High Deductible Health Plans and Health Savings Accounts: Potential Problems for Taxpayers, Opportunities for Policy Makers

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This paper discusses high deductible health plans and health savings accounts. The paper also details a potential problem taxpayers may face when using a health savings account with a high deductible health plan, especially if they have adult children under age 27 who are insured under the plan but who are not tax dependents. The issue discussed also has policy implications which are relevant to tax policy makers (Smith, 2015b).

INTRODUCTION

Employers that offer high deductible health plans to their employees may also give their employees an option to participate in a health savings account. A health savings account can reduce the after-tax cost for healthcare costs paid by the employee. However, with employer-sponsored health plans that may now cover employees' children up to age 26 because of the requirements of the Patient Protection and Affordable Care Act (P.L. 111-148) and the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152), sometimes referred to together as the Affordable Care Act, use of a health savings account may be more complicated than anticipated. This paper discusses a potential problem taxpayers may face when using a health savings account with a high deductible health plan. Taxpayers who may face this potential problem would want to consider it as they contemplate the use of a high deductible health plan and a health savings account. The issue discussed also has policy implications which are relevant to tax policy makers.

HIGH DEDUCTIBLE HEALTH PLANS

Smith (2015a) gives some background on both traditional insurance plans and high deductible health plans. Potential tax benefits related to these different plans are also mentioned. A high deductible health plan is one which requires a relatively large deductible to be met before the insurance company starts to pay toward the medical costs. High deductible health plans are increasing in popularity. Many people are opting for the high deductible plans because of the lower premiums. Of course, one would expect, because of the nature of insurance and deductibles, that a plan with a high deductible would have lower premiums. This occurs because the risk to the insurance company is mitigated if the insured has to first meet the deductible. In addition, it is likely that insured parties may be more careful with their choice and use of medical services if they are paying the entire cost of the services up to the point that the deductible has been met.

High deductible health plans may have an out-of-pocket maximum amount that must be paid by the insured which is smaller than the out-of-pocket maximum in a traditional health plan. Therefore, the two groups most likely to choose a high deductible plan would be those who expect minimal health service needs during the year and those who may have major health service needs during the year. The first group may benefit by paying a lower premium and minimal costs toward the high deductible, making their total cost of health care coverage less than in a traditional plan. The second group may benefit by paying a lower premium and having a lower total out-of-pocket cost even though the deductible and out-of-pocket maximum may both be paid during the plan year.

HEALTH SAVINGS ACCOUNTS

If a high deductible health plan meets certain criteria, an employer can choose to give employees an option to contribute to a health savings account to help pay for the deductible, co-payments, and coinsurance costs of medical services (IRC, Section 223). A health savings account is owned by the individual and is portable if the individual switches employers. The amounts in a health savings account can be invested and earn interest. The contributions and earnings are not taxed if used for qualified medical expenses. Amounts contributed through an employer to a health savings account are excluded from taxes, both income taxes and employment taxes. A health savings account can also be funded directly by an employee who qualifies with a high deductible health plan. These contributions can then be deducted on an individual tax return, but they will not be exempt from employment taxes.

For 2017 the criteria qualifying a high deductible health plan to be eligible for a health savings account are as follows: (1) the deductible must be at least $1,300 for single coverage or at least $2,600 for family coverage, and (2) the maximum out-of-pocket expenses for the plan must not exceed $6,550 for single coverage or $13,100 for family coverage. The maximum contribution that can be made to a health savings account in 2017 is $3,400 if the health plan is for single coverage and $6,750 if the health plan is for family coverage (IRS, 2016c). An additional contribution of $1,000 is allowed in 2017 for those who are at least 55 years old.

Although contributions to a health savings account can only be made while an individual is covered under a qualifying high deductible health plan, the amounts accumulated in that account do not have to be spent in the same year when they are contributed. They can be spent for current medical expenses or for future medical expenses, even those incurred after the individual is no longer insured under a high deductible health plan. If an individual incurs medical costs while insured under the high deductible health plan, he/she can choose to pay for those costs outside of the health savings account and claim a reimbursement for those expenses from the health savings account many years in the future. Of course, that would require more money now—enough to pay for current medical costs as well as the contributions to the health savings account—but would potentially allow for more tax-free earnings to be withdrawn from the account in the future.

If amounts are withdrawn from a health savings account for non-qualified expenses, they are subject to federal income taxes. If these non-qualified expenses are withdrawn before the health savings account holder reaches age 65, they are also subject to a 20 percent penalty (the penalty was 10 percent prior to 2011) (P.L. 108-173, P.L. 111-148).

