You might think of your Health Savings Account (HSA) as a tax-advantaged spending account, where you temporarily put the money you will need to pay qualified medical expenses this year.

But if that’s all you think your HSA is, you may be missing out on some of the account’s most important features. That’s because your HSA has three important tax advantages:

- You don’t pay federal income tax on your contribution.
- If you invest your balance, you aren’t taxed on the earnings as it grows.
- Withdrawals used to pay qualified medical expenses are tax-free in most cases, whether you make the withdrawals now or far in the future.

Some people never spend the money they put in their HSA during their working years, instead planning to take full advantage of the account by saving and investing it to pay for medical expenses in retirement.

But even those who use it to pay current qualified medical expenses usually wind up accumulating a balance over the years. The average balance for those who have had an HSA with Fidelity for the past five years was $8,600 in 2018. Some or all of that balance can be invested and grow tax-free to help cover the cost of future health care expenses. Yet only 9% of all HSA owners invest their balance; the rest leave their money in cash.

The question for many people is: If I want to make the most of my HSA by investing some of the balance, how much should I hold back in cash to cover near-term expenses?

The answer depends on how much money you think you’ll need to cover your qualified medical expenses—and whether you can pay those expenses without using the money in your HSA. But that’s not so easy, is it? You can’t look into a crystal ball and see how healthy—or not—you’ll be in the coming year.

If you want to have ready access to at least some of your balance, you can set a “cash target”—an amount of money you want to have in your HSA in cash at any given time during the year.

The cash target also can act as an investment trigger in your account, allowing you to choose an investment option and automatically invest money above and beyond your cash target amount.
How does a cash target work?

A cash target isn’t a pot of money you collect and then never touch. Instead, you may be constantly using the cash in your HSA to pay for current qualified medical expenses and replenishing it with new contributions.

Think of it like the produce aisle in the grocery store. You want the basket of apples to be full when you’re making an apple pie or a big batch of applesauce, but most of the time, you just want to pick up a few apples to snack on. But the basket has to be constantly replenished so you can get what you need, when you need it.

That’s why, although we talk about cash target as a fixed number, it is actually closely associated with monthly spending and contributions. If you use your HSA to pay your current qualified medical expenses, you also need to replenish the account so you can maintain your cash target.

Everyone’s target is different. It depends on your expectations for spending on health care, as well as your ability to absorb the financial shock of a large, unexpected medical expense, potentially using other personal savings.

You can use an online tool to help you set this target easily. These steps can help you understand your needs and how to prepare for the unexpected.

1. Gather some information

The first thing you should do is estimate how much you spent on qualified medical expenses last year. This includes:

- Doctor’s visits: coinsurance, copays, and any other out-of-pocket costs
- Prescription drugs
- Mental health services, such as therapy appointments
- Eye care, including exams, glasses and contact lenses
- Dentist and orthodontist expenses

If you don’t already know the answer, you should be able to log in to your health insurance provider’s website to find out what expenses have applied to your deductible so far this year. Also consider looking at credit card statements or information from your drug store’s rewards system.
2. Consider what you expect in the coming year

Was last year pretty typical for you, or did you have large expenses you don’t expect to repeat this year? Or, are you expecting larger expenses this year—maybe you’re thinking of starting a family, or it’s time for the kids to get braces?

Depending on whether you expect lower, higher, or similar expenses in the coming year, you can use a percentage of last year’s expenses to estimate the coming year. We use these percentages as directional guidance, but you may nudge them higher or lower.

If you had an event last year that you don’t expect to repeat—the birth of a child, or an injury—you can simply subtract that amount from your total. Conversely, if you know the cost of something you are planning for the upcoming year, such as an elective surgery, you can add that cost to last year’s total.

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<th>Lower</th>
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<td>$2,700</td>
<td>($225/month)</td>
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We spent $3,600 last year, mostly because I broke my leg skiing. That was a rough trip!

I assume I’ll spend less this year.

