Our Nation Needs a Simplified Health Savings Account System

By David E. Libman

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Like so many Americans, I find myself transfixed by the current presidential election. The election's major issues, whether trite or substantive, remain incredibly intriguing: Come January 2009, will we end up with the first African-American president or the first female vice president? What strategy will our next commander in chief pursue in Iraq: fight for 100 years, or leave in 16 months? Will the do-nothing Congress finally become a do-something Congress? Will our economy continue to edge toward the next Great Depression, or will it take a turn for the better? And will Sen. John McCain, R-Ariz., or Sen. Barack Obama, D-Ill. — whoever the winner may be — actually follow through on his campaign promises to make healthcare more affordable?

The oppressive cost of healthcare has been a hot election issue at least since the early 1990s, when President Bill Clinton attempted to pass legislation to provide Americans with universal health coverage. The failed attempt spurred much controversy due, in part, to Clinton's decision to put Hillary Clinton in charge of this pet project. Wounded but not defeated, Sen. Hilary Rodham Clinton, D-N.Y., again made an affordable national healthcare plan a cause célèbre during her recent presidential bid.

With Sen. Clinton gone, Obama promises a similarly ambitious national healthcare plan to make health insurance available to all citizens and require it for children. Obama would obligate large employers to either contribute to their employees' health coverage or contribute a percentage of payroll to the national healthcare plan. Smaller employers would avoid those requirements, but they could receive refundable tax credits of up to 50 percent of all premiums paid on behalf of their employees.

McCain's plan would offer individuals a $2,500 refundable tax credit and families a $5,000 refundable tax credit to be used to purchase of health insurance directly, through their employers, or otherwise. But McCain also would replace current exclusions that allow employers to offer employees healthcare benefits tax free and instead would treat employer-provided health insurance as taxable income to employees. McCain has also suggested expanding the use of tax-benefited health savings accounts.

It's hard to believe either nominee's plan of ''change'' can rapidly cure our nation's rising healthcare costs. This summer's political conventions, and the nominees' constant (sometimes petty) bickering, suggest that our nation remains polarized within the two-party system. ''Reaching across the aisle'' to fix our nation's healthcare cost problem may come eventually, but not quickly enough. Furthermore, regardless of whether monumental change is possible for our nation's healthcare system, each nominee should consider simplifying and expanding the use of HSAs.

A. The Basic Operation of an HSA Plan

At first blush, the HSA idea is not that complicated. The HSA is a tax-benefited savings account, like an IRA, but for use with healthcare costs. To become eligible for an HSA, you need a self-only or family coverage high-deductible health plan (HDHP). In 2008 self-only HDHP plans for individuals require a minimum annual deductible of $1,100 and a maximum annual out-of-pocket medical expense limit of $5,600. An HDHP plan for families requires a minimum annual deductible of $2,200, and a maximum annual out-of-pocket expense that does not exceed $11,200.

Don't let those high deductibles and out-of-pocket expense limits deter you from considering an HDHP plan. Even though the dollar amounts sound high, you may likely save significant money by choosing an HDHP, given the lower premiums associated with HDHP plans. For example, I asked my employer to compare my costs if I chose low-deductible family health coverage or a family HDHP. The low-deductible plan would have cost me $12,000 annually just for premiums, regardless of whether I ever paid any out-of-pocket medical expenses. The HDHP plan came in at much less: $4,200 per year in annual premiums with maximum out-of-pocket medical expenses of $5,500. That's a grand total of $9,700, which is still much less than $12,000, so I chose the HDHP.

In combination with your HDHP, you open an HSA. Contributions your employer makes to your HSA are tax free to you. Contributions you make to your HSA up to a specific limit give you an above-the-line tax deduction. The tax savings that can come with the above-the-line deduction that accompanies an HSA contribution may likely be much more significant than the tax savings from a below-the-line itemized medical expense deduction (if you even itemize your deductions). However, if annual contributions to your HSA exceed the annual contribution limits, the excess is included in your gross income and subject to a 6 percent excise tax.

Money within the HSA can be otherwise invested in things like certificates of deposit, stocks, bonds, etc. Income on those investments accumulates tax free (like an IRA). Any distributions you take from the HSA to pay ''qualified medical expenses'' for you, your spouse, or dependents are also tax free. If you take a distribution for something other than a qualified medical expense, it's taxed as ordinary income to you and subject to an additional 10 percent penalty.

