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What Employees Need To Know About Health Savings Accounts and Health Care Flexible Spending Accounts

Health Savings Accounts (HSAs) and health care Flexible Spending Accounts (FSAs) can help you save money on health care expenses and reduce taxable income at the same time. Both types of accounts are relatively inexpensive to maintain and, with the right education, you can easily decide which is best for you.

While both an HSA and a health care FSA allow you to save money tax-free to pay for eligible health care expenses, the IRS has established a different set of rules for each. In general, you must first decide how much money to set aside each pay period. This amount is then deposited into your account and you may use these funds to pay for deductibles, copays and prescription drugs. You may also use the money to pay for dental care and things like eyeglasses or contact lenses.

Once you have paid for the service, you may receive a distribution from either your HSA or health care FSA. In some cases, you may even have a debit card that lets you access funds at the point of sale.

Regardless of which type of account you elect, you will receive the tax advantage of lowering your taxable income and accessing your funds to pay for qualified expenses on a tax-free basis.

What is an HSA?

Health savings accounts, or HSAs, are used in conjunction with high deductible health plans (HDHPs). If you are enrolled in a qualified HDHP and choose to set up an HSA, you will set aside a certain amount of money each pay period on a tax-free basis to pay for eligible medical expenses.

Your funds will grow over time and can be carried over from year to year. Many HSAs offer investment options once your account reaches above $2,000. You may choose to access these funds as you receive care or you may leave them in your account for long-term savings.

This is often known as the triple tax advantage:

- Money goes into the account tax-free
- Money stays in the account and earnings grow tax-free
- Money is withdrawn and used for eligible health care expenses tax-free

If you choose to withdraw funds from your HSA and do not use them to pay for eligible health care expenses, you will be taxed on the amount. If you are under age 65, you will also be charged an additional tax penalty.

What is a health care FSA?

Health care Flexible Spending Accounts, or health care FSAs, are used to save money on a pretax basis for eligible health care expenses. These accounts do not need to be tied to an HDHP. However, FSAs have something that is often referred to as the “use it or lose it” rule. This means if you don’t use all the money in your account during the plan year, you may forfeit it (COVID-related extensions have been passed for 2020-2022, however, so check with your benefits adviser for the details).

Some FSAs offer a grace period where you may submit reimbursement requests for expenses incurred during the plan year. Other plans allow a limited rollover. Regardless of which option your plan may present, there is no long-term savings potential.

If you are enrolled in an HDHP, you may elect to participate in a limited purpose health care FSA. Funds in this type of FSA may be used to pay for expenses such as dental and vision costs. They may not be used to cover normal medical expenses that are considered eligible under the HSA. For more information, you may want to refer to IRS Publication 969.

What is an eligible expense?

Under both types of accounts, only eligible health care expenses may be paid for using tax-free money. These expenses include copays, deductibles, coinsurance and the cost of prescription drugs, eyeglasses, contact lenses and dental care. For a more complete listing of eligible expenses, please refer to IRS Publication 502.

With an FSA, you will be required to provide proof that expenses submitted for reimbursement were for qualified health care costs. With an HSA, you are not required to provide proof of your expenses. However, you should be prepared to offer substantiation if the IRS audits your account.

Which account is right for you?

Both accounts offer you a way to save on health care expenses through tax-free contributions. So how do you decide which is best for you? Here are a few things to consider.

- **Are you enrolled in a qualified HDHP?** While HSAs are more flexible than health care FSAs, they must be tied to a qualified HDHP. So, you may not contribute to an HSA unless you are also enrolled in a qualified plan.
- **Are you looking for long-term savings options?** An HSA is yours forever, like a bank account. And, if you switch employers, you may take your HSA with you. If your new job doesn't offer a qualified HDHP, you may still access the funds in your account to pay for eligible expenses or you may leave the money in the account.
- **Do you need access to the funds immediately?** One advantage of an FSA is that you have access to the full amount you elected to contribute at the first of the plan year. If you spend the full amount in January, your contributions throughout the remainder of the year are used to pay off that expenditure. If you spend the full amount in January and quit your job in May, in most cases, your employer cannot request you repay those funds. However, if you have money left in your FSA and you terminate your employment, you may also forfeit any remaining funds in your FSA.

Once you've answered the question above, you may want to compare the two plans in their entirety. This chart can help you do just that. Remember, for complete details on both types of accounts, you may want to refer to IRS Publication 969.

	HSA	**Health Care FSA**
Participation Requirements	• Employees enrolled in a qualified high deductible plan. • You may not be enrolled in Medicare. • You may not be claimed as a dependent on another person's plan.	• Employees enrolled in a traditional health plan through their employer, spouse or health care exchange.
Account Ownership	• You own the account. • Unused funds belong to you.	• Your employer sets up and owns the account. • Unused funds belong to the employer.

Contribution Limitations	• Set each year by the IRS. • For 2021, you may contribute up to $3,600 for yourself and up to $7,200 for family. • These limits apply to the entire family. If you and your spouse both have an HSA, you and your spouse may not contribute a combined total of more than $7,200 (for 2021). • Employees age 55 to 65 may contribute an additional $1,000 each year.	• Set each year by the IRS • For 2021, you may contribute up to $2,750. • If you and your spouse both have access to a health care FSA, you may each contribute $2,750 to your account.
Access to Contributions	• You may only access funds that have already been deposited into the account.	• You may access your annual election at any time.
Changes to Contributions	• You may change contribution levels during the year as your plan administrator allows	• You may change contribution levels only if you have a qualified life event.
Investment Options	• Most accounts offer investment options once your account reaches a certain dollar amount. • Earnings grow within the HSA tax-free.	• Investment options are not available.
End of the Year Limits	• Funds continue to accrue and you may access them at any time	• At the end of the plan year, you may have a grace period during which you may access any remaining funds. • Or, your plan may allow a rollover of up to $500 for the next plan year. • All funds must be used according to the schedule set out by your plan.

Penalties	• If you withdraw the money for nonqualified health care expenses before the age of 65, funds will be considered taxable income AND you will face a tax penalty. • If you withdraw the money for nonqualified health care expenses at age 65 or later, funds will be considered taxable income.	• Funds may only be used for qualified health care expenses. • If you fail to use funds according to timelines set by your plan, funds will be forfeited.
If You Switch Jobs	• Your HSA is yours. It goes with you regardless of where you are employed.	• Your FSA is not transferrable to your new job.

Need more information?

Do you have more questions about HSAs and health care FSAs? Talk to your benefits adviser. They can help you determine which option is best for you and further explain the tax benefits of both.

Pano Constantine

(516) 473-0801
pconstantine@acumenins.com

Acumen Solutions Group
600 Broadhollow Road, Suite 200
Melville, NY 11747