Presented to the Committee on Finance
United States Senate

Taking a Checkup on the Nation's Health Care Tax Policy: A Prognosis

Hearing of March 8, 2006

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates the opportunity to submit our comments to the United States Senate Committee on Finance on the President's proposals regarding health savings accounts (HSAs). ASPPA's comments, developed by an ASPPA HSA Task Force, are focused on their impact on employer-provided health care coverage and emphasize whether the proposals will make the HSA/HDHP (high deductible health plan) option more attractive to employers. These comments also address the impact the proposals might have on retirement plan savings.

Section I identifies some of the key objections and hurdles that employers face when making decisions regarding the HSA/HDHP design. Identifying these issues helps one evaluate the impact of the President's proposals, which is found in Section II. Section III addresses the potential impact the proposals might have on retirement plan savings.

All employers are sensitive to the costs of providing health coverage. Each employer generally falls into one of the four categories below. The needs and concerns of employers in each category vary, which results in potentially different impacts for each of them.

(1) Employers who refuse to offer any health coverage regardless of the cost.

(2) Employers who do not currently offer health coverage but might be willing to do so if the costs are reasonable.

(3) Employers who already offer non-consumer driven health care coverage.

(4) Employers who already offer some form of consumer driven health care coverage other than HSAs [*e.g.,* health reimbursement arrangements (HRAs) or health care flexible spending accounts (health FSAs)].

I. Reasons Employers Do Not Implement HSA/HDHP Options

A. Employers' Problems with the HDHP Products

- HDHPs may not be available to employers (*e.g.,* some states mandate certain coverage that precludes HSA eligible HDHPs).

- There may not be a sufficient premium decrement for switching to a HDHP, which is of particular importance to those employers currently offering traditional coverage. If there is not a significant premium decrease in switching to an HDHP, then a larger portion of the total health care cost is borne by either the employer or is shifted to employees. Presumably, premiums for HDHPs will stabilize over time due to market forces.

B. Problems with Employee Education/Morale

- Employee education and morale is a problem for employers who consider switching from traditional health coverage to an HSA/HDHP model. Larger employers may be able to offer employees a choice of benefit plans. Smaller employers do not have that flexibility. For them, a drastic switch to an HSA/HDHP may be viewed as a significant reduction

in benefits. In particular, the elimination of the ability to offer a co-pay option (*e.g.,* for prescriptions and medical office visits) is a huge hurdle to overcome. Not having a co-pay option can be particularly problematic when attempting to attract workers where competitors continue to offer traditional health plan coverage.

- The rules regarding the tax treatment of HSAs are too complicated and fraught with traps (*e.g.,* an individual may be ineligible for an HSA if the individual's spouse is covered by a traditional health FSA). Also, it requires individuals to be responsible for determining the deductibility and tax-treatment.

- The monthly determination of the HSA contribution limit prevents a smooth transition to an HSA/HDHP model. An employee's coverage changes to an HDHP immediately, yet the HSA contribution limit is a month-by-month determination.

C. Loss of Employer Control

- Many employers have a paternalistic approach in providing benefits to employees. Once amounts are deposited into an employee's HSA, the funds can be spent for non-medical expenses. Even though such a withdrawal will result in adverse tax consequences, if the funds were attributable to employer contributions, it still results in a gain to the individual.

- The inability to control the funds results in a reluctance on the part of an employer who seeks to pre-fund an individual's HSA so that there are adequate funds should a large medical expense be incurred.

II. Impact of the President's HSA Proposals

A. Provide an Above-the-line Deduction and Income Tax Credit for Purchase of HSA-Eligible Insurance

The proposal would make available an above-the-line deduction (available regardless of whether a taxpayer itemizes deductions) for premiums for high-deductible health insurance policies. A high-deductible policy is a policy that would qualify the individual to have an HSA, but the individual does not have to actually maintain an HSA. The deduction would be available if the individual does not have employer-provided coverage. In addition, individuals covered under a high-deductible policy would be allowed a refundable credit of the lesser of (1) 15.3 percent of the premium or (2) 15.3 percent of the individual's wages subject to employment taxes.

