Ruminations on Health Savings Accounts

I think there is overlooked opportunity through use of Health Savings Accounts. I will briefly recap what HSAs are and then give you a few new and different ways to look at them. If you are already familiar with HSAs you can skip this next section.

An Introduction to HSAs. The following points are taken verbatim from the 2003 Treasury Department press release:

- HSA funds can be used to cover the health insurance deductible and any co-payments for medical services, prescriptions, or products. In addition, HSA funds can be used to purchase over-the-counter drugs and long-term care insurance, and to pay health insurance premiums during any period of unemployment.
- HSAs are similar to medical savings accounts (MSAs). However, MSA eligibility has been restricted to employees of small businesses and the self-employed. HSAs are open to everyone with a high deductible health insurance plan. The only limitation on the health plan is that the annual deductible must be at least $1,000 for individual coverage and at least $2,000 for family coverage.
- Contributions to the HSA by an employer are not included in the individual's taxable income. Contributions by an individual are tax deductible. Individuals, their employers, or both can contribute tax-deductible funds each year up to the amount of the policy's annual deductible, subject to a cap of $2,600 for individuals and $5,150 for families [subsequently adjusted for inflation]. Individuals aged 55-64 can make additional contributions.
- The interest and investment earnings generated by the account are also not taxable while in the HSA. Amounts distributed are not taxable as long as they are used to pay for qualified medical expenses, such as prescription and over-the-counter drugs and long-term care services as well as the purchase of continued health care coverage for the unemployed individual (via COBRA). Amounts distributed which are not used to pay for qualified medical expenses will be taxable, plus an additional 10% tax will be applied in order to prevent the use of the HSA for non-medical purposes.
- HSAs are portable, so an individual is not dependent on a particular employer to enjoy the advantages of having an HSA. Like an individual retirement account (IRA), the HSA is owned by the individual, not the employer. If the individual changes jobs, the HSA goes with the individual.
- In addition, individuals over age 55 can make extra contributions to their accounts and still enjoy the same tax advantages. In 2004, an additional $500 can be added to the HSA. By 2009, an additional $1,000 can be added to the HSA.

A Different Perspective. The description above is a little dry and technical; so let me see if I can share a few different ways to look at and explain this new product.

- You can look at the HSA as a Flex Spending Account on steroids. For all practical purposes it works like a FSA, but the amounts can roll over every year so there is no "use it or lose it" catch that limits contributions. In addition, while the FSA may not be used to pay long-term care insurance premiums or health insurance premiums when unemployed, but the HSA may be used for those purposes.

- The HSA has the potential to ameliorate some of the problems we face with health care consumption and costs. Health insurance first became a widespread fringe benefit during World War II in an effort by employers to attract good workers despite government mandated wage freezes. This created a new problem of spiraling costs and utilization because the party paying the bill was not the party consuming the service. Obviously, making things free from the user's perspective tends to lead to over-consumption and inefficient allocation of resources. So, we are now faced with the all too common situation of politicians attempting to correct a problem their predecessors created in the first place. The HSA, by putting most of the cost of (and savings from) the spending decisions back on the person making the decision, may help rationalize and improve health care. In other words, the HSA may enable the free market to address health care issues in new and better ways.
- Functionally, an HSA can be viewed as an IRA that not only has no earnings limit, but also has no earnings requirement. High earners or people with no earned income (the idle rich?), who would like to put aside money in a tax advantaged vehicle, can do that with an HSA. A family can put over $6,000 (over $3,000 for an individual) into the savings account. Some HSA providers provide access to thousands of investment options making this a true investment opportunity.
- Structured correctly, the HSA can also provide tax-free distributions. In other words, it acts like a deductible IRA for money going in and a Roth for money coming out. While the HSA cannot be funded after age 65, the remaining balance can be used for qualifying medical expenses at *any* time. If the HSA balance grows so large it exceeds any foreseeable qualifying expenses (including long-term care insurance premiums), the funds may be taken out subject to ordinary income taxes just like a traditional IRA.
- In addition, the contributions may also be free from payroll taxes. Because the HSA is technically health insurance, employer-paid premiums render the contributions not subject to FICA.

Notes:

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