HEALTH SAVINGS ACCOUNTS (HSAs)

A New Kind of Retirement Plan

Health Savings Accounts (HSAs) have been available since 2004, but they are just now starting to receive attention for a new reason – **Retirement Savings and Planning.**

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Overview

HSAs are often misunderstood. This may be the underlying reason why it has taken 15 years for the employee benefits industry to truly recognize the long-term savings power these accounts can provide to your employees.

HSAs are financial instruments regulated not all that differently from a savings account your employees could open at a bank or credit union. Funds that are put away by your employees in an HSA or a savings account both accrue over time. Employees are typically provided checks or a debit card to access funds from their HSA, and employees will generally receive a monthly account statement just like they would with a savings account.

So, what's the big advantage of HSAs? Funds your employees contribute to a savings account do not have tax advantages like an HSA. Funds that go into an HSA are tax-deductible, the interest and investment earnings of an HSA grow tax-deferred, and any funds your employees use for qualified medical expenses can be withdrawn from their HSA tax-free.

In other words, contributing to an HSA can help your employees pay less in taxes and keep more of their hard-earned income. Not to mention that employers save money too. HSA contributions that are made through payroll deduction avoid Medicare and Social Security taxes. This is a 7.65% tax savings for employers, or approximately $1 in tax savings for every $13 an employee contributes to their HSA.

HSAs must also be paired with qualified High Deductible Health Plans (HDHPs) which tend to have lower monthly premiums than other types of health insurance plans. When your employees choose to open an HSA, they will have the ability to make HSA and premium contributions with pre-tax dollars, meaning their tax savings is even greater.

There are two other tax-advantaged accounts with similar features to HSAs—Flexible Spending Accounts (FSAs) and Health Reimbursement Arrangements (HRAs). For example, all these accounts help your employees pay for medical expenses while saving on taxes.

However, it is important to point out how HSAs function differently than these other accounts. HSAs are more flexible and easier to use than FSAs or HRAs. The claims processing experience is a great comparison to use. With FSAs and HRAs, a third-party must verify that funds are being used for qualified medical expenses. This process often requires employees to submit explanation of benefit (EOB) documents or other paperwork to a third-party. With HSAs, no third-party verification is required, providing a much better employee experience.

The remaining content of this whitepaper will provide information about HSAs and how these accounts can be used as a retirement savings vehicle. The content will be divided into four general sections:

- ✓ Requirements for establishing an HSA
- ✓ Unique benefits of an HSA
- ✓ How to use an HSA as a retirement plan
- ✓ The growing popularity and use of HSAs

Section 1: Requirements for Establishing an HSA

There are four requirements to establish an HSA.

- ✓ HSAs can only be established by U.S. taxpayers.
- ✓ HSAs can only be established by employees or individuals who are enrolled in a qualified High Deductible Health Plan (HDHP). If an employee or individual is no longer enrolled in an HSA compatible plan, they can continue to use remaining funds tax-free for out-of-pocket medical expenses, but no new contributions can be made.
- ✓ HSAs cannot be established if a person has "other disqualifying coverage."
- ✓ To establish an HSA, a person cannot be claimed as a tax dependent by another person.

Questions typically surround the definition of an HDHP and "other disqualifying coverage." Let's dive into this further and start with the definition of an HDHP.

What is a HDHP?

HDHPs have minimum deductible and maximum out-of-pocket limitations. These limitations are generally adjusted each year for inflation. **Here are the minimum deductible and maximum out-of-pocket limitations for 2020:**

	Single-only Coverage	Family Coverage
Minimum Deductible	**$1,400**	**$2,800**
Maximum Out-of-Pocket	**$6,900**	**$13,800**

Here are the minimum deductible and maximum out-of-pocket limitations for 2021:

	Single-only Coverage	Family Coverage
Minimum Deductible	**$1,400**	**$2,800**
Maximum Out-of-Pocket	**$7,000**	**$14,000**

The minimum deductible and maximum out-of-pocket limitations vary for single-only and family coverage, meaning your employees who don't have any other family members on their HDHP would be subject to the single-only coverage limitations. Your employees who cover one or more family members on their HDHP would be subject to the family coverage limitations.

