Progressive Revenue Options to Fund Health Care Reform

Politicians and pundits have lately written or spoken of the “difficult choices” and “sacrifices” that will be necessary if the United States is to find a way to fund health care reform in a fiscally responsible way. Some have suggested new taxes on health insurance premiums. A few have even proposed a highly regressive national sales tax, or its cousin, a value-added tax. In fact, however, there are straightforward ways to raise revenue that will not be overly burdensome for taxpayers and which will not harm the economy. They involve eliminating or reducing several subsidies and preferences provided in the federal tax code to the wealthiest and most powerful among us. Combined with savings in the existing health care system, these measures could raise enough revenue to adequately fund health care reform.

Americans may not know the details of every tax break enjoyed by corporations or wealthy individuals, but they might be particularly keen to focus on them after providing Wall Street (and thus the richest people in America) the biggest taxpayer-funded bailout in history.

After propping up major corporations and their CEOs and shareholders, Congress might find it reasonable to make the following deal. Main Street is paying to make Wall Street healthy. Wall Street, when it is healthy, will return the favor.

Selected Options to Raise Over $100 Billion in 2012 to Fund Health Care Reform
(Revenue Impact in Billions of Dollars)

- Reduce Tax Incentives to Invest Offshore, $12.4
- Eliminate Other Tax Subsidies for Wall Street, $15.0
- Reduce Tax Subsidy for Capital Gains and Dividends (28% Top Rate), $34.7
- Expand the Medicare Tax for the Rich, $44.7
- Reduce tax subsidy for investments by raising top rate for capital gains and dividends in 2012 from 20 percent to 28 percent.
- Eliminate other tax subsidies for Wall Street, including the double-standard for stock options given to executives and the write-off for intangible assets.
- Reduce tax incentives to invest offshore, including repealing worldwide interest allocation and requiring corporations to defer deductions on unrepatriated foreign income.

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The following pages describe several progressive revenue options to fund health care reform and the amount of revenue they are likely to raise in 2012. This year is chosen because it is likely to be more representative of future years than 2010 or 2011, when the economy may still be in recession. Some of the estimates were produced by the Institute for Taxation and Economic Policy (ITEP) tax model, while others come from the Congressional Joint Committee on Taxation (JCT).²

The proposals described in this report would accomplish three objectives simultaneously. First, they would raise a significant amount of revenue, more than a trillion dollars over a decade. Second, they would simplify the tax code, since they involve eliminating special deductions and loopholes and moving closer to taxing various types of income received by individuals in the same way. Third, they would ensure that the federal income tax continues to be a progressive tax. Almost all of the new revenue would be paid by taxpayers with adjusted gross income (AGI) above $200,000 for singles and above $250,000 for married couples, in keeping with President Obama’s approach to tax policy.

I. Make the Medicare Tax a More Progressive Tax that Wall Street Investors Pay Just Like Everyone Else

As we consider how to fund health care reform, it’s worth thinking about the one important federal tax already in place that is dedicated to funding health care: the 2.9 percent Medicare payroll tax. Under current law, this tax applies only to earned income, such as wages. It exempts investment income entirely.

We consider several options to remedy this inequity. All of them would apply only to the half of the Medicare tax paid by workers. The 1.45 percent employer tax would not be changed.³

Option 1: Apply the individual portion of the Medicare tax to all income.
Revenue Impact in 2012: $38.1 Billion.
The first option would simply extend the employee half of the Medicare tax (the 1.45 percent tax that currently applies only to wages) to all adjusted gross income (AGI). Employers would still withhold Medicare payroll taxes from wages as they do now. But people who have unearned income would have to pay a 1.45 percent tax on that income when they file their federal income taxes. This would raise $38.1 billion in 2012.

