How Health Savings Accounts Reduce Health Care Costs

Tax & Fiscal Facts

At Issue

Millions of Americans across the country are saving money by using tax-free dollars in Health Savings Accounts (HSAs) to pay for medical costs. However, California is one of only three states that do not allow this tax-free benefit. Learn more about how HSAs can save you money, and how you can stay informed of efforts to change state law so that you, too, can benefit from tax savings. The California Legislature will be considering various changes to tax laws this year.

To stay informed of state law changes affecting HSAs, email foundation@caltax.org and include "HSAs" in the subject line.

Due to rising health insurance costs, more and more Americans are enrolling in high-deductible health plans. These plans have lower monthly premiums, but require enrollees to pay out of pocket for doctor visits and other medical expenses until they reach the plan's maximum amount. To help defray these costs, the federal government and most other states have enacted tax-advantaged Health Savings Account (HSA) laws to allow participants of high-deductible health plans to use tax-free money to pay for out-of-pocket health-related costs for themselves, their spouses and their dependents.

Health Savings Accounts Can Save You Money on Health Care Costs

In states that have enacted HSA tax laws, enrollees in high-deductible health plans (HDHP) can set aside tax-free money in an HSA, use tax-deductible money to pay for health care costs, and earn tax-exempt income and interest in the account. In other words, if California joins the rest of the nation:

- You would pay no taxes on the money you put into an HSA.
- You would pay no taxes on the amounts you withdraw from an HSA, as long as the money is used to pay for qualified health-related expenses.
- And, unlike a regular savings account, you would pay no taxes on the interest income or other income earned in the HSA.

California authorizes the establishment of HSAs, but since California has not passed HSA tax savings laws, you currently are required to pay state income taxes on these transactions.

Why Are Health Savings Accounts Important to Reducing Health Care Costs?

Experts predict that over the next several years, more people will enroll in HDHPs as a way to cut health care costs. According to America's Health Insurance Plans Center for Policy and Research, national enrollment in HDHPs grew from 1 million in 2005 (one year after enactment of federal HSA laws) to more than 17 million as of January 2014. At the same time, the federal government projects that out-of-pocket health care expenses will accelerate between 2015 and 2020.

How These Accounts Can Benefit You

Although HDHPs do not work for everyone, industry experts indicate that in combination with HSAs, these plans allow many people to lower their monthly premiums and to use tax-free money for out-of-pocket medical expenses. Another benefit is that your employer may contribute money to your HSA.

People also like HSAs because they are flexible and can be used to pay for a wide variety of medical expenses, including doctor visits, prescription drugs, medical procedures and follow-up care, such as nursing home or in-home care. The accounts also can be used to pay for non-medical health expenses, such as contacts and eyeglasses, and dental exams and treatment. HSAs can even be used to pay for long-term care insurance.

HSAs do not have a "use-it-or-lose-it" provision. Any funds left over in the HSA at the end of the year roll over to the next year. And once you reach age 65, unused funds may be withdrawn for any use, including retirement – these funds are subject to the ordinary income tax, but not any withdrawal penalties. If you use the money for qualified health expenses, the withdrawals continue to be tax-free.

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The California Tax Foundation is a nonprofit, nonpartisan think tank established by the California Taxpayers Association in 1980. The foundation is dedicated to promoting sound tax policy and government efficiency.

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