HDHPs also cannot provide coverage for any benefits other than preventive care prior to satisfying the minimum deductible, but HSA funds can be used to pay for deductible expenses if your employee chooses.

Contribution limitations are directly tied to whether an employee or individual has single-only or family coverage. The maximum contribution limit can be made every year assuming HSA-eligibility is maintained, and there is no cap on how much money can be accumulated in the account.

Here are the annual maximum contribution limitations for 2020:

Single-only Coverage	**$3,550**
Family Coverage	**$7,100**
Catch-up Contribution	**$1,000**

Here are the annual maximum contribution limitations for 2021:

Single-only Coverage	**$3,600**
Family Coverage	**$7,200**
Catch-up Contribution	**$1,000**

Please note your employees age 55 and older who meet the eligibility requirements for an HSA can make an additional "catch-up" contribution of $1,000.

Other Disqualifying Coverage

As indicated previously, an employee or individual cannot have other disqualifying coverage. Disqualifying coverage is generally other non-HDHP major medical coverage, but it can include other plans as well.

Examples of other disqualifying coverage include:

- Medicare
- Medicaid
- Tricare
- HMOs
- Non-HDHP PPOs
- FSAs and HRAs[1]

Employees and individuals may have other certain types of coverage without jeopardizing their eligibility to establish and contribute to an HSA. Examples of other types of coverage which would be permissible include:

- Dental insurance
- Vision insurance
- Long-term and short-term disability insurance
- Long-term care insurance
- Critical illness insurance
- Fixed indemnity plans

[1] FSAs and HRAs that only reimburse dental or vision expenses would preserve HSA eligibility. Additionally, FSAs and HRAs that only provided post-deductible reimbursements would preserve HSA eligibility.

Section 2: Unique Benefits of an HSA

The unique features of HSAs are really what make it an attractive option for long-term savings. HSAs have two different triple-tax advantages.

Triple-Tax Advantage #1

No federal income taxes

No state income taxes*

No FICA taxes on payroll deductions

HSA contributions avoid federal income taxes and state income taxes.[2] When contributions are made through payroll deductions, your employees also avoid Medicare and Social Security taxes, which are sometimes referred to as FICA taxes.

Triple-Tax Advantage #2

Contributions are tax-deductible

Funds in the account grow tax-free

Withdrawals for medical expenses aren't taxed

HSA contributions are tax-deductible, funds in the account grow tax-free and money that is withdrawn to pay for out-of-pocket medical expenses isn't taxed.

Unlike FSAs and HRAs, HSA funds can be invested in most publicly traded investment vehicles, including stocks, bonds and mutual funds. This gives HSAs an added bonus for long-term savings potential. Here are some other unique features from an employee's perspective:

- ✓ The HSA is owned by the employee, not the employer.
- ✓ The HSA is portable and stays with the employee, even after they leave the employer.
- ✓ No third-party claims substantiation is required. Employees don't have to submit receipts and other documents to access HSA funds.
- ✓ Funds are easily accessible. Most HSA trustees and custodians provide a debit card for instant access to funds.
- ✓ Unlimited carryover balances are permitted. Employees can accrue large account balances over time.

[2] State income taxes apply in California and New Jersey.

Section 3: How to use the HSA as a Retirement Plan

Why use an HSA to save for the future? How is this better than just simply saving for the future?

According to Fidelity Benefits Consulting, the average 65-year-old couple retiring in 2018 will need $280,000 to cover their medical expenses in retirement.[3] Many of your employees aren't thinking about these expenses as they plan for retirement. HSA funds can continue to be used tax-free for medical expenses during retirement. You can help your employees secure a better financial future by using an HSA to build a medical savings fund. Let's think about an HSA compared to a 401(k):

- ✓ HSA contributions are tax-deductible…just like 401(k) contributions.
- ✓ HSA contributions can be invested and earnings grow tax-deferred…just like 401(k) contributions.
- ✓ HSA funds can be withdrawn tax-free for medical expenses in retirement…unlike 401(k) withdrawals.

HSAs have an unlimited carryover feature. Unused funds can carry over year-after-year and HSA account balances can grow to be substantial in size. Some savvy HSA accountholders are fully taking advantage of this attribute.

