

Benefits professionals know that a health savings account (HSA) belongs to its owner and stays with an employee when he or she leaves or loses a job. The author provides additional information about a former employee's options for using an HSA and some of the benefits of establishing one as soon as possible.

HSA's: Six Insights for Employees Leaving or Losing a Job

by Whitney R. Johnson

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The rapid growth of health savings account (HSA) plans over the last few years combined with mounting job losses nationwide has human resources managers facing a new employee question: “What happens to my HSA when I lose my job?” Fortunately, benefits professionals who work with HSAs know the quick and easy answer. The HSA and the money in it belongs to and stays with the employee. This answer is well-rehearsed by benefits professionals because this is one of the primary features of HSAs touted when employers first switch to these plans. Although that quick answer is a solid start to a discussion of the employee’s options, it leaves out a number of important considerations. This article focuses on six key insights employees should consider when they lose their job and their employer-provided high-deductible health plan (HDHP) insurance.

1. Not Necessary to Close the HSA

Some employees believe they need to close their HSA once they change their job or health insurance. This misperception relates to ongoing confusion between flexible spending accounts (FSAs) and HSAs and is easily resolved with the benefits professional’s quick answer, “No, you get to keep your HSA.”

The quick answer, however, often leads to subtle followup questions that can confuse even professionals, such as, “Can I continue to use my HSA for eligible medical expenses even if I am now covered by a traditional health plan instead of the required HDHP?” Yes, HSA owners can use their HSA for eligible medical expenses even if they are no longer eligible to continue in the HSA plan as active contributors.

One of the valuable features of an HSA is that its owner can build up a balance to use as a health safety net for future medical expenses regardless of health insurance coverage. HSA owners can even use their HSA money to cover medical expenses if they have no health insurance at all.

There is no rush to exhaust HSA money prior to the end of the calendar year as there might be with other benefit plans. The law places no time limit on how long the HSA owner has to use

the funds in the account. Owners can use their current HSA balance to pay for medical expenses that they will not incur for years. If the owner remains healthy enough or otherwise saves the money in the HSA, at the age of 65 the owner can use the money for any reason without penalty. A good choice at that age is to use the HSA to pay for Medicare premiums to retain the tax-free benefit. If the HSA owner dies without exhausting the HSA, the HSA can pass as an HSA to a spouse beneficiary or as a cash distribution to a nonspouse beneficiary.

2. Taxes and Penalties May Apply

Some employees elect to close their HSA once they separate from service. This may be due to misunderstandings of the rules, a desire for closure on benefits and connection with the employer, or a real need for the money to fund necessary expenses. The key insight in this situation is to educate HSA owners that federal income taxes and a federal 10% penalty apply to distributions for noneligible medical expenses. If the HSA owner lives in a state with an income tax, the HSA owner most likely owes state income taxes on the amount distributed as well.

Other exceptions to the tax or penalty exist and are important to review for an HSA owner considering a nonmedical distribution. Exceptions exist for disability, death, individuals aged 65 or older, rollovers and return of excess contributions.

Some taxpayers are not as concerned about income taxes and penalties as others. Unlike an FSA, HSA laws allow an owner to take money out of the HSA for any reason. The tax and penalty serve as a deterrent only. The ability to access the funds for any reason may provide much-needed relief to financially stressed individuals. That relief must be balanced with the knowledge of taxes and penalties. For a person without a current income, income taxes may not present an issue; however, the 10% penalty will apply. Saving the HSA for eligible medical expenses is generally the financially sound approach for all but the most financially desperate individuals.

3. Use HSA to Pay for Health Insurance Premiums

The ability to pay for health insurance premiums using pretax HSA dollars is a valuable feature for those separating from service with an employer. This HSA feature is not as well known and becomes very important to employees facing the full cost of health insurance on their own. The general rule is that an HSA cannot be used to pay health insurance premiums. The following exceptions to that rule may help employees who lost a job:

