**Which Is a Better Savings Vehicle For Employees – 401(k) or HSA?**

Studies continue to report that one of the most significant worries for employees of all ages is whether they will be able to accumulate enough to pay for future healthcare costs and still have enough for other needs and wants.

Healthcare costs continue to rise. According to data compiled by the Centers for Disease Control, a healthy couple retiring today should plan on future healthcare costs of $688,000 for women and $494,000 for men, including the cost of long-term care. Fidelity estimates a 65-year old couple retiring this year will need $280,000 to cover retiree health expenses, not including any costs associated with nursing home or long-term care. Even with Medicare availability, individuals will need a substantial nest egg to pay for healthcare and other expenses in retirement.

Retirement funding vehicles are the usual suspects - 401(k) plan, IRA and now, less frequently, a pension plan (see last month’s Digest). For the higher paid, there may also be a nonqualified deferred compensation plan. The traditional theory has been that employees should first save as much as they can in the 401(k) plan. Then, look to alternative savings vehicles, including IRAs and private investments outside of a retirement plan. An overlooked retirement savings vehicle can be a health savings account (“HSA”) available to employees who are covered by a high deductible health plan. The question we hope to address here is - which is better for the average worker to save in, if both are available: a 401(k) plan or a HSA?

- **Projecting Net After-Tax Benefits**
  This is not to say that an employee cannot save within a 401(k) plan, an IRA and a HSA. In fact, those who can afford to should consider using all of them. But what we hope to illustrate is which might be the better savings vehicle, and therefore, where an individual might consider putting their initial available dollars, sometimes only after any company match in the 401(k) plan is earned.

  The four choices we will illustrate include:

  1. Pre-tax contribution to 401(k) plan;
  2. Roth contribution to 401(k) plan;
  3. HSA contribution; or
  4. Company stock in ESPP with 15% discount in purchase price.

  We will use the following assumptions, taking into account the recent drop in federal tax rates, to prepare a projection of future after-tax values:

  - Contribution amount of $5,000;
  - Growing tax deferred for 5, 10, 20 and 30 years;
  - Average annual earnings rate of 3%, 5% or 8%;
  - No company match or seeding;
  - Current tax rate of 30% (for Roth contributions);
  - Tax rate at distribution of 30% (with a 15% capital gains rate for appreciation on ESPP shares upon sale); no rollovers assumed;
  - FICA taxes disregarded.

  On the following page are after-tax net accumulated values illustrated in three charts based on the assumed compound interest rates over the four periods.
Based on these simple assumptions, the best after-tax savings alternative in all scenarios is the HSA. We also ran the numbers assuming a lower tax rate (24%) and a higher tax rate (40%) at distribution. Neither of these changed the result - and the Roth and HSA numbers will remain the same regardless of this rate. What this illustrates is that the triple tax-free nature of a HSA makes a difference, even compared to a Roth contribution to a 401(k) plan. With a Roth, taxes are paid at the time of deferral, which we netted out only at the end of each period.

With the Employee Stock Purchase Plan (ESPP), company stock is purchased with after-tax dollars. The assumed 15% discount amount is taxed at ordinary income rates – but only when the shares are sold (which we presume is at the end of each 5, 10, 20 or 30 year period). In these examples, appreciation above the cost plus discount amount is taxed at the capital gains rate.

Basic Overview of a Health Savings Account
Health savings accounts first came into existence in 2004 as a means to save on a tax efficient basis for a family’s medical expenses. This is not the only defined contribution approach for medical benefits. Health care flexible spending accounts (“FSAs”), health reimbursement arrangements (“HRAs”) and retiree medical accounts have been around longer, but HSAs have now become available at most large employers. Devenir Research estimates that there currently are 23.4 million HSAs, with an average balance of just over $16,000. However, most studies of HSAs indicate that their growth has slowed over the past two years, per EBRI. Less than a quarter of those funding an HSA intend it as a long-term savings vehicle, as opposed to paying ongoing medical expenses, according to a recent survey on financial wellness strategies by OneAmerica.