Option 2: Introduce a higher Medicare tax rate for the rich.
Revenue Impact in 2012: $7.2 Billion.
The second option would not expand types of income subject to the Medicare tax but would instead add a second, higher tax rate for people who earn more than $200,000 for singles and

²Some of the figures borrowed from JCT should be used only as rough estimates, since JCT rightly warns that interactions between a given set of provisions, as well as many other factors, could lead to revenue impacts different from what one might assume from simply looking at JCT publications.
³ Half of the current Medicare tax is paid by employees and the other half is paid by employers (although virtually all analysts think that the employer-paid portion is passed on to employees in the form of lower wages).
Revenue Options to Fund Health Care Reform

<table>
<thead>
<tr>
<th>Option</th>
<th>Revenue Impact in 2012 ($billions)</th>
<th>Source of Revenue Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Expand individual portion of Medicare tax to cover all income (earned and unearned).</td>
<td>38.1</td>
</tr>
<tr>
<td>2.</td>
<td>Expand individual portion of Medicare tax to include an additional 1.05% tax on earned income in excess of $200k/$250k.</td>
<td>7.2</td>
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<tr>
<td>3.</td>
<td>Do both the first and second options together.</td>
<td>54.9</td>
</tr>
<tr>
<td>4.</td>
<td>Do both the first and second options together, but exclude the first $50k/$100k for those 65 and over.</td>
<td>44.7</td>
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II. Reduce or Repeal Tax Subsidies for Wall Street’s Investment Income

<table>
<thead>
<tr>
<th>Option</th>
<th>Revenue Impact in 2012 ($billions)</th>
<th>Source of Revenue Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Raise the top income tax rate for capital gains and dividends to 28% in top two income tax brackets.</td>
<td>34.7</td>
</tr>
<tr>
<td>2.</td>
<td>Tax capital gains and dividends in top two income tax brackets as ordinary income.</td>
<td>75.2</td>
</tr>
<tr>
<td>3.</td>
<td>Tax capital gains and dividends in top two income tax brackets as ordinary income BUT also reduce top two ordinary rates to 33 and 35%.</td>
<td>24.1</td>
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<tr>
<td>4.</td>
<td>Repeal the loophole that allows “carried interest” of private equity fund managers to be taxed as capital gains.</td>
<td>3.0</td>
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III. Close Other Tax Loopholes Enjoyed by Wall Street

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<tr>
<th>Option</th>
<th>Revenue Impact in 2012 ($billions)</th>
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</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Limit corporate tax deductions for stock options to the value at grant date and include stock options in the $1 million limit on compensation that is deductible.</td>
<td>10.0</td>
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<tr>
<td>2.</td>
<td>Repeal the 60-40 rule for gain or loss from section 1256 contracts.</td>
<td>2.0</td>
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<tr>
<td>3.</td>
<td>Eliminate the write-off for intangible assets (section 197 amortization).</td>
<td>5.0</td>
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IV. Prevent Corporations from Using Offshore Schemes to Avoid Taxes

<table>
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<tr>
<th>Option</th>
<th>Revenue Impact in 2012 ($billions)</th>
<th>Source of Revenue Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Eliminate worldwide interest allocation (the soon-to-take-effect rules for how corporations can deduct or not deduct the cost of borrowing when they have foreign operations).</td>
<td>2.4</td>
</tr>
<tr>
<td>2.</td>
<td>Require corporations to defer deductions related to unrepatriated foreign income.</td>
<td>10.0</td>
</tr>
</tbody>
</table>

V. Repeal Inefficient Health Care Subsidies Favoring High-Income Taxpayers

<table>
<thead>
<tr>
<th>Revenue Impact in 2012 from options included in pie chart:</th>
<th>$106.8</th>
</tr>
</thead>
<tbody>
<tr>
<td>10 year total</td>
<td>More than $1 trillion</td>
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</table>

Addendum: The President's Revenue-Raising Options

<table>
<thead>
<tr>
<th>Option</th>
<th>Revenue Impact in 2012 ($billions)</th>
<th>Source of Revenue Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limit the benefits of itemized deductions to 28 cents for every dollar deducted.</td>
<td>24.9</td>
<td>Treasury’s “Green Book”</td>
</tr>
<tr>
<td>Reduce the tax gap and close loopholes.</td>
<td>5.3</td>
<td>Treasury’s “Green Book”</td>
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</tbody>
</table>
$250,000 for married couples. The employer half of the Medicare tax would continue to be a flat rate of 1.45 percent. The employee half, however, would be 1.45 percent of the first $200,000 in earnings (or $250,000 for married couples) and then 2.5 percent of earnings above that amount. This would raise $7.2 billion in 2012.