HSA rules do not require a medical expense to be reimbursed in the same year in which it was incurred. An expense incurred today can be reimbursed from the HSA 10, 20 or even 30 years later. Some HSA accountholders are paying for their out-of-pocket medical expenses as they are incurred using a different vehicle, and they are keeping track of the expenses. Then, at a later date, they'll be able to withdraw a sizeable portion of money from the HSA tax-free to reimburse themselves for those medical expenses that were previously incurred.

Consider an employee who had an HSA for 25 years. During this time, the employee had average annual medical expenses of $3,000, or $75,000 in medical expenses over the 25-year period. If the employee paid for these expenses using a different vehicle, they could withdraw $75,000 from their HSA tax-free during retirement.

In fact, look at how an HSA stacks up to all sorts of different retirement vehicles.

	Tax-free contribution	Tax-free earnings	Tax-free withdrawals
HSA	×	×	×
401(k)	×	×	
403(b)	×	×	
Traditional IRA	×	×	
Roth IRA		×	×

[3] https://www.fidelity.com/viewpoints/personal-finance/plan-for-rising-health-care-costs

Keep in mind for HSAs, tax-free withdrawals apply for medical expenses only. However, this includes expenses for things like Medicare Part A, B, C or D premiums, out-of-pocket medical and prescription drug expenses, and dental, vision or hearing costs.

Compound Interest

Compound interest is a very powerful thing. By investing HSA funds, account balances can accumulate to large amounts. Here are some examples of HSA account balances over time:

HSA Investment	Balance after 25 years at a 7% rate of return
$100/month ($1,200/year)	**$75,898.85**
$200/month ($2,400/year)	**$151,797.69**
$300/month ($3,600/year)	**$227,696.54**
$400/month ($4,800/year)	**$303,595.38**
$500/month ($6,000/year)	**$379,494.23**

That's a lot of money that can be used to pay for medical expenses in retirement, but HSA funds don't have to be used for medical expenses only. HSAs funds that are withdrawn for non-medical expenses are subject to income taxes and a 20% penalty, but the 20% penalty is waived at age 65. If an employee or individual used their HSA for non-medical expenses at age 65 or later, they would be subject to income taxes but no penalty. That means withdrawals would be taxed similarly to that of a 401(k).

HSAs also have the added benefit of no minimum distribution requirements. Other retirement vehicles will typically require minimum fund withdrawals starting at age 70 ½.

Using HSAs as a retirement vehicle is becoming more popular for all the previous reasons cited. Some investment advisors are starting to recommend a three-pronged retirement savings approach:

- ✓ Contribute enough to the 401(k) to maximize the employer's contribution match.
- ✓ Any additional contributions available should be directed into the HSA.
- ✓ If the HSA maximum contribution has been reached and additional funds are available for long-term savings, then put those into the 401(k).

Consider an employee who earns $70,000 per year and has decided to save 10%, or $7,000 of his or her income for retirement. The employer offers a 401(k) with a dollar-for-dollar match on the first 4% of the employees' salary. The employee also has single-only coverage under an HDHP and is HSA-eligible. Using the three-pronged retirement savings approach:

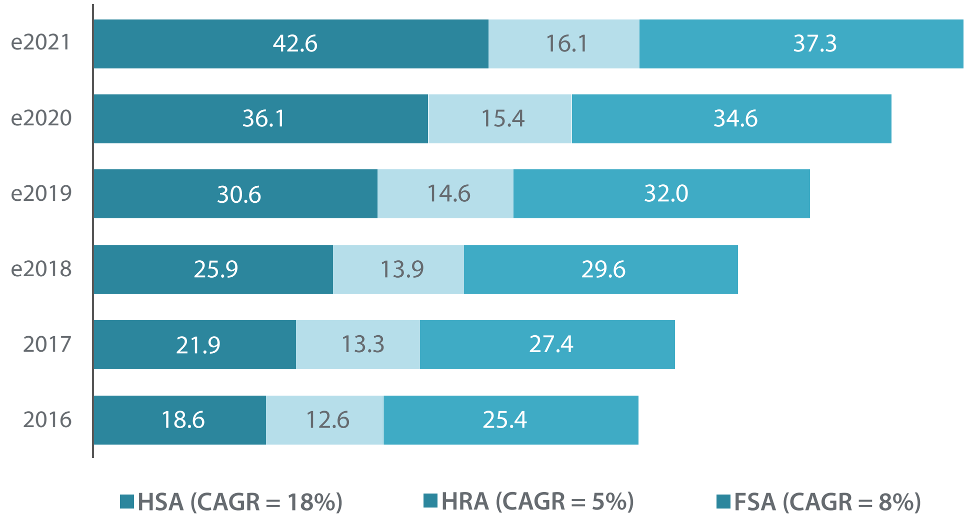
- ✓ The employee should contribute 4%, or $2,800 of their salary to the 401(k) so that they also receive a $2,800 matching contribution from the employer.
- ✓ The employee should put the maximum contribution into their HSA. In this case, that is a $3,500 HSA contribution for 2019.
- ✓ The employee has $700 remaining for retirement savings, and this money should be directed into the 401(k).