Amounts withdrawn from health savings accounts for qualified medical expenses are not subject to federal income taxes. "Qualified medical expenses are those expenses that would generally qualify for the medical and dental expenses deduction" (IRS, 2016b, p. 8). To be a qualified medical expense with respect to a health savings account for a specific taxpayer, the expense must have been incurred by (1) the taxpayer or the taxpayer's spouse, (2) a dependent claimed on the taxpayer's return, or (3) a person the taxpayer could have claimed as a dependent except that (a) the person filed a joint return, (b) the person had gross income in excess of the exemption amount ($4,050 for 2016), or (c) the taxpayer (or spouse if filing jointly) could be claimed as a dependent on another tax return for the tax year (IRS, 2016b).

DISCUSSION

"The Affordable Care Act requires group health plans and health insurance issuers that provide dependent coverage of children to continue to make such coverage available for an adult child until age 26" (IRS, 2010). The Affordable Care Act also makes changes to some sections of the tax code. These changes provide an exclusion from taxpayers' income for employer payments related to insurance plans and medical costs for adult children of the taxpayer who are not yet 27 but who may now be covered under the group health plan of a parent. The Internal Revenue Service also interpreted these changes to apply to health flexible spending arrangements (IRS, 2010).

A health flexible spending arrangement is a tax-advantaged plan an employer may offer in conjunction with a more traditional health plan. It is usually funded by employee contributions on a pre-tax basis through a salary reduction agreement between the employee and the employer. The flexible spending arrangement amount can then be used by the employee to pay for deductibles, co-payments, and coinsurance under the traditional health plan. The IRS interpretation of the Affordable Care Act changes means money from a health flexible spending arrangement can be used for medical expenses for a taxpayer's child who is not yet 27 even if he/she is not a tax dependent. However, no such change or interpretation was made with respect to health savings accounts.

Many taxpayers who are now choosing or contemplating high deductible health plans, potentially with an associated health savings account, have children who are not yet 26 years of age but who also do not qualify as tax dependents (or as those who would have been tax dependents but for the exceptions listed above for a health savings account reimbursement). This means that the medical costs paid through a high deductible plan for these adult children who are not tax dependents cannot be reimbursed through the health savings account.

To be a tax dependent, an individual has to meet the tax code requirements as (1) a qualifying child, or (2) a qualifying relative (IRC, Section 152). To be a tax dependent as a qualifying child, several requirements must be met: (1) the individual must be a child who has a specifically defined relationship to the taxpayer, (2) the individual must be under age 19 and younger than the taxpayer(s) or under age 24 if a student and younger than the taxpayer(s) or permanently and totally disabled, (3) the individual must not have provided over half of his or her own support, (4) the individual must not be filing a joint return or only doing so to claim a refund of withheld or estimated tax payments, (5) the individual must have lived with the taxpayer for more than half of the tax year, (6) the individual must be a U.S. citizen, a U.S. national, a U.S. resident, or a resident of Canada or Mexico, and (7) the individual (or his/her spouse if filing jointly) must not be claimable as a dependent on another tax return. To be a tax dependent as a qualifying relative, several requirements must be met: (1) the individual must either have a specific relationship to the taxpayer (wider scope than for qualifying child) or have lived with the taxpayer for the entire year (without violating local law), (2) the individual must not have been a qualifying child of any taxpayer, (3) the individual must have gross income less than the exemption amount ($4,050 in 2016), (4) the taxpayer must have provided over half of the support of the individual, (5) the individual must be a U.S. citizen, a U.S. national, a U.S. resident, or a resident of Canada or Mexico, and the individual (or his/her spouse if filing jointly) must not be claimable as a dependent on another tax return (IRS, 2016a).

As can be determined by looking at the requirements above for a tax dependent, there are many cases where an adult child may not qualify as a tax dependent (or for one of the exceptions) even if he/she qualifies as an insurance dependent under the Affordable Care Act. In many of these cases, the adult child is somewhat independent but may not be totally independent financially. The parent taxpayers may be providing some of the support for the child, including payment of some or all of the out-of-pocket medical expenses that are not covered directly by the insurance company.