**Option 3: Combine Options 1 and 2.**
**Revenue Impact in 2012: $54.9 Billion.**

Our third option would combine the first and second options, so that the employee portion of the Medicare tax would both cover all adjusted gross income and have two rates, 1.45 percent for AGI up to $200,000/$250,000 and 2.5 percent for AGI beyond that. This would raise $54.9 billion in 2012, which is greater than the sum of the revenue estimates for Options 1 and 2 because of interaction between the broader base for the tax and the higher rate for high-income people.

One potential objection to this option is that people age 65 and older are more likely to have unearned income that would be newly subject to the Medicare tax. This objection should not be overstated for several reasons. First, the Medicare tax would only be 1.45 percent for most retirees. Second, most Social Security benefits are already excluded from AGI, and Option 3 would maintain that exclusion, meaning most Social Security benefits would not become subject to the expanded Medicare tax.

Nonetheless, objections will be raised to a new tax that affects the elderly. Option 4 below would address this.

**Option 4: Combine Options 1 and 2, but exclude the first $50K/$100K for the aged.**
**Revenue Impact in 2012: $44.7 Billion.**

Option 4 is the same as the previous options except that for people age 65 and older, the first $50,000 of AGI for singles, or the first $100,000 of AGI for married couples, would be excluded from the increase in the Medicare tax. In other words, the employee portion of the Medicare tax would apply to all AGI and would have two rates, 1.45 percent and 2.5 percent, but the first $50,000 or $100,000 of AGI for those age 65 or older would be excluded (to the extent that it is not earnings that are already subject to the Medicare tax under current law). This would raise $44.7 billion in 2012.

**II. Reduce or Repeal Income Tax Subsidies for Wall Street's Income & Products**

The current Medicare tax is not the only tax that favors investment income over income from work. Under the present income tax, people who live off of their investments (people whose income takes the form of capital gains and corporate stock dividends) are allowed to pay federal income taxes at lower rates than people whose income comes from work. This means a subsidy is provided, through the federal tax code, both to investors and to the Wall Street brokers who handle their investments. In addition to being unfair, this tax subsidy has failed to provide any economic benefit to the nation as a whole.
There was a time when the income tax treated investment income like other income. In particular, that was the achievement of the Tax Reform Act of 1986, signed by President Ronald Reagan. But in the years that followed, the top income tax rate for capital gains was lowered far below the top income tax rate on other types of income. By the time George W. Bush took office, capital gains income was subject to a special top rate of 20 percent, which was about half the top rate for “ordinary” income.

In 2003, President Bush expanded this tax subsidy by reducing the special top tax rate for capital gains to 15 percent, less than half of the top rate of 35 percent for “ordinary income” that was in effect by then. The 2003 law also created a new tax break for corporate stock dividends by limiting the dividend tax to the same top rate of 15 percent as capital gains.

Consider the result today. A wealthy person typically receives dividends on various stocks he owns. He might also buy and sell stocks, and when he sells a stock for more than he paid for it, he gets to treat that profit as a capital gain. Or with the help of clever tax advisors, he might even be able to treat a large portion of his earned income as capital gains. These two forms of income — dividends and capital gains — are subject to a top federal income tax rate of only 15 percent.

Now consider a single person who works for a wage and earns just $50,000 a year. This person’s wages are taxed at progressive rates, and a portion of them is actually taxed at 25 percent. In other words, the wage-earner faces a “marginal” rate of 25 percent, meaning each additional dollar earned is taxed at that rate.

Someone who has very high wage income currently pays a marginal income tax rate of 35 percent, which is more than double the 15 percent preferential tax rate for capital gains and dividends.

Proponents of the preferential rates for investment income enacted under President Bush argue that they encourage investment in businesses, which leads to more jobs and a better life for everyone. But given the evidence of how the economy has performed in the years since these tax cuts have been in effect, this view seems delusional.

We consider several options to reduce or eliminate the income tax preference for capital gains and dividends for high-income taxpayers. None of these options will affect taxpayers with adjusted gross income (AGI) under $200,000, or under $250,000 for married couples. This makes little difference because people below the $200,000/$250,000 threshold have only a tiny share of the total income subject to the preferential 15 percent rate.