B. Needless Complexity

The HSA sounds simple, right? Well, it could be. But the HSA idea, which is fundamentally a good one, has become mired in a multitude of rules and regulations that make the usage of HSAs incredibly complex. Those rules complicate the use of HSAs if you and your spouse each have HDHPs, you are enrolled in Medicare, you have a flexible spending arrangement with your employer, a health reimbursement arrangement with your employer, or an Archer medical savings account (MSA), etc., etc., etc. The HSA idea gets even more complicated if your employer volunteers to contribute to your HSA. That voluntary gesture subjects your employer to an intricate set of comparability rules, which require it to make comparable contributions to other comparable employees.

Consider just a few examples of that needless complexity:

1. The contribution rules. Any person (employer, family member, or anyone else) may contribute to your HSA, but those contributions are limited annually, depending on whether you have self-only or family HDHP coverage. In 2008, if you have self-only HDHP coverage, your HSA contribution limit is $2,900. With family HDHP coverage, your HSA contribution limit is $5,800. However, if you and your spouse each separately have family HDHP coverage under separate plans, your maximum combined family contribution limit becomes the lesser of the lowest applicable HDHP family deductible or the $5,800 statutory maximum contribution. The family maximum contribution is further reduced by any contributions made to you or your spouse's Archer MSAs during the year. (Archer MSAs are somewhat similar to HSAs and are discussed further below.)

2. The Department of Veterans Affairs rule. Individuals otherwise eligible for an HSA that have received medical benefits from the Department of Veterans Affairs in the preceding three months may not make contributions into their HSAs.

3. Different definitions of qualified medical expenses. Qualified medical expenses for purposes of HSA distributions may include amounts paid for medical care for you, your spouse, or your dependents. Generally, the same types of medical expenses that qualify for a below-the-line itemized medical expense deduction constitute qualified medical expenses for purposes of HSA distributions. Those include expenses associated with diagnosis, cure, treatment, mitigation, disease prevention, equipment, and supplies.

Still, not all expenses that ordinarily qualify for an itemized medical or dental expense deduction constitute qualified medical expenses for purposes of HSA distributions. For example, medical insurance premiums can count toward your below-the-line itemized medical expense deduction, but they do not constitute qualified medical expenses for purposes of HSA distributions. However, some nonprescription drugs that *don't* qualify for the itemized medical deduction *do* qualify as an above-the-line deduction for purposes of tax-free HSA distributions.

4. Archer MSAs. Starting in 1997, Archer MSAs preceded HSAs as a tax vehicle designed to help individuals save on healthcare costs. (HSAs came later with Congress's passage of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003.) Archer MSAs are similar to HSAs, but unlike HSAs, they are limited to

self-employed individuals or employees of small employers with 50 or fewer employees. The Archer MSA rules require different HDHP deductible limits and out-of-pocket expenses than the HSA rules. Archer MSAs also require different contribution limits and penalty percentages for nonqualified medical expense distributions. If that were not enough, the Archer MSAs are subject to a cutoff year to limit the amount of Archer MSAs in existence, but the HSA accounts have no such cutoff year.

5. FSAs or HRAs can affect your use of an HSA. Other tax-benefited accounts may also affect your HSA usage: in particular, employer flexible spending accounts (FSAs) and health reimbursement arrangements (HRAs). If you have an HDHP and a health FSA or HRA that reimburses qualified medical expenses, you generally cannot make contributions to an HSA. Even this rule is subject to exceptions. If you're having trouble sleeping some night, you can read about those exceptions in IRS Publication 969, available at http://www.IRS.gov.

6. Employer contributions. The comparability rules apply only to amounts an employer voluntarily contributes to an employee's HSA, not after-tax amounts that an employee asks his employer to deduct from his paychecks. An employer that voluntarily decides to contribute to an employee's HSA or Archer MSA subjects itself to comparability rules. The comparability rules require the employer to make comparable contributions to other comparable participating employees with HDHPs and Archer MSAs or HSAs. The comparability rules don't distinguish between small and large employers. If an employer is part of a larger controlled group, the entire controlled group is treated as a single employer.