- **Receiving COBRA continuation benefits.** If the employee elects to continue to receive insurance through the employer COBRA continuation benefits, the employee can use his or her HSA to pay the employee’s portion of the health insurance premium. Congress made this option more appealing in 2009 by passing the federal stimulus bill, which provides that a federal subsidy will pay for 65% of the COBRA premiums for an employee who involuntarily lost his or her job between September 1, 2008 and December 31, 2009. The remaining 35% of the premium can be paid for using the HSA, tax free, instead of with posttax dollars.
- **Receiving unemployment compensation.** Even if the employee elected not to take advantage of the COBRA continuation benefits, the employee can still use the HSA to pay for health insurance premiums tax free if the employee is receiving unemployment compensation from a state or federal agency. This allows employees who are able to purchase insurance less expensively on their own to still take advantage of the HSA to pay the insurance premiums. COBRA continuation coverage is likely priced competitively when 65% is paid by the government, but some employees may still find a nongroup policy more affordable or otherwise preferable.
- **Other exceptions.** Although less related to someone losing or changing jobs, it is worth noting some other exceptions that allow HSA owners to use their HSA to pay for insur-

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ance premiums. Employees who reach the age of 65 are allowed to use their HSA to pay for the employee's portion of the premium of an employer-provided health insurance plan. They are also allowed to use the HSA to pay for the Medicare premium. This includes any premiums for Medicare Part A, B or for Medicare HMO. The exception does not include Medigap premiums, which are not considered an eligible medical expense. HSA owners can also use their HSA to pay for long-term care insurance premiums with annual dollar limitations in place.

4. Use Existing HSA With New Health Insurance

Often individuals forced to buy their own health insurance elect to buy HSA-eligible health plans, given HDHPs' relative affordability. In most cases, HSA owners can use their existing HSA plan with their new insurance provider. Not having to change the HSA provides some stability in a time of change. Many HSA owners identify more closely with the HSA that pays for day-to-day medical expenses than with the HDHP insurance, a fact that makes changing health insurance providers easier. This point is insightful because new HSA owners often struggle to separate the HSA from the health insurance plan. Although over time the realization that these are two separate plans takes hold, many individuals forget that point when starting a new health insurance plan.

HSAs are often marketed and sold separately from HDHP insurance. This reduces confusion that the two are the same. In other instances, the two are sold as a bundle; either the insurance company packages two separate products together or offers both solutions. Some of the bundled products require the HSA owner to close the HSA if he or she no longer receives insurance through the HDHP provider. In this case, the employee is generally required to open a new HSA at another HSA custodian or trustee. A new employer may also require the HSA owner to switch to a new HSA provider to simplify the employer's administration.

Even if not required to change HSA providers, some HSA owners may simply prefer to move their HSA. The employer, not the employee, likely selected the orig-

inal HSA. To switch HSA providers, the HSA owner completes a trustee-to-trustee transfer of the funds to the new HSA provider. Moving the money as a trustee-to-trustee transfer is important because it preserves the tax-free character of the HSA and reduces errors. Trustee-to-trustee basically means that the two providers work together to move the funds directly, and the HSA owner never gets direct access to the funds outside of an HSA.

An alternative approach to moving the existing HSA funds is for the HSA owner to take a full distribution and then roll the funds into a new HSA. The rollover method is less desirable for most people due to the increased likelihood of a costly mistake. Rollovers not completed within 60 days result in a failed rollover, and taxes and penalties are owed on the full amount. Plus, only one rollover is allowed per 12-month period.

5. Make an HSA Contribution

A smart move for many HSA owners who lose their job is to add more money to their HSA. This counterintuitive approach makes sense because it may be the last year for the HSA owner to add more money to his or her HSA. The tax savings for the contribution may be more important than ever for someone in a time of change. Plus, the HSA owner may need extra funds for medical expenses, such as insurance premiums discussed above, that were previously covered by the employer. An HSA owner without the financial ability or desire to add more may still benefit from the knowledge of how this rule works because he or she may incur uncovered health expenses later in the year and decide at that time that running the cost through the HSA makes sense.

A common misperception among HSA owners is that they cannot contribute to their HSA after they lose eligibility for the HSA. Although this misperception almost certainly helps avoid excess contributions—where individuals contribute more than they are allowed—full knowledge of the rule allows an HSA owner to maximize the contribution in the final year without overcontributing.

Individuals must be eligible for an HSA to make an HSA contribution. However, the HSA laws allow an individual that is currently ineligible for an HSA to make a

contribution for a period when the person *was* eligible, provided the contribution is made before the tax-filing due date. An example helps explain.