We spent $3,600 last year too. Normal kids’ illnesses and injuries add up.

That’s pretty typical for us. I’d expect next year to be about the same.

We should aim high!

We spent $3,600 last year, but we’re expecting a baby, so we will definitely have more bills to pay next year.
3. See where you stand.

Now consider what you’re setting aside in your HSA, including any employer contribution you may be getting. Then see if you tend to spend more than you contribute.

We look at the numbers from a monthly standpoint because many people set their contributions during annual enrollment based on how much they are setting aside per-paycheck on everything—including insurance premiums, 401(k) contributions, and HSA contributions. (If you’re wondering how to balance contributions to your HSA with those to your retirement savings, read Where to save your money for the long term.)

To figure out your gap—if you have one—simply subtract your expected spending from your monthly contribution:

If you are falling short of your expected monthly spending, you have a few options:

- Increase your monthly contribution by the amount of your gap. (If you discover you’re not contributing enough, you can change your contribution amount during the plan year. You don’t have to wait for annual enrollment.)
- Write a check to your HSA account to front-load it in order to cover the gap. If you go this route, you will have to report the contribution at tax time so you can deduct the contribution from your income for the year. Also be sure this amount, coupled with any employer contributions made over the remainder of the year, does not put you beyond the maximum allowable annual contribution.

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<th>Contributing</th>
<th>Spending</th>
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<td>$200</td>
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I’m already contributing $300 a month.

That’s more than enough. I can invest the rest.

We’re contributing $300 a month.

That’s perfect for how much we spend, but it wouldn’t hurt to contribute more.

We’ve been contributing $200 a month, but that’s not enough.

Let’s increase it to $375.
4. Consider how you will pay your bills

As you look at what you expect to spend this year, think about how you plan to pay your medical bills.

- Are you comfortable paying some of these expenses from another source or account, rather than using your HSA?
- If you ran out of money in your HSA, would you have other resources to pay your bills? Or would you have trouble paying those bills?

This is an important consideration, because of course you can’t know for certain how much you’ll spend on health care in the coming year.

How do you feel about paying for your health care expenses today? Are you comfortable writing a check for a $200 office visit or a $75 prescription, but would want to ensure you have immediate access to cash in your HSA if you incur a bill that is, say, $500? The cash target you set will depend on a combination of your expected expenses and your comfort in handling those bills in addition to those you don’t expect.

Decide which category you fall into and then consider the next calculation to set your total cash target. This is not a monthly figure but a rolling total—the amount of cash you should aim to keep in your HSA at any given time in case you need it.
With respect to federal taxation only. Contributions, investment earnings, and distributions may or may not be subject to state taxation. The three tax advantages are only applicable if the money is used to pay for qualified medical expenses.

Fidelity recordkept data of 65,000 Fidelity HSA five-year continuous account holders through December 31, 2018.

Fidelity recordkept data of HSA accounts through December 31, 2018.

Generally, people with higher financial capacity can self-smooth out the volatility of health care expenses, whereas people with lower financial capacity need higher cash targets. For example, a person with higher financial capacity may not care whether they have one annual expense of $4,800 or 12 monthly expenses of $400 each, whereas a person with low financial capacity could not sustain a $4,800 expense. Even though these two people will have same annual expense, their financial capacity will dictate their multiple of the monthly spending need. Monthly expense multipliers of ½, 4X, & 10X are based on Fidelity's qualitative assessment of financial capacity. They are intended as directional indicators for how much to keep in cash, not rules to be applied. Your own needs may vary and ultimately you should select a cash target that you are comfortable with.

Settlement times may vary depending on the type of security you are selling in your account.

This information is intended to be educational and is not tailored to the investment needs of any specific investor. All investing involves risk, including the risk of loss.

Fidelity does not provide legal or tax advice. The information herein is general in nature and should not be considered legal or tax advice. Consult an attorney or tax professional regarding your specific situation.

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