In order to fund an HSA, the individual (and family members if family coverage is selected) must be enrolled only in a high deductible health plan (“HDHP”). Contributions to the HSA can be made by eligible individuals and/or their employer, subject to annual dollar limitations. The key for HSAs is their income tax advantages compared to other savings vehicles. This is one of the few triple tax-free benefits. Contributions are made on a before-tax basis, grow tax deferred, and are not taxable when distributed - as long as used to pay for qualified medical expenses.

There are administrative rules that must be followed. An individual cannot just open a savings account and call it their HSA. It must be established through a trustee, similar to an IRA. There are a few banks and other entities that specialize in being trustees for HSAs. Most companies that offer a HDHP with an associated HSA will have an approved trustee. However, an individual can establish their own HSA and need not use the company-approved one for making contributions. Individual contributions can be made any time during the year up through April 15 of the following year - the normal filing deadline of a federal tax return. Thus, for this year, eligible individuals have until April 15, 2019 to make a contribution to their HSA.

A recent HSA Bank survey of HR professionals reported that only 10% were very confident their employees understood the healthcare choices they were making. Choosing the better healthcare option can be challenging for many. A recent survey by Alegeus reported that just over half of respondents indicate they struggle to understand and compare plan options. HSA participants are 68% more likely to have a savings goal and 80% more likely to save aggressively for future expenses. Yet only about 11% of eligibles contribute the maximum amount allowed to an HSA and only 13% invest their HSA savings for growth. Fidelity research found that those who saved in both an HSA and 401(k) saved an average of 10% of their pay, compared to savings of less than 8% for those with only a 401(k). And HSA savers had an average of $119,000 more in retirement savings. Where do you fit?

Proposed Legislation Expanding HSAs
We could be seeing as early as next year changes in the design of health savings accounts. There are now two distinct bills that have been approved by the House (H.R. 6199 and H.R. 6311) that have bipartisan support. However, it remains to be seen whether the Senate will approve either or both of these bills before year-end. Here is a brief summary of key points in H.R.6311 (titled “Increasing Access to Lower Premium Plans & Expanding HSAs Act”):

- The annual HSA contribution limits would increase equal to the HDHP out-of-pocket limit (this would be $6,750 for self-only coverage and $13,500 for family coverage in 2019);
- Both spouses would be permitted to make catch-up contributions to the same HSA;
- Employees with a health FSA or HRA would be able to transfer balances to their HSA, so long as they are enrolled in a high deductible health plan. These transfers would be allowed at the employer’s discretion and capped at $2,650 for individuals and $5,300 for families. The maximum amount allowed to be carried over from a health FSA to a HSA would be three times the annual contribution limit;
• Employees eligible for Medicare Part A upon turning age 65 would be permitted to contribute to their HSAs;

Here is a brief summary of key points in H.R. 6199, entitled “Restoring Access to Medication and Modernizing Health Savings Accounts Act”:

• Employers would be allowed to offer certain free or discounted medical services, either on-site or at a retail clinic, without jeopardizing HSA eligibility. This would include immunizations, vision and hearing screenings, physical exams, drug testing and similar non-significant medical care;

• An individual whose spouse is eligible for a regular health FSA would be eligible to contribute to a HSA;

• Up to $500 ($1,000 if family coverage) would be able to be used for qualified sport and fitness expenses. This would include membership fees in fitness facilities and the purchase of safety equipment, subject to a $250 limit (but golfing, hunting, sailing and horseback riding would not be eligible expenses);

• The current restriction against paying for OTC drugs through HSAs, health FSAs, HRAs would be repealed.

If enacted before the end of the year, most of these new rules would go into effect as of next year. However, it remains to be seen whether Congress can get their act together in a contentious election year.