Section 4: The Growing Popularity of HSAs

Will employees really start using HSAs for retirement savings?

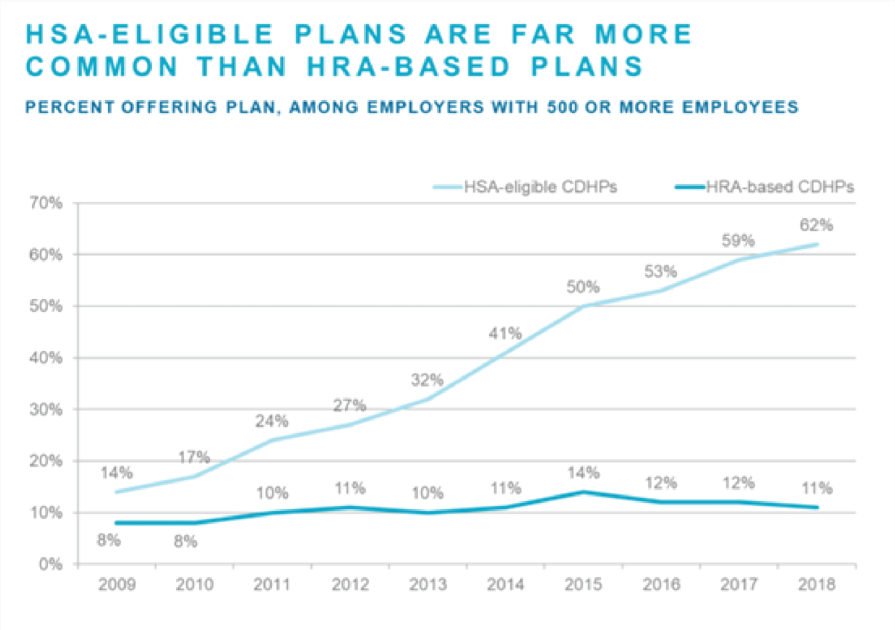
Let's take a look at the current and future state of HSAs. The number of employees and individuals with an HSA is growing at an 18% compound annual growth rate (CAGR). At the end of 2018, there were an estimated 25.9 million people with an HSA. By 2021, it is estimated that 42.6 million people will have an HSA. HSAs are growing at a much higher CAGR compared to FSAs and HRAs and are expected to be the leading health benefit account by 2020. The chart below reflects all of this information numerically.

Health Benefit Accounts by Product Type, 2016 to e2021 (in millions)



