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NEW PROVISION IN "TAX EXTENDERS" BILL WOULD MAKE HEALTH SAVINGS ACCOUNTS MORE ATTRACTIVE AS TAX SHELTERS

In closed-door negotiations on the "tax extenders" package, bipartisan House and Senate negotiators agreed to include an expansion of Health Savings Accounts (HSAs) that would make these accounts more lucrative as tax shelters for high-income individuals. The HSA expansion, which has never been passed by either the House or the Senate, would raise the contribution limits for HSAs and allow high-income people to use HSAs to shelter even more income from taxation.

Under current law, any individual who enrolls in a high-deductible health plan may establish an HSA. Individuals may not only make tax-deductible contributions to HSAs and have the earnings on these funds grow tax-free, but also may withdraw funds tax-free from the accounts, as long as the funds are used to pay for out-of-pocket medical costs. This tax treatment — under which *both* contributions *and* withdrawals are tax advantaged — is without precedent in the tax code. As a result, many health and tax policy analysts have warned that HSAs are likely to be used extensively as tax shelters by high-income individuals. The GAO recently issued a study which shows HSAs are, in fact, being used disproportionately by high-income individuals and indicates many of these people are using HSAs as tax shelters.

The HSA provision added to the "tax extenders" bill would allow people to put much more money into their HSAs each year than they would need to cover the deductible in their health plans. All HSA participants would be allowed to contribute up to $5,450 (for family coverage) each year to their HSA, irrespective of the deductible required under their health plan. (Currently, HSA contributions are limited to the *smaller* of the participant's deductible or $5,450. Plan deductibles are generally lower than that.) This change would encourage increased use of HSAs as tax shelters — especially by high-income individuals, the ones who can best afford to substantially increase their HSA contributions.

This provision also would encourage people with HSAs to *increase* the amounts they spend for health care, undercutting claims that HSAs lower health care spending. Individuals would be allowed to "overfund" their HSAs, contributing up to $5,450 annually for family coverage while facing a deductible as low as $2,100 for such coverage. This could encourage some people to spend a portion of their excess HSA balances on health care.

Another element of the HSA expansion would allow individuals to make one-time transfers of funds from their Individual Retirement Accounts (IRAs) to an HSA without tax or penalty. (Under current law, individuals generally may not withdraw funds held in IRAs for purposes other than retirement without paying income taxes and a financial penalty.) Since withdrawals from a traditional IRA are generally taxed but withdrawals from an HSA are not, this provision would allowed people to convert up to $5,450 in savings in a traditional IRA that would be otherwise be taxed upon withdrawal to entirely tax-free savings in an HSA.

This change too would disproportionately benefit high-income households. Not only are they much more likely than less-affluent households to have IRA accounts and to make large contributions to them, but they receive a larger tax subsidy than other households from shifting funds from a taxable IRA to a tax-free HSA because they are in a higher tax bracket.