We compare each option to the tax laws that will be in effect in 2012 if President Obama’s tax proposals are enacted, which means the top two income tax rates for “ordinary” income would revert to 36 and 39.6 percent and capital gains and dividends would be subject to a preferential rate of 20 percent.4

4 President Obama’s proposals relating to income in the top two income tax brackets mostly consist of making no change to current law. Under current law, the Bush tax cuts expire at the end of 2010. The President proposes to extend the Bush tax cuts for income in all but the top two brackets, meaning “ordinary” income in the top two
Option 1: Raise preferential rate for capital gains and dividends to 28 percent.
Revenue Impact in 2012: $34.7 Billion.
The first option would raise the top income tax rate for capital gains and dividends to 28 percent. This means capital gains and dividends would still be subject to a preferential rate, but the tax subsidy would be reduced. This would raise about $34.7 billion in 2012.5

Option 2: Tax capital gains and dividends like any other income.
Revenue Impact in 2012: $75.2 Billion.
The second option would simply tax capital gains and dividend income just like any other income. This means that in 2012, capital gains and dividends would be subject to the same income tax rates as other income, with the top rates reaching 36 percent and 39.6 percent. This would raise $75.2 billion in 2012.

Option 3: Tax capital gains and dividends like any other income; keep Bush top tax rate reductions.
Revenue Impact in 2012: $24.1 Billion.
The third option is a compromise. The wealthy are allowed to keep the reduced income tax rates enacted under Bush, meaning the top two income tax rates would remain 33 and 35 percent, instead of reverting to 36 and 39.6 percent as Obama has proposed. But, capital gains and dividends would be taxed as all other income, meaning capital gains and dividends would also be taxed at a top rate of 35 percent. This would raise $24.1 billion in 2012.

Option 4: Repeal the loophole that allows “carried interest” to be taxed as capital gains.
Revenue Impact in 2012: $3.0 Billion.
The third option would not change the preferential rates that apply to capital gains and dividends but would simply eliminate one of the many loopholes that wealthy people use to convert “ordinary” income into capital gains to benefit from the lower rate.

Private equity fund managers receive a portion of their compensation in the form of “carried interest,” which is a portion of the capital gains on the funds under their management. Because this income is clearly compensation for work (compensation for managing other people’s money) it’s pretty obvious that it is “ordinary” income rather than capital gains. Unfortunately, these fund managers, who have been known to earn hundreds of millions a year, pay taxes at only the 15 percent capital gains rate on their carried interest. This option, which President Obama has proposed, would raise $3 billion in 2012.6 (Of course, if the preferential rate for capital gains was eliminated, this loophole would disappear.)

 brackets would be taxed at 36 and 39.6 percent while capital gains would be taxed at 20 percent. The President would, however, partly extend the Bush tax cut for dividends by setting a top rate of 20 percent for dividends rather than allowing them to be taxed as “ordinary” income, as they would be under current law after 2010.  
5 It is possible that JCT’s revenue estimates for tax options related to capital gains would diverge from ours because we do not assume behavioral responses to these changes. For example, JCT may assume that ending the tax subsidy for capital gains may result in reduced capital gains realizations which might mitigate (somewhat) any resulting revenue increase. On the other hand, ending the tax subsidy for capital gains would eliminate a vast number of tax shelters, and JCT may assume that this will amplify the resulting revenue increase. 
http://www.jct.gov/publications.html?func=download&id=3519&chk=0c4f4e4bda6a3dab938e820651082a1d&n o_html=1
III. Eliminate Other Tax Subsidies Enjoyed by Wall Street

Tax subsidies directed toward business may seem to benefit investors, but they provide little economic benefit to the nation as a whole. In fact, it's likely that such subsidies actually make the economy less vigorous because they result in investments that are made in order to save taxes rather than to meet the demand for a good or service as efficiently as possible.

We consider options to eliminate just a few of the many tax subsidies currently enjoyed by Wall Street.

**Option 1: End the double standard for stock options paid to corporate executives.**

**Revenue Impact in 2012: Around $10 Billion.**

Corporations get to deduct compensation paid to employees just as they deduct other expenses, but there is a $1 million limit on corporate tax deductions for compensation paid to any single employee. There is an exception for pay based on “performance,” and corporations...
often provide compensation to their executives in the form of stock options in order to use this exception to the general rule.

