Issue BRIEF

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Tax-Free Savings Accounts for Medical Expenses:

A Tax Cut Masquerading as Help to the Uninsured

The U.S. House of Representatives has approved legislation (H.R. 2596, the "Health Savings and Affordability Act of 2003") that will increase the cost of health insurance for people who are sick and don't have cash to pay for health care—the people who need assistance most. At the same time, it will do very little to help uninsured workers. In fact, these accounts have the potential to ***increase*** the number of uninsured workers in our country. The price tag for this misguided bill is estimated to be **$174 billion over 10 years—**an enormous tax break for those who can benefit from a tax deduction and who can afford to set aside dollars to invest and earn income tax-free.

Worse, this costly tax cut bill was attached to the Medicare prescription drug legislation that passed the House of Representatives. Therefore, this tax break is not only masquerading as help to the uninsured, but is has been further hidden among the many critical issues under consideration as Congress struggles to work out the differences between the House and Senate Medicare prescription drug bills. **If there is an additional $174 billion on the table, Congress should use these funds to improve the Medicare prescription drug benefit.**

Tax-Free Personal Savings Accounts: If You Have the Money to Spare

H.R. 2596 creates two kinds of personal savings accounts that people who have the ability to set aside cash can use to reduce their income taxes and to earn investment income tax-free. Money that is deposited in these accounts is tax deductible, and the funds in the account can be invested in stocks and bonds, and the earnings from these investments are tax-free. Withdrawals for certain medical expenses are not taxed. Withdrawals not used for these certain medical expenses incur tax and a 15 percent penalty. Withdrawals for non-medical purposes after age 65 carry no penalty. Thus, these personal savings accounts can be a way for people—who can spare the money—to shelter significant funds from taxes. The two types of accounts in H.R. 2596, Health Savings Security Accounts (HSSAs) and Health Savings Accounts (HSAs), are compared in the table on page 4.

FamiliesUSA
The Voice for Health Care Consumers

1334 G Street NW
Washington, DC 20005
202-628-3030
E-mail:
info@familiesusa.org
Web site:
www.famililesusa.org

Tax-Free Accounts Will Not Reduce the Number of People Who are Uninsured

Workers can use HSSA funds to pay the premiums of employer-based coverage if their employers don't pay any part of the premiums. HSSA funds can also be used to pay for health insurance coverage in the private individual market. Thus, proponents of HSSAs argue that currently uninsured workers will be able to use the funds to buy insurance.

However, many uninsured workers have incomes that are too low to owe federal income tax and certainly don't have $2,000 or $4,000 in cash to set aside for this purpose: Thirty-six percent of uninsured people have incomes under 100 percent of the federal poverty level, or $18,400 for a couple with two children. These people gain no benefit from an HSA or an HSSA because they owe no taxes.

For another large segment of the uninsured, the accounts provide, at best, a 10 cent tax subsidy for each dollar they would have to spend on health insurance premiums: Twenty-nine percent of the uninsured have incomes between 100 and 200 percent of poverty, or between $18,400 and $36,800 for a couple with two children.

For these low-income uninsured, even if a worker were able to put away cash into an HSSA, this small subsidy won't go far to pay for the high cost of health insurance coverage—whether through an employer or in the individual private market. The average price of employer-sponsored family coverage was $7,954 in 2002. Prices of coverage in the individual private market, which generally charges people more if they are older or in less-than-perfect health, are much higher. Of course, if a worker or a family member has any serious health condition, it is likely that individual coverage will not be available at all.

Table 1

Estimated Tax Benefits in 2004 for a Family of Four by Income Level

Poverty Level	Income	Percent of Uninsured Population	Benefit
100% of poverty	Under $18,400	36%	$0
100-200% of poverty	$18,400-$36,800	29%	Maximum of 10¢ for each $1 set aside

For the two-thirds (65 percent) of uninsured people living on incomes below 200 percent of poverty, setting aside almost $8,000 to pay for health insurance is not an economic possibility. A small tax deduction—if they have taxable income—does not make health insurance affordable for these families.

For Workers with Insurance, Tax-Free Accounts Will Increase Out-of-Pocket Costs

Some employers will gravitate to these accounts as a way to shift rising costs to workers by offering only cheaper health insurance plans with higher deductibles and higher copayments. Since employers and workers can both contribute to the same HSSA, employers can ask their workers to “match” the employer’s contribution and, at the same time, can justify offering a higher-deductible, higher-copayment plan to workers. This cost equation will work against sicker workers—the high copays will add up to more than the value of the employer contribution to the HSSA. Low-income workers who cannot afford to divert dollars from their pay to an HSSA will see an *even greater* net loss in the value of their employer-based insurance coverage while their employer saves money on the cheaper plan. And in many cases, the new cheaper plan will be the only option available to workers. Thus, the employer-based coverage package will be eroded, and the same low-income workers who cannot afford to put cash into an HSSA will face increased out-of-pocket costs that they can’t afford.