❖ Other Factors to Consider

There are other factors that should be considered and can play a role in deciding where to save. Here are a few:

Funding The Account - There are differences not only in the maximum amounts that can be contributed annually (much more into the 401(k) than the HSA), but also how and when contributions are made. HSA contributions need not be based on an employee’s pay, but rather on their medical plan coverage. As a result, an employee can continue to fund an HSA after he/she has terminated employment (until Medicare eligibility), so long as he/she remains covered by a HDHP. A full-year HSA contribution can be made even when eligible only for part of the year, as long as the employee is HSA-eligible on December 1 of the year and remains eligible for a 13-month “testing period.” Excess contributions to both HSA and 401(k) need to be timely withdrawn or there are tax penalties.

Company Contribution - An important consideration can be to compare the 401(k) company match to any company contribution made to an HSA. Many companies continue to “seed” or contribute to HSAs for those who select a HDHP, with the amount usually determined based on whether single or family medical coverage is elected. (However, we saw fewer companies seeding HSAs in 2018 than in 2017). We also saw seven companies that provided a match to employee HSA contributions in 2018. This requires the employer to have a Section 125 plan to offer a match. Both plans are subject to rules that prevent greater employer contributions to highly-paid employees.

Manner of Contribution - 401(k) elective deferrals are made directly from eligible compensation each pay period as elected. Most companies with HDHPs allow employees to elect payroll deduction into an approved HSA. Employees must affirmatively elect this option and there is no auto-enrollment feature for HSAs. Employees can establish and fund HSAs outside of the company account and can fund it at any time up to the contribution deadline. However, this can result in owing FICA taxes on the contribution, as opposed to no FICA if contributed through payroll deduction.

Both Spouses Employed and HSA Eligible - If both spouses are employed, and eligible to participate in their employer’s 401(k) plan, each can fund the maximum amount, pre-tax or Roth, and each may make catch-up contributions if over age 50. The rules for HSA funding are a bit more complex. If both are covered by a HDHP, each could fund their own HSA up to the single-person limit ($3,450 for 2018 & 2017). However, if one has self-only coverage and the other has family coverage, or even if both elect family coverage, the couple will have to share the family contribution limit ($6,900 for 2018 and $7,000 in 2019). They can allocate this maximum in any way they choose. In can make sense to have each fund an account if both employers seed HSAs. Catch-up contributions are available for both at age 55 or older only if they have and fund separate accounts.

When Account Can Be Accessed and For What - There are a number of differences here, but the HSA generally offers greater flexibility as long as withdrawals are used to pay for qualified medical expenses. This includes co-payments, deductibles, and certain expenses not covered by medical coverage. After age 65, HSAs can be used to pay for Medicare Part B premiums. HSAs can be accessed immediately or deferred to pay for future expenses. A little known fact is that the reimbursement rules do not require that amounts be withdrawn in the year a medical expense is incurred. An individual can reimburse themselves at any time. Thus, you can pay for a qualified expense out of
pocket while delaying a withdrawal from the HSA until years later, allowing for the tax-free growth in the HSA account.

While children up to age 26 may be enrolled in a HDHP, medical expenses paid from a HSA for a child are only tax-free if the child meets a different definition of eligibility – a qualifying dependent who is a child up to age 19 or a full-time student up to age 24 or disabled child of any age. In contrast, 401(k) elective deferrals generally cannot be accessed until age 59½ if the individual remains employed by the company. Most 401(k) plans have a loan feature and can allow for in-service withdrawals in certain circumstances.

**Penalties** - There is a 10% early distribution penalty associated with distributions of taxable amounts from 401(k) plans prior to age 59½ (with a few limited exceptions). There is a 20% penalty if HSA funds are used for non-medical expenses before age 65.

**Investment Alternatives** - This is another area where there can be significant differences. 401(k) plans offer a wide choice of investment alternatives and nearly 70% of companies offer target date funds. In contrast, most HSAs have limited investment choices and typically, until there is a threshold balance, HSA accumulations cannot be invested in equities and earn a small fixed rate of return.