Comparable contributions have to be either the same amount to each employee, or the same percentage of comparable employees' HDHP deductible. Comparable participating employees are segregated into categories of current full-time employees, current part-time employees who work less than 30 hours per week, or former employees. So if an employer has 100 comparable former employees and wishes to contribute $100 to one former employee's HSA, the employer has to contribute $100 each to the other 99 former employees' HSAs. If the employer doesn't do that, it pays a penalty.

Comparable contributions to employees are also distinguished according to whether the employee has self-only or family coverage, but the rules get strange. For example, an employer could satisfy the comparability rules by contributing $1,000 per year to the HSAs of each employee with employee-only coverage but nothing to the HSAs of employees with family coverage. An employer could contribute $750 to the HSAs of each employee with employee-plus-one coverage, and $900 to the HSAs of each employee with employee-plus-two coverage. But if an employer gave $900 to each employee with employee-plus-one coverage, but only $750 to employees with employee-plus-two coverage, that employer would breach the comparability rules.

Any breach of the comparability rules subjects an employer a 35 percent penalty on the aggregate it contributes to the HSAs or MSAs of employees for the calendar year. Thus, an employer that knows it is going to breach the rules has an incentive to contribute less in the aggregate, so that the 35 percent penalty is correspondingly less.

Beyond the foregoing, in many situations, the comparability rules don't apply at all, including regarding employees compensated through collective-bargaining arrangements, employees without HSAs or MSAs, employees with cafeteria plans, etc.

C. A Better, Simpler Plan for the HSA System

If you made it this far, you've probably concluded (as I have) that the HSA rules involve an off-putting complexity that could make many rational eligible individuals simply say, "Forget it! I'll just pay higher premiums for health insurance and forgo the HSA idea — even though it may be cheaper — just so that I don't have to figure this all out." Many rational employers may also say, "Forget it! Let the employees contribute to their own HSAs because the financial onus associated with the comparability rules is too great."

Both reactions, although understandable, are unfortunate. With tinkering, Congress could simplify the HSA system for both individuals and employers. More people could end up using HSAs to achieve affordable healthcare, plus generate savings to use toward medical expenses in the future. The major aspects of a simpler HSA plan follow.

1. The HSA annual contribution limit should equal the maximum out-of-pocket expense of your HDHP. Under the current system, a family may not contribute more than $5,800 annually to its HSA, yet the maximum HDHP out-of-pocket expense limit is $11,200. If you are an HSA account holder without significant assets already saved in your HSA, this disparity leads to sobering possibilities:

- In any given year, your annual out-of-pocket medical expenses might exceed the amount you're allowed to contribute into your HSA.
- Correspondingly, if you take distributions up to the maximum contribution limit from your HSA, anything you take beyond that limit (if there is anything left in your HSA account) is subject to income tax plus a 10 percent penalty.
- Any excess that you might try to contribute to your HSA (beyond the annual contribution limit) so that you can take distributions to cover medical expenses up to the maximum HDHP out-of-pocket limit is subject to the 6 percent excise tax.

A fair HSA system should allow eligible individuals to contribute the same amount into their HSA annually that they might need to distribute out for purposes of paying qualified medical expenses.

2. Spouses with separate family HDHP plans should not be penalized by having their annual contribution limited to the lowest maximum deductible of either of the two plans. Do we really value family and marriage in this country? If we do, why do we have rules like this one? Under the current system, if I'm married with family HDHP coverage, and I'm the only person with HDHP coverage, my family's HSA contribution limit is up to $5,800 annually.

Yet if my wife also has family HDHP coverage, our family contribution would be limited to the lowest deductible of the two HDHP plans. To avoid this marriage

penalty within the HSA rules, I could divorce my wife. I prefer not to do that. Therefore, I suggest this rule be changed. The contribution limits should be the same regardless of marital status.

3. Receipt of medical benefits from the Department of Veterans Affairs in the preceding three months should not prevent you from making contributions to your HSA. This suggestion seems self-explanatory. We should honor our veterans, not make their lives more difficult.

