By Danielle Schultz

Understanding Health Savings Accounts

Health Savings Accounts (HSAs) have been around for a while, but they haven't achieved the popularity that their designers expected. Although HSAs often are an option in cafeteria-style employee benefits programs and an alternative for the self-employed or small businesses looking to control costs, advisors may not have seen too many of them and might not yet realize the planning opportunities that HSAs represent. HSAs can offer advisors an important tool to help clients secure not only good health coverage, but also tax-free retirement income and current tax deductions.

The two-step nature of HSAs can really confuse clients. An advisor needs to help the client not only compare available health coverage, but also select a custodian and an appropriate investment mix for the savings component of the insurance. In addition, advisors can help the client devise a withdrawal strategy to maximize tax and retirement benefits.

Affordability

HSA coverage can cost half as much as a traditional plan that has a moderate ($500 to $1,000) deductible. HSA plans are required to have at least a $1,200 individual deductible and can go up from there. However, since the amount deposited to the HSA investment account annually is currently (in 2011) limited to $3,050 for an individual or $6,150 for a family (if under 55), there is no real reason to select a higher deductible unless the client simply cannot afford the premiums.

Once the deductible is met, many HSA plans offer 100-percent coverage, often with no co-insurance. For the client whose expenses exceed the deductible, the out-of-pocket costs may actually be less than what would have been paid on a more conventional 80/20 co-share plan. Timothy M. Hayes, a NAPFA member and president of Landmark Financial Advisory Services in Pittsford, NY, noted that those who use an HSA in the usual way—depositing in the account and reimbursing themselves—will probably still see a net financial gain.

"The net-net can be as much as 25 percent lower than with a conventional deductible plan," he said.

There are other possible benefits to purchasing this type of insurance, too. Although most people will still have to submit to an underwriting evaluation, some insurance companies may be slightly more lenient because of the high deductible. Also, it appears so far that these plans have seen lower year-to-year increases than conventional health insurance policies.

When selecting a plan, it's important to compare the difference in the yearly cost of different levels of deductibles with each high-deductible level. For example, a plan with a $1,750 deductible will be cheaper per year than a plan with a $1,200 deductible, but is it more than $550 cheaper? If the client can take the risk of having to cover a higher deductible, premium savings may be worthwhile. On the other hand, after the insurance deductible exceeds the amount that can be deposited in an investment account and deducted from income tax, the client sacrifices the tax advantage. Therefore, depending on the client's ability to afford the premium and max out the investment deposit, a deductible less than or equal to the investment account deposit should probably be selected. Similarly, in order to create a cap for unexpected costs, the client should probably choose an HSA that offers 100-percent coverage after meeting the deductible, rather than a co-share or co-payment. It's important to remind the client that the deductible and any co-share are per year, so the out-of-pocket cost of an extended or chronic illness (e.g., cancer, Parkinson's, or chronic cardiac care) could be quite high.

Given those parameters, who are best candidates for HSAs? "Young, healthy couples without kids, or older couples with grown children who have relatively predictable health expenses," said Kevin O'Reilly, a NAPFA member and principal of Foothills Financial Planning, Inc. in Phoenix. "What they can set aside up front can indicate what deductible they should choose."

Investment Options

A variety of options are available for investing the funds in the account, and a planner should help a client sort out the options. For small amounts, or for the first year the plan is implemented, many clients choose a local bank savings account—perhaps a credit union, suggested O'Reilly, because they often offer a better rate on small accounts.

Many other options are available, such as using Vanguard funds, having a linked brokerage, and so on. Fees and rules imposed by custodians differ, too. Some custodians charge a fixed monthly fee, while some require a specified amount to be deposited in a savings account with a linked brokerage account for amounts over the minimum.

Depending on how much the client plans to deposit and how actively the account will be used, the planner will need to compare actual management costs. If a client is covering a spouse and children, the investment per year can accumulate to a substantial tax-free sum, especially if bills are paid out of pocket (see below).

Tax Deductions

As we all know, it is quite difficult for many clients to achieve the 7.5 percent of adjusted gross income threshold that is necessary for medical bills to be deductible from income tax returns in a given year. However, with an HSA, the contribution is deductible regardless of whether medical bills actually equal that amount. For a young, healthy client who may have nothing but a physical and a dental checkup, an HSA can produce a deduction far in excess of any medical bills, in addition to the initial savings on insurance premiums. There is no income limit phase out for the deduction.

Accumulation and Withdrawal Options

The client can deposit the funds into the investment account and then withdraw any amount to pay medical bills. Some custodians even provide a debit card to pay bills from the account. However, the client whose plan has a PPO should probably wait for the insurance determination before whipping out the debit card, as PPOs often significantly reduce the allowable costs the doctor can charge. On the other hand, the client who uses a health provider who is not part of the PPO's network will only be credited against his deductible with whatever the PPO considers allowable cost. Higher amounts can be withdrawn from the investment account, but they will not apply to meeting the deductible. O'Reilly suggests that people should probably seek to bunch discretionary medical treatments into years where they have already met the deductible.

From a planning perspective, the real benefit can accrue when the client can pay medical bills out of pocket, without dipping into the investment account. For example, a couple, both of whom are at least 55 years old and who have a teenager, could deposit and deduct $8,150 per year. Even after children age out of the parents' plan, the money deposited in the account stays with the owner of the plan—the parents. There are no restrictions on coverage by another pension plan (although the insured cannot be covered by other health insurance).

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It is very important for the client using an HSA to maintain accurate records and receipts for all medical bills paid out of pocket at any time, but especially in retirement. Here's why: There is no requirement that reimbursement be requested in a timely manner. Thus, clients can accumulate years' worth of medical bills and submit them after retirement, thereby withdrawing funds tax-free. Or, clients who have reimbursed themselves from the account over the years but still managed to accumulate funds can treat the HSA investment account as a dedicated health care expenses set-aside.

Once the insured reaches age 65 and enrolls in Medicare, the HSA cannot receive further contributions. Withdrawals may then be made for any purpose, but if the funds are used for other than medical bills, the withdrawals are taxable as regular income. However, if the withdrawals are used to pay medical costs not covered by Medicare, including dental and long-term care insurance, the withdrawals are tax-free. This means they were tax-deductible going in and tax-free coming out.

HSA investment accounts can be passed to a spouse as the designated beneficiary, and the account will be treated as the spouse's HSA, with the same restrictions as to medical expense withdrawals. If the designated beneficiary is not the spouse, the account stops being an HSA, but the fair market value becomes taxable to the beneficiary in the year of the owner's death.

Life Planning Considerations

Some clients are suspicious of HSAs when offered by employers, seeing them as just another way employers can cut costs while shifting payment to employees. "It's important to analyze the final cost based on possible scenarios," Hayes said. Also, the value of any employer contribution should be considered.

O'Reilly tells his clients to consider what impact the higher deductible will have on their healthcare choices. "[An HSA] shouldn't drive behavior not to go to the doctor. Planners have to make sure that these decisions are not solely numbers-based," he said.

Today, Roths and IRAs get all the attention, but for the right type of client, an advisor can provide another avenue to accumulate tax-favored investments by helping the client consider and understand health savings accounts.

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