

# The Tax Treatment of Health Insurance and Out-of-Pocket Expenses

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## Current Tax Treatment For Employers

- *Deductible as Business Expense*
  - Employer contributions to employees' health insurance are treated like compensation and deductible as a business expense
- *No FICA Tax*
  - The employer does not pay the employer's share of FICA tax on amounts contributed to workers' health insurance
  - Should mean employers are indifferent between wages and benefits, but employers pay payroll tax on wages, not on benefits
- 2018
  - Excise tax on high-cost health plans

## Current Tax Treatment For Workers (Including Self-Employed)

- **No Income and FICA Tax**
  - Employer contributions to workers' health insurance are *excluded* from income for income *and* FICA tax purposes
    - Workers do not pay income and FICA taxes on employer contributions
  - Worker contributions for health insurance through a salary reduction arrangement reduces the worker's taxable income for income *and* FICA tax purposes
    - Worker payments to FSAs to pay out-of-pocket expenses *reduce* taxable income

## Health Savings Accounts (HSAs)

### Tax preferred contributions, build up and distributions

- Contributions to HSA (regardless of source) reduce taxable income
  - Limited to \$3,100 individual, \$6,250 family
- Must have qualified HDHP
  - Deductible: \$1,200 individual, \$2,400 family
  - OOP Max: \$6,050 individual, \$12,100 family
- “Catch-up” contributions allowed for individuals 55+
- HSA balances rollover
- Interest or earnings on HSA accumulate tax free
- Distributions for qualified medical expenses are tax free
- Contributions not subject to 7.5% AGI test

## Current Tax Treatment For Individuals

- Individuals who purchase health insurance on own:
  - Premiums and OOP expenses are tax deductible only if they exceed 7.5% of AGI
  - Only portion above 7.5% of AGI is tax deductible
  - Taxpayer must itemize to get deduction
  - Only 6% of all tax returns tax such a deduction
- HSA contributions not subject to AGI rule
- 2014: premium and cost sharing subsidies if < 400% FPL

## Changing Tax Treatment of Employment-Based Health Benefits: Bipartisan Policy Goal

Sen. Baucus (D-MT) (Nov. 2008)

- No details other than mentioning limit or cap on tax exclusion base on “value of health benefits” and/or on a person’s income.
- Exclusion can be based on a sliding scale of income
- Led to PPACA excise tax on high cost health plans.

President’s Advisory Panel on Federal Tax Reform (Nov. 2005)

- Exclusion limited to \$5,000 individual, \$11,500 family

Republican Study Committee (2012)

- FEHBP pays first \$5,000/\$11,000 for single federal workers/families
- Opposed to current 70-75%

## Other Recent Examples

### National Commission on Fiscal Responsibility and Reform

Aka Bowles-Simpson (Dec. 2010)

- 2014: cap exclusion at 75<sup>th</sup> percentile of premiums
- 2014-2018: freeze cap in nominal terms through 2018
- 2019-2038: phase out exclusion
- Reduce excise tax on high cost plans to 12% (year unspecified)

### Heritage Foundation

- Replace current tax treatment of health coverage with a uniform, nonrefundable tax credit that individuals and families could use to purchase health coverage either through the work place or directly from an insurer

## Proposals to Change Tax Treatment of Health Coverage Not New

- 1980s, President Reagan
- 1991, Sen. Lloyd Bentsen (D-TX)
- 1999, House Majority Leader Dick Armey (R-TX) & ranking Ways and Means Democrat Pete Stark (D-CA)
- 1999, Stuart Butler Heritage Foundation & David Kendall of the (Democratic) Progressive Policy Institute
- 2000, Reps. Jim McCrery (R-LA) and Jim McDermott (D-WA)
- 2007, President Bush – standard deduction \$7,500/\$15,000

## Theory on Changing Current Tax Treatment

- Premiums excluded from taxable income
- OOP not excluded from taxable income
  - except through FSA or HSA
- Workers prefer health benefits with low cost sharing
- Low cost sharing leads to overuse of health care services, which drives up premiums and makes insurance less affordable (especially among low income)
- Taxing (or limiting exclusion) will lead to less comprehensive benefits, higher cost sharing, lower use of health care services, less spending on health care, lower costs

## Top Three Income Tax Expenditures Ranked By Total Fiscal Year 2012–2016 Projected Revenue Effect (\$billions)

|   | 2012  | 2012-2016 | 2012-2016<br>Distribution |
|---|-------|-----------|---------------------------|
| Total   | 1,100 | 6,466     | 100%                      |
| Exclusion of employer contributions for medical insurance premiums and medical care | 184   | 1,071     | 17%                       |
| Deductibility of mortgage interest or owner occupied homes                          | 99    | 609       | 9%                        |
| 401(k) plans  | 68    | 356       | 6%                        |