Example 1: Assume Susan lost her job and her insurance coverage on July 1, 2009. From January 1 through June 30, 2009 Susan was covered under a self-only HDHP and was otherwise eligible for an HSA. Susan's 2009 maximum HSA contribution is \$1,500. The federal maximum for self-only individuals is \$3,000 but Susan was eligible for only half the year so she is eligible for only half the maximum. The IRS rules require a pro-rata calculation based on the number of months of eligibility (individuals must be eligible on each day of a month for it to count). The math gets more complicated with the pro-rata calculation when catch-up amounts for individuals aged 55-65 are added in, but the logic is the same.

Assume Susan already contributed \$500 to her HSA. Susan can still contribute another \$1,000 to reach her \$1,500 maximum for 2009. She is no longer eligible for an HSA because she ended eligibility on July 1, 2009, but it is not too late to contribute. Susan can contribute up to \$1,000 any time before her tax due date on April 15, 2010.

Example 2: Use the facts from above, except that Susan does not want to commit \$1,000 to her HSA and plans to gamble that she will remain healthy until she gets a new job. Susan loses the gamble and becomes ill in January 2010 and seeks health care treatment costing \$1,500. Susan can still make the additional \$1,000 contribution to her HSA as it is still before her April 15, 2010 tax due date for 2009. The \$1,000 added to her \$500 existing 2009 contribution maximizes her 2009 HSA contribution and provides tax-free funds to pay the medical bill. She can contribute the money and then take it back out immediately to pay for the medical expenses (or to reimburse herself if she paid the medical bill out of personal funds or on a credit card). This level of flexibility can prove important to unemployed HSA owners.

6. Preserve the HSA Establishment Date

HSA owners are often not clear on what to do with their HSA after they lose eligibility. One common approach is to

exhaust the HSA by paying for eligible medical expenses and then close the HSA. That works well for many HSA owners.

A better approach for more financially savvy HSA owners is to use the HSA for eligible medical expenses only until the account reaches a relatively low balance and then save the remaining balance. The HSA owner should maintain a balance that will allow enough money to cover a number of years of any HSA administrative fees as well as any minimum balance requirements. This approach allows HSA owners to preserve the HSA establishment date.

HSA owners who exhaust and close their HSAs will lose their establishment date. The IRS rules are somewhat generous and grant an 18-month grace period. An HSA owner who opens a new HSA within 18 months of closing one can continue to use the original establishment date. HSA owners who simply keep the HSA open never lose their establishment date and do not start the 18-month period.

Importance of the Establishment Date

The establishment date is crucial because HSA owners can use their HSA to pay for eligible medical expenses incurred only after that date. Upon quick review there is not too much to this statement as it allows HSA owners to use their HSA for future, not past, medical expenses. The insight into this rule is that it allows an HSA owner to manage the HSA to use it for eligible medical expenses even in years when he or she does not have sufficient funds in the HSA. FSA owners often face the problem of either deferring too much or not deferring enough to cover medical expenses. Understanding the details on how HSAs work, especially the establishment date rule, allows HSA owners to more closely manage this issue.

This point is easier to understand for employees first becoming eligible for an HSA. New HSA-eligible employees often make the mistake of waiting to open an HSA either because they are busy or are just reluctant to part with money or time. When they do incur an unexpected medical expense they discover that it is too late to use an HSA for that expense because HSAs can be used only for eligible medical expenses incurred after establishment.

For this reason, a best practice for HSA owners is to open an HSA as soon as possible. The amount of the initial deposit does not matter; getting the HSA established is the important step.

Example 1: Bill and Todd are young, single and employed at ABC Corp. On January 1, 2009, Bill and Todd enrolled in a \$2,500 HDHP offered by ABC Corp. and were otherwise eligible for an HSA. ABC Corp. does not contribute money directly into an HSA. Bill and Todd are both healthy and do not expect to incur any medical expenses in 2009. Accordingly, Bill does not open an HSA. Todd, who paid closer attention in the enrollment meeting, established an HSA with a one-time \$50 contribution.

For the next six months both enjoyed perfect health. On July 1, however, while car pooling together to work, they crashed into a tree. Each incurred a \$2,500 hospital bill. Bill, who never established an HSA, must pay the \$2,500 with non-HSA funds. Todd, however, established his HSA in January and can use his HSA to pay the \$2,500.