Here is what happens if an employer offers workers a choice between a high-deductible, high-copayment health insurance plan with a tax-break account and more traditional health insurance—that is, insurance with reasonable deductibles and copayments: The HSA/HSSA plans, with high deductibles and high copayments, are likely to siphon off healthier people who anticipate few medical treatment costs and hope to shelter some income from taxes in the account. The people who can’t afford to put cash into an HSA/HSSA will stay in insurance plans with a smaller deductible and lower copayments. So will people who have health problems and who expect to have health care expenses. As these plans lose their healthier enrollees, they will be left with a higher proportion of unhealthy people. More unhealthy people will mean higher costs, so premiums will have to be raised. The higher the premiums rise, the more healthy people with financial wherewithal will decide to opt into HSAs/HSSAs. This continuing cycle of “cherry picking” healthy people will make the insurance we’re used to—plans with smaller deductibles and low copayments—extremely expensive, leading more and more employers to drop this kind of coverage.

This scenario is not the alarmist prediction of a few; it has been documented in research by the RAND Corporation, the Urban Institute, and the American Academy of Actuaries. In fact, the American Academy of Actuaries found that premiums for traditional insurance could more than double if use of these kinds of personal savings accounts becomes widespread.

Fix the Coverage Holes in Medicare Instead of Creating a New Tax Loophole

Rather than spend $174 billion on tax cuts, the U.S. House of Representatives could allocate the money to fix holes in the prescription drug coverage package they’ve proposed for Medicare beneficiaries. For example, $174 billion could pay for coverage for seniors’ or disabled people’s drug spending between $2,000 and $4,900—which, under the current House bill, must be paid entirely by Medicare beneficiaries. Forty-three percent of these beneficiaries are struggling to make ends meet on incomes below $18,000 a year.

HSSAs and HSAs: Similarities and Differences

Question	Health Savings Security Accounts (HSSA)	Health Savings Accounts (HSA) (basically the same as MSAs*)
Who is eligible to participate?	1. Income tax filers with a health insurance policy that meets the requirements below, or 2. Uninsured filers	*Only* income tax filers with a health insurance policy that meets the requirements below
Is there an income limit on those using this deduction?	• $85,000 for an individual • $170,000 for a family	No income limits
How much can you deduct from taxes and place into an account?	• $2,000 for an individual • $4,000 for a family • For filers over 55, the allowable amount is higher and increased each year.	The amount of the deductible of the health insurance policy linked to the HSA (see below)
Who can make contributions to the personal savings account?	Any one or a combination of: • eligible income tax filer • filer's employer • family members of eligible filer (non-deductible) The aggregate of funds placed in the account cannot exceed the above maximum	Either one or a combination of: • eligible income tax filer • filer's employer
In the health insurance policy linked to the personal account, how big must the deductible be?	• >$500 for an individual • >$1,000 for a family policy	• $1,000-$2,500 for an individual • $2,000-$5,050 for a family
In the health insurance policy linked to the personal account, is there a maximum out-of-pocket limit before the policy picks up all your health costs?	No	• Yes, no more than $3,350 for an individual • $6,150 for a family
Does the account grow from investments tax-free?	Yes	Yes
What expenses can the withdrawal cover without incurring tax?	1. Medical expenses not covered by the linked health insurance policy due to deductibles or copayments 2. Premium for a health insurance policy that meets the deductible requirements above and if no employer pays a portion of the premium (group, COBRA, or individual market) 3. Health insurance for individuals older than 65, including Medicare expenses	Only medical expenses not covered by the linked health insurance policy due to deductibles or copayments
What if funds are withdrawn and used for non-medical purposes?	If amount withdrawn for non-medical reasons, the dollars are included in gross income and taxed plus 15 percent penalty (except such amounts contributed by a family member and returned)	If amount withdrawn for non-medical reasons, the dollars are included in gross income and taxed plus 15 percent penalty
Can the funds be withdrawn at retirement for non-medical purposes?	Yes, but amounts are included in gross income (but no 15 percent penalty applies)	Yes, but amounts are included in gross income (but no 15 percent penalty applies)

* Medical Savings Accounts