**Fees & Expenses** - The fees and expenses in 401(k) plans are much more transparent now due to the DOL fee disclosure rules. This has led many companies to use institutional class funds to lower the costs to employees. In contrast, individuals will need to look closely into the fees and expenses associated with HSAs. They are not always transparent and very likely can be higher than those in the 401(k) plan. Some HSAs provide a debit card to make it easier to utilize funds.

**Plan Administrator** - While large mutual fund companies and some insurance companies are the primary recordkeepers/administrators for the 401(k) plans at most large companies, HSA administrators may be banks or lesser known entities.

**Portability** - Both have portability, although a 401(k) plan generally cannot be transferred to an IRA or similar plan until age 59½ or upon termination of employment at any age. A HSA can be transferred to a similar account and need not be maintained where funded during employment.

**Required Minimum Distribution (RMD)** - A 401(k) plan, as well as traditional IRAs, are subject to the RMD rules which require distributions generally beginning after age 70½ (see February 2016 Digest for summary of these rules). However, Roth IRAs are not subject to these rules, so 401(k) amounts rolled into or converted into a Roth IRA can remain through the lifetime of the IRA. HSAs are not subject to the RMD rules.

**Beneficiary Designation** - Both 401(k) plans and HSAs permit a designation regarding who will receive benefits upon death of the account owner. A 401(k) plan is subject to the ERISA spousal beneficiary rules. For a HSA, if a spouse is the designated beneficiary, he or she can continue to use the account to pay for qualified medical expenses. If someone else is beneficiary, the account ceases to be an HSA and the value at death is taxable income to the beneficiary.

**Divorce** - Both vehicles can be transferred in the event of a legal separation or divorce to a former spouse pursuant to a QDRO (401(k) plan) or state court order (HSA) on a tax-free basis.

**Rollovers Into Account** - A 401(k) plan can – but need not – permit rollovers from other qualified employer plans and IRAs. HSA to HSA rollovers are also allowed. HSAs can allow a one-time rollover from an IRA equal to the annual contribution limit for the HSA. Thus, this can be an interesting planning technique.

**Tax Rates** - Tax rates could be higher or lower at the distribution date than we assumed. This does not impact the Roth 401(k) account or the HSA – both of which can avoid most income taxation, but it can impact the pre-tax 401(k) and ESPP alternatives.

**Saver’s Credit** - Subject to AGI limits, employees may be eligible for a non-refundable tax credit for making contributions to 401(k); a proposal would extend a similar credit to contributions to a HSA, but it has not been enacted to date.

**State Tax Issues** - One state (PA) does not allow an exclusion for 401(k) plan elective deferrals, while a few states (AL, CA, NJ) do not allow a state exclusion for HSA contributions and two states (NH & TN) may tax interest and dividends earned within HSAs.
Tax Reporting - Both 401(k) plans and HSAs are subject to annual tax reporting. An individual should file Form 8889 with their tax return to report contributions made to a HSA for the year. IRS Form 5498-SA will be sent by the recordkeeper in January confirming contributions. Elective deferrals to a 401(k) are reflected on Form W-2 for the year, as are any employer contributions to a HSA (Box 12, Code W). Distributions from 401(k) plans are reported on a 1099-R, while distributions from HSAs will be reported on Form 1099-SA.

Here are a few differences between a 401(k) and an HSA when considering funding in 2018 or 2019:

