an HSA that are used to pay the medical expenses of the individual and his or her spouse or dependents are tax-free.

Distributions that are not used to pay medical expenses are subject to income tax. Such distributions are also subject to an additional 10% penalty tax *unless the distribution is made after age 65 or on account of death or disability.*

**Note:** the age 65+ tax treatment is similar to that of distributions from tax-deductible retirement plans (IRA, 401k, etc...). In essence, contributions that are not used for medical expenses can then be applied to retirement savings.

### **Who should consider opening an HSA?**

If you are currently enrolled in an employer health insurance plan that qualifies as a "high deductible plan," and you have no other coverage (including a spouse's plan), enrolling in an HAS may be a good idea. Enrollment will allow you to make additional tax-advantaged savings, pay for medical expenses with pre-tax money, and possibly allow an additional resource for retirement savings...there is limited (if any) downside.

If you are purchasing health insurance for yourself, or if you have a choice from your employer, you should consider a high deductible plan coupled with an HSA, which may have significantly lower premium expenses than a plan with similar benefits but lower deductibles. How advantageous an HSA might be will depend on a number of factors (whether your employer makes your HSA contribution, actual premium savings, marginal tax bracket, expected health and claims history, administrative costs of the HAS, and investment options), but it may be worth comparing the numbers before making a final purchasing decision.

If you currently have a family plan and regularly use medical services, you may be better off with a traditional non-HSA plan, since the savings may not offset the extra out of pocket costs.

### **How do you open an HSA account?**

Your insurance company will typically provide an option to open an HSA account that pays interest. Interest rates tend to be low, but this is the most convenient choice. However, if you plan to use the account for retirement savings, then you may open your own HSA account that includes brokerage account options.

### **How is this different from a Flexible Spending Account?**

Unlike the “use it or lose it” provisions associated with an FSA, the HSA can accumulate money that is not used during the year.

You can have both an FSA and an HSA, but if you use money in your FSA to pay for medical expenses, you may not apply money from your HSA to those same expenses. There’s no double dipping.

Please let me know if you would like to learn more about HSAs and whether they make sense for you to consider.

Bill Moeckel, CFA, CFP