Todd has only \$50 in his HSA but can contribute the extra \$2,450 after the accident to pay the bill and use his HSA (assuming he remains eligible). This allows Todd to pay the full \$2,500 tax free from his HSA while Bill is stuck paying with after-tax dollars.

Example 2: Assume that on top of his car accident, Todd also incurs an unexpected \$5,000 dental bill that is not reimbursed through insurance. Todd cannot contribute the full \$5,000 to his HSA because it exceeds the federal HSA limits for a single person. Taking advantage of the HSA rules, however, Todd can pay the \$5,000 bill with non-HSA funds and then reimburse himself in the future from his HSA, when he has funds available, because the expense was incurred after the establishment date.

Manage HSA to Maximize Tax Benefits

HSA owners who preserve their establishment date should save medical receipts that they are unable to reimburse from the HSA due to lack of funds in the account. When the HSA owner again becomes eligible for an HSA, he or she can make a contribution and then immediately take the money back out to reim-

burse the unreimbursed medical expenses made during the years when a contribution wasn't possible. This allows him or her to pay for those expenses pre-tax. Depending upon how long the HSA owner went without eligibility to contribute, it may take a while to reimburse for the medical receipts, but the law does not place a time limit (just a limit on how much can be contributed each year). This approach works only for someone who eventually becomes eligible again for an HSA, but the low cost of keeping the HSA open (generally tying up a few hundred dollars or less) makes keeping this option open viable for most HSA owners.

Example: Jose, an HSA owner, lost his job and his HDHP insurance in January 2005. He quickly found new employment that offered a traditional health plan. No longer eligible for making HSA contributions, he saved the \$200 remaining in his HSA to preserve his establishment date. Over the next few years Jose paid his doctor visit copays, his over-the-counter drug costs, dental and other eligible medical expenses that were not covered by his traditional health insurance using out-of-pocket, after-tax dollars. He had one particularly large dental bill of \$2,000 that was not paid for by insurance or any pre-tax plan. He saved all the receipts, which totaled \$5,000 by 2009.

In 2009, his employer switched to a HDHP health plan, making him once again eligible for an HSA. He signed up for the family HDHP policy. He contributed the maximum family amount of \$5,950 for 2009. He then wrote himself a check for \$5,000 to reimburse himself for the prior year receipts. All of those expenses were incurred after the HSA establishment date so they are eligible medical expenses. By maintaining his establishment, Jose is able to pay those medical expenses with pretax dollars through the HSA even though they occurred in years he was not eligible to contribute to the HSA.

Save HSA Money as Emergency Fund

Some HSA owners take the "save the HSA" approach to a greater extreme and never use their HSA for eligible medical expenses but instead save it for the future or

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as an emergency fund. This approach works best for financially well-off individuals who want to maximize their tax benefits.

The HSA owner gets the tax benefit of the deduction for the HSA contribution and then allows the money to grow tax-free rather than use it for eligible medical expenses. Paying for eligible medical expenses with taxable assets makes more sense because that reduces the taxable earnings in those accounts while preserving the tax-deferred growth in the HSA.

This approach is made very powerful because HSA laws allow an HSA owner to change his or her mind at any point in the future. As long as the HSA owner saves the medical receipts that were paid with after-tax dollars, he or she can be reimbursed for those receipts at any point in the future—even years later. This essentially turns the HSA into an emergency savings account.

Example: Vee contributes \$5,000 to his family HDHP in 2009. Vee incurs \$4,000 in eligible medical expenses in 2009. Rather than use his HSA to pay those expenses,

Vee instead pays for the bills with after-tax money. Using this approach, he protects the HSA and his assets in the HSA grow tax-free.

Even better, Vee can change his mind at any time. Assume in 2010, Vee encounters some financial trouble. He can reimburse himself \$4,000 from his HSA for his 2009 medical expenses. Because he already paid those bills he can use this money for any financial needs. The HSA is serving as an emergency fund in this case.

Vee must be careful to save the receipts, and he cannot otherwise have been reimbursed for those same receipts. This feature carries forward indefinitely.

Benefits professionals and employers can help individuals who have lost their jobs to consider the relevance of each of these points in deciding what to do with their established HSAs.

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