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LAST-MINUTE ADDITION TO TAX PACKAGE WOULD MAKE HEALTH SAVINGS ACCOUNTS MORE ATTRACTIVE AS TAX SHELTERS FOR HIGH-INCOME INDIVIDUALS

By Edwin Park, Robert Greenstein and Joel Friedman

As part of the last-minute deal making today on the "tax extenders" package, House and Senate negotiators have agreed to include an expansion of Health Savings Accounts that would make these accounts more lucrative as tax shelters for high-income individuals. The HSA expansion is identical to legislation (H.R. 6134) introduced by Representative Eric Cantor (R-VA) and Rep. Paul Ryan (R-WI) that was approved by the House Ways and Means Committee in September. The legislation was never considered on the House floor or by the Senate either in committee or on the floor.

HSAs are tax-favored savings accounts attached to high-deductible health insurance plans. Their use was authorized by the 2003 Medicare prescription drug law.

The following paper analyzes H.R. 6134, the HSA provisions that were approved by Ways and Means and that have now been added to the "tax extenders" package.

KEY FINDINGS

- **In closed-door final negotiations on the "tax extenders" package, House and Senate negotiators added a tax break benefiting high-income taxpayers that was never passed by either the full House or Senate.**
- **The measure, which the House Ways and Means Committee approved on September 27, would make Health Savings Accounts more lucrative as tax shelters for high-income individuals.**
- **The measure would increase the amounts that could be contributed to HSAs each year, thereby allowing those who could make these additional contributions to shelter even more of their income from taxation.**
- **The measure also would encourage people with HSAs to increase the amounts they spend for health care — undercutting claims that HSAs lower health care spending — because the bill would allow people to put much more money into their HSAs each year than they would need to cover the high deductible in their health plans.**
- **The GAO recently issued a study which shows HSAs are being used disproportionately by high-income individuals and indicates many of these people are using HSAs as tax shelters.**

Background: Current Law Regarding HSAs

Under current law, any individual who enrolls in a high-deductible health insurance plan may establish a Health Savings Account. (Individuals with HSAs may not have any other health coverage beyond the high-deductible insurance plan, except for certain limited types of coverage such as for long-term care,

disability, vision or dental insurance.) An individual with an HSA may take a tax deduction for contributions that he or she makes to the account. Contributions are allowed up to the *lower* of the amount of the deductible under the individual's high-deductible health insurance plan or an annual limit that is set at $2,700 for individuals and $5,450 for family coverage in tax year 2006. Both employers and employees may make contributions to an employee's HSA in the same year, although the combined contributions made on behalf of an individual may not exceed the contribution limit. Unlike with individual retirement accounts (IRAs), there are no income limits on who may use HSAs.

Under HSAs, 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 to a savings account *and* withdrawals from that account 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 Study

A new Government Accountability Office study issued earlier this month demonstrates that HSAs are indeed being used disproportionately by high-income individuals.[1] The GAO analyzed Internal Revenue Service data on tax filers who made HSA contributions in 2004; these IRS data are the first income data available on actual HSA use throughout the U.S. population.

The GAO found that although only 18 percent of tax filers under age 65 had incomes exceeding $75,000, some 51 percent of tax filers making HSA contributions did. The GAO also found that the average income of HSA users was $133,000 in 2004, compared to $51,000 for all non-elderly tax filers.

In addition, the GAO found that among HSA participants, the higher the participants' incomes, the larger the tax-deductible HSA contributions they made. The average HSA contribution made by participants with incomes exceeding $200,000 was more than double the average contribution made by participants with incomes below $50,000.

The GAO study also provided strong indications that many HSA participants are using their accounts as tax shelters. The GAO reported that the majority of people with HSAs withdrew *no funds* from the accounts in 2004, and HSA participants in the focus groups that the GAO convened spoke of using their HSAs for tax sheltering purposes.

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[1] See Government Accountability Office, "Consumer-Directed Health Plans: Early Enrollee Experiences with Health Savings Accounts and Eligible Health Plans," GAO-06-798, August 8, 2006, and Edwin Park and Robert Greenstein, "GAO Study Confirms Health Savings Accounts Primarily Benefit High-Income Individuals," Center on Budget and Policy Priorities, September 20, 2006.