IMPLICATIONS FOR PARENTS WITH ADULT CHILDREN

If parents with adult children who qualify for the insurance plan but who are not tax dependents have a choice between a traditional health plan and a high deductible plan, the tax implications of a high deductible health plan with a health savings account should be considered before the choice is made. The tax benefit of a health savings account may be the tipping point which makes the high deductible health plan preferable to a traditional plan. However, if adult children are involved, the tax benefit may not be the same as if there are no adult children insured on the policy. If an adult child who is not a tax dependent has unexpected surgery or a visit to the emergency room early in the insurance plan year, these costs could meet most or all of the deductible and some of the additional out-of-pocket cost required under the insurance policy. These costs would then not be eligible for reimbursement through the health savings account. If amounts had already been contributed to the health savings account, these amounts could be used for future health care costs for qualified individuals, but that might be in a future year. This would not leave the money available to cover the current deductible and coinsurance for the adult child. That money would have to come from another source. Of course, if other money is available, the amounts in the health savings account could simply be used for future health care costs.

However, if other money is not available, the taxpayer might need to discontinue contributing to the health savings account that year in order to have the money available for the medical services for the adult child. Although the amount contributed to a flexible spending arrangement is determined before the plan year starts and that amount cannot be adjusted unless there is a change in family status, a health savings account is on a calendar year (to match most taxpayers' tax years), and the amount contributed can be adjusted during the year. However, if the insurance plan year starts in the middle of the year, the health savings account may already be one-half funded for the year before it becomes known that an adjustment might be desired based on an adult child having medical services for which the cost applied toward the high deductible.

If the parents are actually paying the out-of-pocket medical costs for their adult children, the following things should be considered:

1. Consider the likelihood that the adult child(ren) will have medical services that will be applied to the deductible or out-of-pocket maximum. Use this likelihood in determining how much money to contribute to the health savings account (unless the parents can afford to fund both regardless).
2. For medical services which can be planned in advance, have the taxpayer, the spouse, and tax dependents plan to receive medical services first during the plan year so those costs will be reimbursable through the health savings account. One potential drawback even with this planning is that the deductible and out-of-pocket maximum are charged by the insurance company based on when claims are processed, not necessarily when the medical services were received. So sometimes even the best efforts at planning cannot achieve the desired outcome.
3. If unexpected medical expenses arise for adult children that will apply to the deductible or out-of-pocket maximum, consider adjusting the health savings account contributions if necessary. Of course, this would reduce the tax benefit if something less than the maximum contribution is made to the health savings account. Otherwise, if the taxpayer can afford it, the health savings account can continue to be fully funded even though the amounts contributed might then be used for future expenses of qualifying individuals.

If the adult children who are not tax dependents but who are covered under the parents' high deductible health plan are going to pay their own out-of-pocket costs, the following things should be considered:

1. The adult children would want to be aware of the potential costs if they require medical services that will be applied to the deductible or the out-of-pocket maximum. This would be true if the medical services are planned or if they are unexpected.
2. The parents may want to consider contributing less than the maximum amount to the health savings account if they expect that their adult child(ren) might help pay the deductible or out-of-pocket maximum. However, if the parents can afford it, they may still want to contribute the maximum to the health savings account to use for future medical costs.
3. The parents may want to ignore the possibility that their adult child(ren) may pay some or all of the out-of-pocket maximum initially when determining how much to contribute to the health savings account.

The contributions could then be adjusted if the out-of-pocket maximum is at least partially paid by an adult child. assuming there is still part of the calendar year left to adjust their contributions.

IMPLICATIONS FOR POLICY MAKERS

While it would not be revenue neutral to the government to allow a parent's health savings account to be used to pay for medical costs for children under age 27 who are not tax dependents, this would make the tax laws applicable to health savings accounts more consistent with the requirements of the Affordable Care Act. It would also make the tax benefits under a health savings account more consistent with the interpretation that the Internal Revenue Service has made that money from a flexible spending arrangement can be used for a child under age 27 even if the child is not a tax dependent. This change to the tax law would also reduce the complication of families with high deductible health plans and health savings accounts having to plan their medical expenses during the insurance plan year to maximize the portion of the out-of-pocket maximum paid by tax dependents while trying to postpone medical costs for adult children who are not tax dependents.

CONCLUSION

Policy makers should consider whether a change in the tax law with respect to health savings accounts (and medical savings accounts) would make sense. The potential change in the law could allow a taxpayer to pay for medical costs for children under age 27, regardless of whether they are tax dependents, from a health savings account. The cost of such a policy should be estimated so it can either be funded or offset if the tax law is changed.

Until such a change is made in the law, taxpayers with adult dependents covered under their high deductible health plan who are not tax dependents should carefully consider the effects on their high deductible health plans and health savings accounts. Some of implications to be considered were detailed in this paper.

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