4. The definition of medical expenses should be the same for HSA distributions as it is for a below-the-line medical expense deduction. Currently, health insurance premiums aggregate toward the below-the-line medical expense deduction, but they do not constitute qualified medical expenses for purposes of HSA distributions. But some nonprescription drugs constitute qualified medical expenses for purposes of HSA distributions, yet they don't aggregate toward the itemized medical expense deduction. This makes no sense.

If we want to encourage Americans to obtain health insurance, HSA distributions to pay health insurance premiums should constitute qualified medical expenses. The HSA contribution limit should probably be increased to account for this insurance premium addition to the range of qualified medical expenses. Furthermore, the same nonprescription drugs that qualify for HSA distributions should aggregate toward the itemized medical expense deduction.

5. To the extent possible, the rules for HSAs and MSAs should be exactly the same. Archer MSAs and HSAs are similar and clearly designed to achieve the same goal: savings on healthcare costs through the use of a tax-benefited account. Therefore, to the extent possible, the various rules that apply to each account should be the same.

6. Eliminate the comparability rules for employer contributions. The comparability rules presumably sought to encourage employers that contribute to one employee's HSA to contribute to all comparable employees' HSAs, and also to discourage discrimination among employees. However, in our current fragile economy, imagine a small employer with eight employees that is considering making a contribution to only two of its best employees' HSAs. If knowledgeable of the comparability rules, the employer may simply scrap the idea and raise those two employees' salaries in order to avoid the 35 percent penalty that comes from breaching the comparability rules. A larger employer with even more employees may have an even greater incentive to forgo making any voluntary HSA contributions.

If the government wants to encourage employers to contribute to employees' HSAs, it should not do so by penalizing those who want to contribute to some, but not all, employees' HSAs. Rather, the government should make the process as simple as possible. Admittedly, scrapping the comparability rules creates a greater risk that employers will discriminate in how they compensate some employees. However, that discrimination may be remedied through other means. And overall, I believe that making employer contributions easier by eliminating the comparability rules will lead more employers to contribute to HSAs than those that currently do so.

7. How do you plan to pay for all this? I'm not suggesting anything that causes the government to spend anything out-of-pocket. The foregoing suggestions merely pose the possibility of reducing tax revenue. I don't purport to be an economist, but I do think there are many arguments as to why that possible reduction in tax revenues could be minimal.

Furthermore, I'll admit to some pet peeves regarding other things the government spends money on, which I believe are not as important as making healthcare affordable to the average citizen. So here are a few thoughts:

This argument is almost a cliché, but if individuals have to spend less on healthcare, they may be able to spend more on other things. (Isn't this why the government recently gave us a rebate, that is, a stimulus package, on our taxes?) That increased spending on other things could stimulate the economy and presumably produce tax revenue. Furthermore, more affordable healthcare might encourage and allow individuals to spend more on preventative care, which could cause an overall reduction in government costs associated with the current healthcare system.

Recently, the federal government has arranged bailouts of $29 billion to Bear Stearns, and $200 billion to Fannie Mae and Freddie Mac. It also rescued AIG with $85 billion. Then, after AIG's executives enjoyed a $450,000 retreat in a posh Southern California resort, the federal government offered AIG further assistance exceeding $37 billion. If that were not enough (and apparently, it was not), there is the $700 billion bailout approved by Congress. Ultimately, if the federal government has enough money to rescue Wall Street from its own poor choices, it should also have enough money to help reduce the tax burden on average citizens who are trying to pay for increasing healthcare costs.

Recent reports suggest that Iraq may have up to an $80 billion budget surplus. Yet the United States still contributes billions to help reconstruct Iraq. Perhaps the United States should make Iraq pay its own bills and use the money it saves to help U.S. citizens.

I often read the articles that place the U.S. annual tax gap (the amount of owed taxes not collected each year) in the range of approximately $300 billion. Perhaps the government should improve efforts to collect on that tax gap. At this point, it could use the money.

Finally, and I realize this last suggestion risks violating free-speech rights, but perhaps we should tax politicians every time they say they care about making healthcare more affordable, unless they actually mean it. The needless complexities in the current HSA system disclose unwillingness by politicians to do what is really necessary to create a plan that everyone can easily use to save money on healthcare costs. Until we get a simpler solution, maybe politicians should have to pay for the lip service they give in lieu of actual workable solutions that could stem the rising costs of healthcare.