The Ways and Means Committee Bill (H.R. 6134)

H.R. 6134, the measure the House Ways and Means Committee approved on September 27 and that was added to the "tax extenders" package on December 7, would make HSAs even more attractive as tax shelters to high-income households. Several provisions of H.R. 6134 raise significant concerns:[2]

1. Allowing people who can afford to do so to make tax-deductible HSA contributions that *exceed* the deductible amount in their high-deductible health plans — which would encourage increased use of HSAs as tax shelters and likely induce increased health care spending as well. Under current law, individuals with HSAs can make tax-deductible contributions up to 100 percent of the deductible in their health insurance plans, or up to the statutory limit on HSA contributions (set at $2,700 for individuals and $5,450 for family coverage in 2006), whichever is lower. H.R. 6134 would relax these limits by permitting *all* HSA participants to contribute up to $2,700 for individuals and $5,450 for family coverage, irrespective of the deductible required under their health plans. This provision would clearly promote tax sheltering.

- Some high-income individuals may wish to use an HSA as a tax shelter but cannot currently make tax-deductible contributions of up to $2,700 for individual coverage and $5,450 for family coverage because their insurance plans carry deductibles considerably lower than that. The deductibles for plans used in conjunction with HSAs need be no higher than $1,050 for individual coverage and $2,100 for family coverage. (One employer survey found that the average deductible in high-deductible insurance plans attached to HSAs was $1,901 for individual coverage and $4,070 for family coverage in 2005.[3]) Under H.R. 6134, all HSA participants would be allowed to contribute $2,700 if they have individual coverage and $5,450 if they have family coverage, regardless of the level of their deductible.

- The ability for individuals to increase their tax-deductible contributions to HSAs and to shelter more money in these accounts would make HSAs still more attractive to high-income individuals, who are the people who can best afford to substantially increase their HSA contributions. The likely result would be to induce more high-income individuals to establish a HSA and to increase the amounts that high-income HSA participants contribute to the accounts. Furthermore, since these individuals would be contributing funds *not needed to cover health costs incurred under their deductibles*, it is likely that a substantial share of the additional contributions would be used for tax-sheltering purposes rather than to cover current out-of-pocket health care costs.

- In particular, this change is likely to make HSAs more appealing to individuals with very high incomes who have reached the maximum annual contribution limits on their IRA or 401(k) plans (or who are ineligible to make tax-deductible contributions to IRAs because their incomes

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[2] The bill contains several smaller HSA provisions, in addition to the three provisions discussed here. The other provisions change the 12-month period used each year to calculate cost-of-living adjustments in the HSA parameters, allow individuals who became covered under a high-deductible increase plan as late as the last month of a year to make the full tax-deductible HSA contribution for the year, and modify the comparable contribution requirements that apply to contributions to employees' HSAs made by employers who elect to make such contributions.

[3] Gary Claxton *et al.*, "What High-Deductible Plans Look Like: Findings from a National Survey of Employers, 2005," Web Exclusive, *Health Affairs*, September 14, 2005.

exceed the IRA income limits). These individuals would now be able to shelter more substantial amounts in their HSAs, and to do so on top of the large contributions they make to their tax-favored retirement accounts.

- This provision would skew the distribution of HSA tax benefits further to affluent individuals and thereby make the distribution of HSA tax subsidies still more regressive. As the GAO report indicates, HSA tax benefits already are heavily skewed to these individuals.

This provision would likely have a second dubious effect as well — *it would likely lead to an increase in health care spending by individuals with HSAs.* Indeed, by eliminating the relationship between the deductible and the maximum contribution to an HSA, the bill would undermine the very rationale advanced for HSAs in the first place — that they can reduce health care spending.

- HSAs proponents argue that the high deductibles required under HSA-eligible insurance plans encourage individuals to be more prudent consumers of health care, because individuals will be responsible for the cost of health care below the deductibles and thus will be more likely to limit health care use to necessary, cost-effective services. Although many health care analysts have questioned this claim,[4] tying the maximum tax-deductible HSA contribution to the amount of the high deductible at least encourages the use of higher deductibles in the health plans attached to HSAs. (This is the case because the higher the deductible, the larger the HSA contribution allowed.) *By severing this link, the bill would encourage individuals with HSAs to switch to health insurance plans with lower deductibles, thereby weakening whatever incentives the high deductibles may provide in curbing health care expenditures* and leaving HSAs exposed primarily as tax shelters, especially for affluent people.