Stock options are, quite literally, options to buy stock — at a set price. If in 2009 a company grants an executive an option to buy stock for $20 a share, that grant is essentially worth nothing on the day of the grant if the stock is selling for exactly $20 a share at that time. But, the executive might wait a few years, until the stock is selling at, say, $40 a share. The executive could exercise the stock options at that time and receive income of $20 for each share purchased with the options.

The federal tax code actually makes stock options attractive for corporations in another way (besides excluding them from the $1 million limit on corporate deductions for employee compensation). Corporations take tax deductions for the value of options when exercised (which is usually high). But in reporting their profits to stockholders, companies treat as an expense only the estimated value of the options when granted, which has been much lower than the amount taken as tax deductions.

Option 1 in this category is a variation on a proposal introduced in the previous Congress by Senator Carl Levin (D-Mich.). 7 This proposal would (a) limit corporate tax deductions for stock options to the estimated value at grant date and (b) include stock options in the $1 million limit on compensation that is deductible. This could raise as much as $10 billion in 2012, based on Senator Levin’s statements that it could raise “$5 to $10 billion annually.”

Option 2: Repeal the “60-40 rule” for gains and losses on certain transactions.

Revenue Impact in 2012: $2 Billion.

If Congress leaves in place the preferential 15 percent income tax rate for capital gains and dividends, it may want to focus on certain loopholes and tax avoidance methods that high-income people use to claim that their income is subject to the 15 percent rate.

Under current law, the preferential 15 percent rate is available for capital gains only if they are “long-term” gains, meaning gains a taxpayer enjoys after holding an asset for more than a year before selling it. If a taxpayer holds an asset for a year or less and sells it at a profit, that profit is a “short-term” gain which is taxed as ordinary income (meaning the preferential rate does not apply).

Some speculators engage in certain types of transaction on such a frequent and rapid basis that it is nearly impossible to distinguish short-term gains from long-term gains. Naturally, they would like to report as many of these gains as long-term as they can possibly get away with, in order to enjoy the preferential capital gains rate.

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7 S. 2116.
The “60-40” rule allows taxpayers to treat their gains on futures contracts, foreign currency contracts and certain other transactions as 60 percent long-term and 40 percent short-term. In reality, almost all of these sales are probably short-term.

Repealing the “60-40” rule would raise $2 billion in 2012.9 (Of course, this option would not raise additional revenue if the tax preference for capital gains and dividends was eliminated.)

The Obama administration proposes to repeal the 60-40 rules, but only for dealers, not investors in these types of transactions. The administration’s version of this proposal therefore raises much less revenue (only $0.2 billion in 2012). It’s obvious that the dealers are not the intended beneficiaries of the tax preference for capital gains (since they are not even investing their own money). But even investors in these transactions are receiving a benefit that is inconsistent with the overall policy of subsidizing long-term capital gains since almost all of these sales are probably short-term.

Option 3: Repeal a tax subsidy for mergers and acquisitions (the write-off for intangibles)

Revenue Impact in 2012: $5 billion.

When companies purchase physical assets such as machinery, they can deduct the cost of such assets over time as the assets wear out, which makes sense. In the early 1990s, however, corporations successfully lobbied to get similar write-offs for certain purchases of “intangible” assets, such as patents, copyrights, trademarks and even “goodwill.” (This is called “section 197 amortization” by tax professionals.)

These intangible assets typically don’t lose value over time and often go up rather than down in value. Yet current law allows companies to write off their cost over 15 years (i.e., at about 6.7 percent a year).

This has led many analysts to conclude that the write-off for intangibles is really a tax subsidy for mergers and acquisitions. House Ways and Means Chairman Charlie Rangel’s 2007 tax reform bill would have limited this tax subsidy (by extending the write-off period from 15 years to 20 years, a 5 percent annual write-off.)

The option we consider here would repeal the tax subsidy altogether. The rule that existed previously would once again apply, meaning that companies could write off intangible assets only if they could substantiate that the asset was actually declining in value. For example, the useful life of a patent generally can be determined because at some point the patent will expire. Goodwill, on the other hand, generally does not get used up over time and therefore could not be amortized if this tax subsidy were repealed.