ASPPA recommends that the President's proposal be modified to provide that the income tax deduction and credit be available for any portion of a HDHP premium that would otherwise be paid by a taxpayer on an after-tax basis, regardless of whether the insurance is obtained in the individual insurance market. Many employers provide health coverage, but do not pay the entire cost of such coverage. The employee-paid portion would be paid on an after-tax basis unless the employer permits the payments to be made pre-tax through a premium conversion feature of a cafeteria plan (*i.e.,* an IRC §125 plan). Not all employers, however, offer cafeteria plans.

If adopted as proposed, those employees who must pay a portion of employer-sponsored coverage on an after-tax basis would be at a disadvantage to those individuals who obtain HDHP coverage in the individual insurance market. If an employer provides an employee a cash subsidy for individual market insurance (to take advantage of the tax incentives), then some employees will elect to keep the cash rather than obtain coverage. The likely result would be a reduction in the number of individuals who have health coverage.

B. Increase HSA Contribution Limits and Provide a Refundable Income Tax Credit to Offset Employment Taxes on HSA Contributions Not Made by an Employer

The maximum annual HSA contribution limit would be increased to the out-of-pocket limit under the corresponding high-deductible health insurance policy (current law generally caps the HSA contribution limit at the policy's deductible

amount). For 2006, the statutory maximum out-of-pocket limit is $5,250 for self-only coverage ($10,500 for family coverage). In addition, individuals making after-tax contributions to an HSA would generally be allowed an income tax credit equal to the lesser of (1) 15.3 percent of the premium or (2) 15.3 percent of the individual's wages subject to employment taxes.

ASPPA recommends that this proposal be adopted. The ability to only contribute up to the deductible has been a concern because the total out-of-pocket expense is the amount at risk to individuals. Accordingly, this proposed change would alleviate that concern, which would make HSAs more attractive to both employers and individuals.

C. Provide a Refundable Tax Credit to Lower-Income Individuals for the Purchase of HSA-Eligible Health Insurance

Individuals under age 65 would be allowed to claim a refundable income tax credit equal to 90 percent of premiums paid on a high-deductible health insurance policy. The amount of the credit would also be limited by the maximum credit amount per covered family member of $1,000 per adult and $500 per child for up to two children. The maximum credit available to any taxpayer would be $3,000. The maximum credit would begin to be reduced (phased out) at between $15,000 and $25,000 of taxable income, depending on the number of individuals covered by the policy. In addition, the tax credit could be claimed on the taxpayer's tax return or in advance. Eligibility for the advance credit option would be based on the taxpayer's prior year tax return. Individuals claiming the credit in advance would reduce their premium payment by the amount of the credit, and Treasury would reimburse the health insurer for that amount. Taxpayers would be eligible only if they do not participate in a public or employer-provided health plan. Eligible health insurance plans would be required to meet minimum coverage standards, including coverage for high medical expenses. In addition to private health plans, individuals would be able to purchase insurance through private purchasing groups, state-sponsored insurance purchasing pools and state high-risk pools.

ASPPA recommends that this proposal be modified to increase the phase-out limits and to permit the credit regardless of whether the taxpayer participates in individual market insurance or employer-sponsored coverage. The proposal in its current state would have no impact on making HDHPs more attractive to employers, and it would likely have little or no impact on making HDHPs more attractive to the affected taxpayers.

D. Make Other Statutory Changes to Improve HSA Administration

Qualified medical expenses that can be reimbursed by an HSA would be expanded to include premiums for the purchase of non-group HSA-eligible plans. In addition, the reimbursement of the expenses by an HSA established no later than the date for filing the return for that taxable year would be excludable from income. Moreover, employers would be allowed to contribute existing HRA balances to the HSAs of the same employees.

