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New Research from EBRI:

Study Says Changing Tax Preferences for Health Benefits Involves Trade-Offs Requiring Thorough Understanding

WASHINGTON—Proposals to overhaul the tax treatment of health benefits involve trade-offs and potential unintended consequences that need to be thoroughly examined, according to a study released today by the nonpartisan Employee Benefit Research Institute (EBRI).

Various proposals have been made to change the tax treatment of health coverage, which currently is tax free to both employers and workers. Proponents of ending or changing this treatment argue, among other things, that current tax rules are unfair and contribute to unnecessary spending for health care. But the study notes the proposals also could affect the number of employers offering health benefits and the comprehensiveness of the benefits being offered.

The new study, published in the June 2006 *EBRI Issue Brief,* examines changes that policymakers are discussing, explores the history of tax laws concerning the tax treatment of health benefits and the cost to the federal government in forgone taxes because of these laws, and examines some of the advantages and disadvantages that could result from the proposed changes. The full study is available at www.ebri.org.

"Since health insurance coverage produces a number of positive external societal benefits, withdrawing the current tax incentive implicitly would suggest that individuals would obtain less-than-optimal medical care," says the study, written by Paul Fronstin, director of the EBRI health research and education program. "Currently, that incentive is provided through an employment-based system that has systemic efficiencies that an individual-based system would not be able to equal."

The study adds: "Any honest debate of overhauling the federal tax treatment of health coverage in the United States needs to address not just what a new system might do, but what the trade-offs and unintended consequences might be, and who would likely be the most affected by the change."

The most significant proposals for changing the tax status of health benefits, the study says, would:

- Limit the tax exclusion for health benefits to $5,000 for individual coverage and $11,500 for family coverage obtained through an employer or purchased directly from an insurer. This proposal was included among the recommendations of a 2005 presidential advisory panel.
- Expand health savings accounts (HSAs) and high deductible health plans (HDHPs). Under this plan, which President Bush advocates, individuals would be able to deduct the full premium for a HDHP used in conjunction with an HSA, even if purchased directly from an insurer.

- Allow full tax deductibility of health care expenses from income. Under this proposal, individuals would be able to deduct all out-of-pocket health care expenses as a way to encourage more people to adopt less comprehensive coverage with more cost sharing.

The study notes that historians often suggest that the tax-preferred status of employment-based health benefits led to the rise in its prevalence and comprehensiveness. The tax treatment of health benefits was fortified in the tax code through a series of laws and rulings that date to the 1920s, but it was not until 1954 that Congress made it clear that employer spending on employee health benefits was not to be counted as employee income, the study says.

Health benefits now account for one of the largest tax expenditures in the U.S. budget. Estimates for personal federal forgone tax revenue in 2006 related to the exclusion from individual income of employer contributions to health benefits range from $91 billion (Joint Committee on Taxation) to $133 billion (Office of Management and Budget), the study reports.

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