- In fact, H.R. 6134 would be likely to increase health care spending by HSA users. Individuals would be permitted 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. Tax-favored funds held in a HSA may be used to pay for practically any medical expense, including health services and some elective procedures that typically *are not covered* by health insurance plans, as well as to pay for health services that often are restricted under health insurance plans in their amount, duration and scope. Essentially, HSAs provide a tax subsidy for virtually any out-of-pocket health care costs. Permitting annual "overfunding" of the accounts may encourage some individuals with HSAs to obtain additional elective health care services they would not otherwise consume, and thus to increase their total health care spending.

  In other words, the additional HSA contributions that the bill would allow would be likely to increase *both* tax sheltering *and* health care spending. Some of the additional contributions would be sheltered, and some would used for health care services that beneficiaries otherwise would not purchase.

2. Allowing one-time transfers of funds held in Individual Retirement Accounts to HSAs. Under current law, individuals generally may not withdraw funds held in Individual Retirement

[4] See Edwin Park, "Health Savings Accounts Unlikely to Significantly Reduce Health Care Spending," Center on Budget and Policy Priorities, June 12, 2006.

Accounts (IRAs) for purposes other than retirement (and a few other specified uses) without paying income taxes and a financial penalty. H.R. 6134 would add an exemption to this rule by allowing individuals, on a one-time basis, to transfer funds from their IRA to an HSA without tax or penalty. The only conditions would be that the sum of the amount transferred and any deductible contributions the individual made during the same year could not exceed the maximum annual HSA contribution limit (which, as noted, would be $2,700 for individual coverage and $5,450 for family coverage under the bill), and that an individual making such a transfer must remain enrolled in a HSA-eligible high-deductible health insurance plan for at least 12 months.

- This provision would offer a tax benefit to people who have funds in traditional IRAs. Contributions to a traditional IRA are tax-deductible, and earnings on IRAs accrue tax-free, but withdrawals in retirement *are treated as ordinary income and subject to income tax*.[5] In contrast, funds held in a HSA are *never* taxed; contributions are deductible *and* withdrawals are tax-free, as long as withdrawals in a given year do not exceed an individual's (or family's) out-of-pocket health care costs that year. Under H.R. 6134, individuals would be allowed 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.

- Data on IRAs show that high-income individuals are much more likely to have IRA accounts and make the largest contributions to them.[6] In addition, the higher one's tax bracket, the greater the tax subsidy that would be gained by converting a portion of an IRA, from which withdrawals would be treated as taxable income, into an HSA from which withdrawals are entirely tax free if they are appropriately timed. As a result, this provision also could provide disproportionate tax benefits to high-income households.[7]

- This provision also could set an unsettling precedent; it could open the door to subsequent efforts to expand the provision to allow individuals to transfer funds held in traditional IRAs — as well as funds in 401(k) plans that have the same tax-deferred treatment as IRAs — to HSAs on an ongoing basis. Although shifting funds from IRAs and 401(k)s to HSAs may appear to be little more than moving funds from one tax-preferred account to another, it could have substantial, damaging long-term budgetary effects. Large amounts of assets are held in traditional IRA and 401(k) accounts, and substantial withdrawals from these accounts, which

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[5] Some contributions to traditional IRAs are not deductible, but the earnings on non-deductible contributions still grow tax free and then are subject to tax upon withdrawal. In contrast, contributions to Roth IRAs are not deductible, but earnings accrue tax free ***and*** withdrawals also are tax free.

[6] See, for example, Leonard E. Burman, William G. Gale, Matthew Hall, and Peter R. Orszag, "Distributional Effects of Defined Contribution Plans and Individual Retirement Accounts," Tax Policy Center Discussion Paper No. 16, August 2004 (revised). Also see Congressional Budget Office, "Utilization of Tax Incentives for Retirement Savings," August 2003, and Peter Orszag, "Balances in Defined Contribution Plans and IRAs," *Tax Notes*, February 2, 2004. Although income limits now exist on who can make tax-deductible contributions to traditional IRAs, many high-income households have large IRA accounts for several reasons. First, for a number of years prior to enactment of the Tax Reform Act of 1986, there were no income limits on who could make tax-deductible IRA contributions, and high-income households made heavy use of IRAs. Many such households still have these IRAs. Second, individuals leaving an employer with a 401(k) plan commonly roll over their 401(k) accounts into an IRA. There is no income limit on who can make such rollovers. Finally, the income limits on who can make tax-deductible contributions to IRAs do not apply to individuals whose firms do not sponsor a retirement plan or who are self-employed.