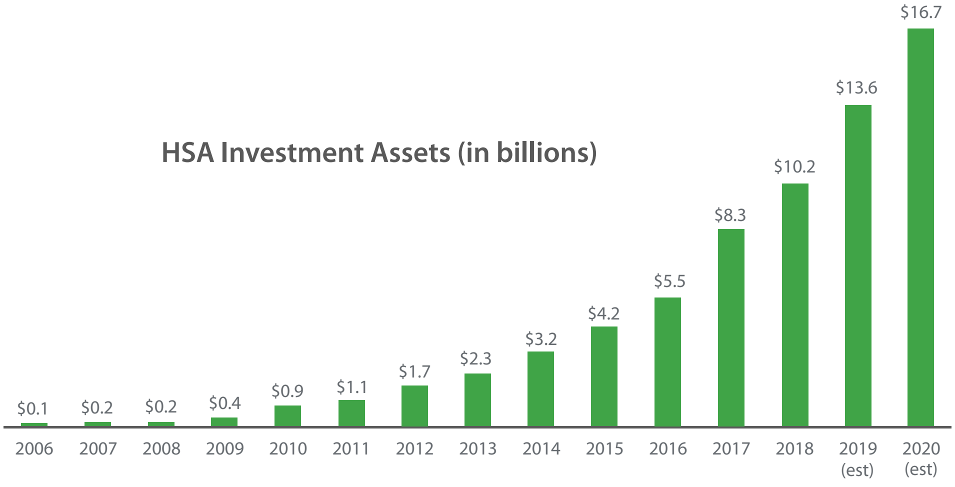
Source: Aite Group

More employers are offering HDHPs that are compatible with HSAs. According to Mercer, 62% of employers with 500 or more employees offered an HDHP that was compatible with an HSA. That number was only 14% in 2009. In comparison, the number of employers offering HRAs in combination with a health insurance plan remained relatively flat over this same time period. The chart below reflects these trends.



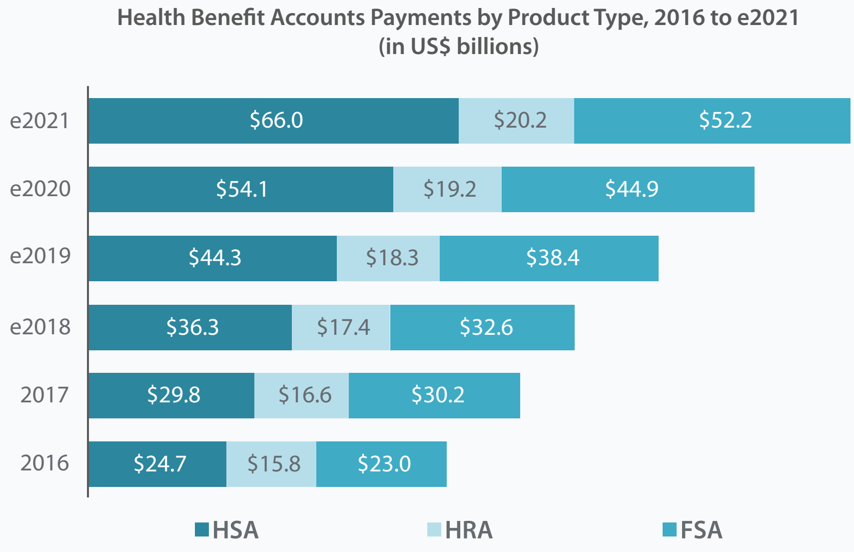
Source: Mercer

At the end of 2018, HSA investment assets totaled $10.2 billion, a 23% increase over the prior year. This would be HSA funds held in vehicles such as stocks, bonds or mutual funds. These investments are usually held for long-term savings and growth. HSA investment assets are expected to reach $16.7 billion by 2020. It's clear there is an increasing trend toward saving HSA funds rather than spending them on immediate out-of-pocket expenses. The chart below reflects the growth in HSA investment assets since 2006.



Source: Devenir Research: 2018 Year-End HSA Market Statistics & Trends Executive Summary

There are also additional savings opportunities to be had. Many employees spend their HSA funds on immediate medical expenses rather than saving for the future. It's estimated that $36.3 billion was spent on medical expenses in 2018. With proper education and awareness, some of that money can be redirected by employees for retirement savings.



Source: Aite Group

Summary

HSAs are arguably the most effective retirement savings vehicle due to the triple-tax savings advantages and other unique features. HSAs are increasing in popularity and will surpass FSAs (which have been around for more than 40 years) in enrollment by 2020.

Healthcare costs continue to rise, and employees will need to find an effective way to manage these expenses in retirement. An HSA can be the perfect solution.

HSA eligibility is directly tied to enrollment in an HDHP, so these accounts will only be available to your employees if you offer an HDHP. At minimum, it should at least be an option for employees to choose.

Employees rely on their employers for information on healthcare and retirement planning. You can lead the way by making sure your employees understand their expected medical expenses in retirement and by providing an HDHP and HSA so that they can plan accordingly for these expenses.