ASPPA recommends that this proposal be adopted. It will make HSAs more attractive to all individuals. The ability to contribute existing HRA balances to the HSAs of the same employees may be attractive to employers currently providing HRAs. Many HRA sponsors, however, will not take advantage of such a provision due to loss of control over how the funds are spent as well as the resulting funding obligation (the majority of HRAs are unfunded, and contributing balances to an HSA would require funding).

ASPPA also recommends that the proposal be modified to permit participants in a qualified IRC §401(k) or 403(b) plan to make a one-time transfer of their elective contribution, up to $10,000, to an HSA.

E. Improve the Health Coverage Tax Credit

The proposal would make a number of modifications and improvements to the Health Coverage Tax Credit (HCTC) that was created under the Trade Adjustment Assistance (TAA) Reform Act of 2002. Under current law, the HCTC is a refundable tax credit equal to 65 percent of the cost of qualified health insurance paid by eligible individuals, including certain recipients of TAA benefits and certain individuals between the ages of 55 and 64 who are receiving pension

benefits from the Pension Benefit Guaranty Corporation (PBGC). The proposal would modify the HCTC by subjecting state-based HCTC coverage to rules more like HIPAA. The proposal would also permit spouses of HCTC-eligible individuals to claim the HCTC when the HCTC-eligible individual becomes entitled to Medicare coverage, if the spouse is age 55. The proposal would also make a number of technical clarifications to the HCTC.

ASPPA recommends that this proposal be adopted; however, it will have little or no impact on making HSAs more attractive to employers.

III. Impact of the President's HSA Proposals on Retirement Savings

Some commentators have suggested that the President's proposals will have a detrimental impact on retirement plan savings. Under the current rules, HSAs can serve as a powerful savings tool whereby all amounts contributed are not subject to taxation. The President's proposals will make the HSA an unprecedented savings tool. The tax credit being proposed will permit HSA contributions to be made without being subject to payroll taxes. The credit, coupled with higher contribution limits (up to $10,500 if the HDHP is family coverage), will serve as a huge incentive for individuals to establish HSAs. The HSA contributions may very well be in lieu of retirement plan contributions.

Consider an individual who has $5,000 of income to save. If the amount is deferred into a 401(k) plan, then it is subject to federal payroll taxes, but is not subject to federal income taxes. Any distributions from the 401(k) plan would be subject to federal income taxes. On the other hand, if the contribution is made to an HSA (assuming the out-of-pocket maximum under the HDHP is at least $5,000), then the contribution is not subject to income taxes or payroll taxes. If a distribution is made from the HSA for a qualifying medical expense, it will be entirely tax-free. If a distribution is made for a non-qualifying medical expense, it would be subject to taxation—which is the same treatment that would apply if the distribution were made from the 401(k) plan. Thus, if the amount of money that an individual has to save is limited, the HSA would clearly be the better alternative.

The issue is whether the HSA is meant to serve as a retirement savings vehicle in addition to a health plan. The HSA has preferable tax treatment and is not subject to nondiscrimination and coverage rules that apply to a qualified plan. Whether small business owners will decide to forego a qualified retirement plan in lieu of an HSA is speculative. There is a distinct possibility, however, that over time, HSAs will be touted as a retirement savings plans. This goes beyond the intended purposes of HSAs, which is to implement the consumer-driven health care concept and ensure that there are adequate funds to meet the out-of-pocket medical expenses that one might incur under a HDHP.

ASPPA recommends that limits be put into place to curtail the use of HSAs as a retirement savings plan. As stated above, ASPPA supports the increase in the HSA contribution limits and the tax credits. An approach that would help ensure that HSAs are not viewed as retirement savings plans would be to prohibit contributions once the value of the HSA has reached a certain threshold. For example, if an HSA balance is at least $100,000 if filing jointly ($50,000 for individual coverage) as of December 31, then no additional contributions may be made to the HSA in the following taxable year.

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