[7] On the other hand, some high-income individuals probably would not elect this option, preferring to make the maximum allowable tax-deductible contributions to HSAs, thereby converting taxable income to tax-free savings.

will be subject to taxation, are expected in coming decades. If individuals can transfer significant sums over time from tax-deferred retirement accounts to HSAs and subsequently withdraw them on a tax-free basis to pay for medical costs in retirement, the already alarming federal budget forecast for coming decades will grow still worse.

3. Allowing one-time transfers of funds held in Flexible Spending Accounts and Health Reimbursement Accounts to HSAs. Flexible Spending Accounts (FSAs) allow employees to set aside funds on a tax-free basis, up to a limit determined by their employer, to pay for out-of-pocket medical costs. Unlike with HSAs, unspent balances held in a FSA do not roll over year-to-year (beyond the first 2 ½ months of the following year), and FSAs are not portable. Health Reimbursement Accounts (HRAs) are savings accounts attached to high-deductible plans that are similar in a number of respects to HSAs but do not have the same tax advantages. Only employers may contribute to such accounts (i.e., employees may not).[8] Balances can be carried over in subsequent years, but employees do not retain the HRAs if they leave their employer.

H.R. 6134 would allow employers to transfer, on a one-time basis, funds held in an employee's FSA or HRA to the employee's HSA without any tax being owed. (The employee would need to remain enrolled in a high-deductible health plan eligible for a HSA for one year after the transfer.) The one-time transfer would have to be completed before 2012.

- This change, too, would be of greatest benefit to higher-income households. They are the households that can afford to contribute the most to a FSA to pay for out-of-pocket medical costs, and they consequently are more likely to have significant FSA balances that could be transferred to a HSA. They also derive the largest tax benefits from FSAs and HSAs, since they are in the top tax brackets.

- This change would likely encourage more employers to switch from HRAs to HSAs. Many employers provide HRAs rather than HSAs, and employers (as well as their employees) may be reluctant to switch to HSAs without having the option to transfer existing HRA balances to employees' HSAs on a tax-free basis. This provision would facilitate these switches.

The three provisions of H.R. 6134 described here all would make HSAs more attractive and thereby increase participation in HSAs, particularly by higher-income, healthy individuals who need little or no health care. In addition to warnings that HSAs will be extensively used as tax shelters, a number of analysts have warned that if healthy individuals begin to use HSAs in sufficient numbers, that would create a risk of "adverse selection," under which healthy and less-healthy individuals divide into separate health insurance arrangements.

Most analysts agree that if adverse selection becomes widespread in employer-based coverage — with healthy individuals abandoning comprehensive coverage in large numbers for high-deductible coverage tied to HSAs — this will drive up premiums for comprehensive, low-deductible employer-based coverage and risk causing individuals who rely on such coverage and are in poorer-than-average health to be priced out of the insurance market and to become uninsured or underinsured.[9]

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[8] Employer contributions to HRAs are not considered taxable income to employees.

[9] For a summary of why HSAs risk adverse selection, see Edwin Park and Robert Greenstein, "Latest Enrollment Data Still Fail to Dispel Concerns About Health Savings Accounts," Center on Budget and Policy Priorities, Revised January 30, 2006. See also Emmett B. Keeler, et. al., "Can Medical Savings Accounts for the Nonelderly Reduce Health Care

Conclusion

Making HSAs more attractive and easier to use as tax shelters for high-income individuals, as H.R. 6134 would do, would be especially disturbing in light of the GAO findings that HSAs already are being used disproportionately by affluent households and provide disproportionate tax subsidies to them. The GAO also found evidence that HSAs are being used extensively as tax shelters; the GAO reported that the majority of people with HSAs withdrew no funds from the accounts in 2004, and HSA participants in the focus groups the GAO convened "reported using their HSA as a tax-advantaged savings vehicle, accumulating HSA funds for future use."[10] Rather than addressing these problems, H.R. 6134 would exacerbate them.

The bill also would add to deficits. At a time when the budget faces extremely large shortfalls in future decades, it makes little sense to be increasing deficits further by making HSAs even more attractive as tax shelters to high-income households.

Costs?" *Journal of the American Medical Association,* June 5, 1996, p. 1666-71; Len M. Nichols, et. al., "Tax-Preferred Medical Savings Accounts and Catastrophic Health Insurance Plans: A Numerical Analysis of Winners and Losers," Urban Institute, April 1996; and American Academy of Actuaries, "Medical Savings Accounts: Cost Implications and Design Issues," May 1995.

[10] Government Accountability Office, *op cit*., and Park and Greenstein, *op cit*.