

Health Savings Accounts – A New Tax Incentive for Consumer Driven Health Care

Overview of Health Savings Accounts (HSAs)

As part of the Medicare Prescription Drug Act passed late last year, Congress created HSAs to allow individuals to pay for day-to-day health care expenses with tax-free dollars.

This benefit is similar to what some employees have enjoyed for years with Health Care Reimbursement Accounts (HRA) or Flexible Spending Accounts. In an HRA, the employee sets aside a certain dollar amount of pay for use for eligible health care expenses. The contributions to the account are tax-free and distributions used for eligible medical expenses are also tax-free. Funds not used during the year; however, are forfeited.

HSAs offer the same tax advantages of HRAs without the forfeiture rule – you are allowed to grow the funds in the HSA year after year. Additionally, an individual can set up an HSA without the necessity of an employer provided plan. An HSA is administered through an HSA custodian, generally a bank or other financial institution, rather than the employer. This allows you direct access to your funds through checks, debit cards, and other convenient methods rather than having to submit reimbursement forms with your employer.

The HSA legislation gives individuals and small employers the chance to pay for medical expenses with tax-free dollars. Large employers also need to consider whether adding an HSA option makes sense.

Who's Eligible for An HSA? In order to be eligible for an HSA, you must have a health insurance policy with a high deductible. A health insurance plan qualifies as a "High Deductible Health Plan" (HDHP) if the annual deductible is at least \$1,050 for individuals and at least \$2,100 for families. A HDHP must also cap total out-of-pocket expenses at \$5,000 for individuals and \$10,000 for families. If you have doubts, ask your insurance provider if your plan qualifies. Insurance companies are actively creating new plans to fit the definition of HDHP.

You also must be under the age 65 to be eligible – individuals eligible for Medicare benefits are not eligible for HSAs.

What Are the Tax Benefits? Individuals are allowed to contribute and deduct up to \$2,700 and families up to \$5,450 (based on 2006 IRS limits). Of course, as part of the Internal Revenue Code, it's a bit trickier than that. The actual maximum contribution amount is the lesser of the \$2,700 (or \$5,450 for families) and the amount of the HDHP.

Example: Bob, who is single, is covered under a HDHP with a \$5,000 deductible. Bob's maximum contribution to an HSA is \$2,700 the limit set by the law (the lesser of \$2,700 or \$5,000).

The earnings on the account also grow tax-free year after year.

In addition to medical expenses, money in an HSA can also be used to buy long-term care insurance. At age 65, you can take the money out of the account penalty-free for non-medical reasons -- basically making the HSA work like a 401(k) or IRA. Distributions used for non-medical reasons are taxable but not penalized. Of course, you can leave the money in the account and use it tax-free for medical expenses. If you are under age 65 and take a non-qualified distribution, the distribution is taxable plus subject to a 10% penalty.

What Are the Investment Options? The law allows for a wide variety of investment options in HSAs; including, checking accounts, savings accounts, stocks, bonds, mutual funds and even real estate. For most people, a checking account or its equivalent makes the most sense. This is money that people will use for day-to-day health care expenses.

What Does Congress Hope to Achieve With HSAs?

The philosophy driving the creation of the combination of a HDHP and HSA is put consumers back in control of health care expenses. A consumer with a high deductible has an incentive to watch expenses and ask about alternatives when seeking medical help. This should help reduce the rapid rise in medical costs.

The government expects this to be a popular plan – it forecasts one million new accounts in 2004 and growing to 40 million accounts by 2014. Now is a good time to consider whether an HSA is a good plan for you.

Summary of Benefits of HSAs

- Tax deduction of up to \$5,450
- Pre-tax dollars can be used to pay for medical expenses
- You are in control of more of your health care decisions
- Funds left in an HSA can grow tax-deferred for years
- Your account stays with you even if you change employers
- After age 65 you can withdraw your funds for non-medical reasons and they are taxed as ordinary income