<table>
<thead>
<tr>
<th></th>
<th>401(k)</th>
<th>HSA</th>
</tr>
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<tbody>
<tr>
<td>Maximum Employee Contribution</td>
<td>$18,500*</td>
<td>$3,450 (’18)/$3,500 (’19) single; $6,950(’18)/$7,000 (’19) family</td>
</tr>
<tr>
<td>Catch-Up</td>
<td>$6,000 (age 50)</td>
<td>$1,000 (age 55)</td>
</tr>
<tr>
<td>Timing of Contributions</td>
<td>During the year</td>
<td>During year or by 4/15 of next year</td>
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<tr>
<td>Contributions Subject to FICA</td>
<td>Yes</td>
<td>No, if through payroll deduction</td>
</tr>
<tr>
<td>Penalties</td>
<td>10% for early distribution</td>
<td>20% for non-medical pre-65</td>
</tr>
<tr>
<td>IRA Rollover</td>
<td>Yes</td>
<td>1-time from IRA to HSA</td>
</tr>
<tr>
<td>Subject to RMD</td>
<td>Yes (except Roth account or After-Tax)</td>
<td>No (if for qualified medical expenses)</td>
</tr>
<tr>
<td>Taxable at Distribution</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Eligible for Saver’s Credit</td>
<td>Yes (subject to AGI limits)</td>
<td>No</td>
</tr>
<tr>
<td>Subject to ERISA</td>
<td>Yes</td>
<td>No (if employer involvement limited)</td>
</tr>
<tr>
<td>Protection From Creditors</td>
<td>Yes</td>
<td>Per state law</td>
</tr>
</tbody>
</table>

*projected to increase to $19,000 in 2019; to be announced later this month

Conclusion

With over 95% of Ayco’s corporate partners now offering HDHPs, employees who elect a HDHP during annual open enrollment have an opportunity to contribute to an HSA in addition to saving within their employer’s 401(k) plan. Employees are accustomed to being told that contributing as much as they can afford to their company’s 401(k) plan is the best way to save for their future needs. In contrast, few employees would consider the HSA to be a better or even a comparable savings vehicle. Of employers that offer both, relatively few educate their employees about the comparative benefits of saving within a 401(k) vs. a HSA.

The decision an employee makes where to save for future expenses should not necessarily be an either/or. Both HSAs and 401(k) plans provide tax efficient means to save for future expenses. Several surveys have revealed that employees who have access to both a 401(k) and HSA save more than those with access only to a 401(k). A common sense strategy might be to fund the 401(k) to receive the maximum company match then fully fund the HSA to the single or family maximum amount, and only then fund the remainder of the 401(k) up to the tax law limits. That is, any savings strategy should be coordinated.

In addition, spending of HSA and 401(k) plan assets should be thoughtfully planned. To maximize the potential value of an HSA, individuals should pay out-of-pocket medical expenses with other assets. A survey released by Bank of America Merrill Lynch reported that over 50% of employees usually spend their entire HSA annual contributions on short-term health care costs. Thus, the long-term advantage of an HSA is not being taken advantage of. Educating employees as to the relative opportunity that HSAs offer is an ongoing corporate challenge.

Time to Update Your Rollover Notices

It is estimated that at least 75% of employees will rollover a portion or all of either their 401(k), qualified pension, §403(b) plan or §457(b) governmental plan at some point. Plan administrators are required to provide a written explanation to a recipient of a distribution from one of these plans which are eligible for rollover. This notice must be provided within a “reasonable” period of time before making the distribution. This is called, by those in the trade, a §402(f) notice. It describes what portion of the distribution is eligible for rollover, as well as the choice to rollover all or a portion of the distribution and the tax implications of any taxable portion. The IRS has provided safe harbor notices which employers may utilize for this required notification, or an employer may adopt its own customized notice.

There have been a number of changes to the rollover rules over the years, the most recent being a change in the deadline for rolling over qualified plan loan offsets made by the Tax Cuts & Jobs Act of 2017. Last month, the IRS released Notice 2018-74 providing updates and revisions to
its safe harbor notices reflecting recent tax law changes, as well as to clarifying other rules that were not incorporated into its previous safe harbor notices issued in 2014.

There actually are two separate safe harbor notices, one for a distribution that includes a Roth account and another for a non-Roth distribution. In some cases, a plan administrator will be required to send both notices (which means that the recipient could receive nearly 20 pages of somewhat technical and repetitive information).

Some of the changes incorporated in the new model notices include the following:

- As of January 1, 2018, any portion of plan loan offset amount (i.e., outstanding loan balance at employment termination) may be rolled into an IRA or any eligible retirement plan by the individual’s tax filing due date, including extension for the year in which the offset occurs. (This replaces the prior 60-day rollover requirement for plan loan offsets).