The Joint Committee on Taxation (JCT) estimated that Rangel’s proposal to limit write-offs for intangibles would raise over $20 billion over ten years.10 Eliminating the tax break entirely

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http://www.jct.gov/publications.html?func=download&id=1192&chk=8cb3d1980bc182925652f6a567485aab&n0_html=1
would raise at least twice that amount. We therefore estimate that this option could raise $5 billion in 2012.

**IV. Prevent Corporations from Using Offshore Schemes to Avoid Taxes**

Perhaps the least defensible of all tax subsidies are those that encourage corporations to shift income offshore. This can involve setting up actual factories offshore, in part to avoid taxes. Or, more commonly, it involves taking profits actually earned in the United States and moving them, on paper, to offshore tax havens, through complicated tax avoidance techniques.

**Option 1: Repeal worldwide interest allocation.**

**Revenue Impact in 2012: Around $2.4 Billion.**

The “worldwide interest allocation” rules, which were enacted in 2004 but have not yet taken effect, would make it easier for multinational corporations to take U.S. tax deductions for interest payments that are really expenses of earning foreign profits and therefore should not be deductible against U.S. profits.

The housing bill enacted in the summer of 2008 delayed implementation of this tax break for two years, until 2011. Based on the revenue projections that the Joint Committee on Taxation (JCT) made for that provision in 2008, we estimate that eliminating the worldwide interest allocation rules could raise around $2.4 billion in 2012.\(^\text{11}\) Repeal of worldwide interest allocation was also included in Congressman Rangel’s 2007 tax reform bill.

**Option 2: Require corporations to defer deductions on unrepatriated foreign income.**

**Revenue Impact in 2012: Around $10 Billion.**

Corporations are allowed to defer paying taxes on the profits of their offshore subsidiaries until those profits are brought home (repatriated). But many of the expenses a corporation incurs to earn offshore profits are deductible against their U.S. taxable income right away. Allowing immediate deductions of these expenses is really a tax subsidy for moving operations offshore or shifting profits offshore.

Option 2 would remove this perverse subsidy. This reform, which was included in Congressman Rangel’s 2007 tax reform bill, would ensure that if corporations defer taxes on profits earned abroad, then they must also defer the deductions taken against that income.

The Obama administration has recently proposed to do the same, except that it would exempt expenses related to research and experimentation. This exception is unnecessary and would likely benefit the tech and pharmaceutical industries that exploit the current rules. Also, the Obama administration plans to use the revenue saved to make permanent the “research and


experimentation” credit, which is a credit that has been abused by companies not doing much real research. We would propose to use any revenue from this sort of reform for health care.

Based on JCT’s revenue estimate for this provision of the Rangel bill, we estimate that Option 2 can raise $10 billion in 2012.12

V. Repeal Inefficient Health Care Subsidies Favoring High-Income Taxpayers

Option: Repeal Health Savings Accounts (HSAs) Prospectively.

Revenue Impact in 2012: Around $1.1 Billion.

As they begin to search for revenue to fund health care reform, many lawmakers say they want to start by finding savings within the current patch-work of policies intended to subsidize or expand access to health care. This part of their search may involve changing direct spending programs, but it could also include the existing tax subsidies for health care. For example, the tax subsidy for Health Savings Accounts (HSAs) is one that favors the wealthy and may actually make the health care system less efficient overall.

Introduced as part of the Medicare prescription drug law in 2003, HSAs are accounts to which individuals can make tax-deductible contributions and which are connected to a high-deductible health insurance plan. They offer the most benefits to those who are in the highest tax bracket and need no or little medical care.

One fear health care advocates have about HSAs is that they will, over time, encourage healthier and wealthier people to leave the traditional health insurance market, which will make health insurance even less affordable for those at-risk workers and families who really need it.

Tax fairness advocates fear that HSAs are just a way for better-off people to shelter income from taxes. The deduction is worth the most to well-off families who will likely have health insurance with or without a tax incentive. Last year, the Government Accountability Office found that HSAs are typically used by people with incomes far higher than average.13

This option, which was suggested by the Congressional Budget Office last year, would bar any new contributions to HSAs but would not eliminate the tax advantages for savings currently in HSAs. This option would raise $1.1 billion in 2012.14