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 75th 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)

<table>
<thead>
<tr>
<th>Expenditure Description</th>
<th>2012</th>
<th>2012-2016</th>
<th>2012-2016 Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>1,100</td>
<td>6,466</td>
<td>100%</td>
</tr>
<tr>
<td>Exclusion of employer contributions for medical insurance premiums and medical care</td>
<td>184</td>
<td>1,071</td>
<td>17%</td>
</tr>
<tr>
<td>Deductibility of mortgage interest or owner occupied homes</td>
<td>99</td>
<td>609</td>
<td>9%</td>
</tr>
<tr>
<td>401(k) plans</td>
<td>68</td>
<td>356</td>
<td>6%</td>
</tr>
</tbody>
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