- There is a new self-certification procedure for claiming eligibility for a waiver of the 60-day deadline for making rollovers (per Rev. Proc. 2016-47).

- Confirm that the 10% additional tax under IRC §72(t) applies only to amounts includible in income.

- Clarification that it is not necessary to itemize deductions on a tax return to qualify for the exception to the 10% additional tax for deductible medical expenses.

- Explanation of how the rollover rules apply to governmental §457(b) plans that include Roth accounts.

- Description of a new exception to the 10% additional tax for certain federal retirees who participate in a phased retirement program and an expansion of this exception for qualified public safety employees.

- Indication that taxpayers’ affected by a federally declared disaster and certain other events may have an extended deadline for making rollovers.

Speaking of disasters, the IRS announced last month disaster relief for those employers and individuals impacted by Hurricane Florence.

Although Notice 2018-74 does not explicitly state an effective date, plan administrators should plan on reviewing current rollover notices and either swapping old notices for the new ones or adding the required new descriptions to any customized notice as soon as possible.

**You May Need to Review Your Relocation Policy with Regard to Qualified Moving Expense Reimbursements**

Most large employers and many mid-size employers have a formal written relocation policy. A quick review of the policies at several dozen Ayco corporate partners confirms that most reimburse an employee for qualified moving expenses associated with a relocation requested by the employer, as well as certain other expenses relating to the move. A qualified moving expense reimbursement (QMER) is any amount directly or indirectly received by an individual from an employer as payment for what would otherwise be deductible as a moving expense if paid by the individual. These would include the reasonable expense of moving household goods and personal effects, as well as the costs of traveling to a new home - but not the cost of any meals.

IRC §132(a)(6) provides that QMERs are excludible from wages (i.e., not taxable to the employee) for both income tax and employment tax purposes. However, the Tax Cuts & Jobs Act (TC&JA) eliminated this exclusion from income for taxable years beginning after 2017 and before 2026, except in the case of an armed forces member on active duty who relocates pursuant to a military order.

The IRS recently issued Notice 2018-75 clarifying a number of questions with regard to payments or reimbursements made after 2017 for expenses resulting from moves that occurred prior to January 1, 2018. The TC&JA did not specify whether the suspension of this exclusion from income applies to all payments irrespective of when the move occurred. The IRS has now confirmed that the change in the rule and suspension of the exclusion applies only to payments or reimbursements for expenses incurred in connection with relocations that occur after December 31, 2017. Thus, if an employee relocated in 2017 but payments were not made until 2018, the exclusion for qualified moving expenses will apply. In addition, if an employer already has included these amounts in an employee’s wages, and withheld and paid federal employment taxes,
the employer may use an adjustment process or a refund claim process to correct the overpayment. Employers should, therefore, review how they have handled this issue with regard to relocations that occurred in 2017 when payments were made this year.

Did You Know...?

- The Health FSA contribution limit has been projected to increase to $2,700 for 2019. Some employers already have issued 2019 open enrollment information to employees describing the limit as the same as this year - $2,650. The limit is subject to indexing based on the increase in the Consumer Price Index for All Urban Consumers (CPI-U) each year.

- According to the 12th annual survey by the Kaiser Family Foundation, employer-sponsored health insurance covers 152 million Americans. The average annual premiums in 2018 were $6,896 for single coverage and $19,616 for family coverage, an increase of over 50% since 2008.

- Entertainment expenses are no longer deductible under IRC §274. But changes made by the TCJA did not specifically address business meals. In Notice 2018-76, the IRS has now clarified that business meals that are not lavish or extravagant which are provided to current or potential customers during an entertainment activity (e.g., hot dogs at a ball game) where an employee is present may still be 50% deductible.

- Movies which revolve around or deal with retirement or retirees include: On Golden Pond, About Schmidt, Cocoon, Going in Style, The Best Exotic Marigold Hotel, RED, Ladies in Retirement, Las Vegas. Any others you enjoyed, let us know.

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