CENTER ON BUDGET AND POLICY PRIORITIES

820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org www.cbpp.org

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SUBSTANTIAL FLAWS IN TRADE HEALTH INSURANCE TAX CREDIT NEED TO BE ADDRESSED BEFORE CONSIDERATION OF AN EXPANSION

by Edwin Park

In 2002, as part of trade legislation, Congress established a refundable tax credit for the purchase of certain types of health insurance coverage by workers who have lost their jobs due to trade and who qualify for Trade Adjustment Assistance (TAA). Individuals who receive assistance through the Pension Benefit Guaranty Corporation also are eligible for this health insurance tax credit.

Under the TAA health insurance tax credit, also known as the Health Coverage Tax Credit (HCTC), eligible individuals can use the credit primarily to purchase health insurance through their former employer. (This is known as “COBRA coverage.”) They also may use the tax credit to purchase various forms of state-sponsored health insurance if their state has elected to offer such coverage.

Some federal policymakers are now considering expanding eligibility for this health insurance tax credit to more of the uninsured. Senator Charles Grassley (R-IA) and Senator Max Baucus (D-MT), the chairman and ranking member of the Senate Finance Committee, respectively, introduced legislation last year (S. 1693) to expand eligibility for the tax credit to individuals currently receiving unemployment insurance benefits. In addition, the Administration has touted the tax credit as a model approach to providing health insurance to the uninsured and believes the HCTC can pave the way for enactment of its broader tax credit proposal for the purchase of health insurance in the individual health insurance market.[1]

Early reports concerning the performance of the HCTC, however, have been disappointing. Enrollment in the tax credit is very low. Only a tiny percentage of the individuals eligible for the HCTC are using it. Treasury Department data indicate that *three percent* of the more than 230,000 individuals eligible for the tax credit were using it by the end of November 2003.

This minimal enrollment appears to be the result of major flaws in the design and implementation of the credit.

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[1] For analysis of the Administration's proposal to provide a refundable tax credit for the purchase of health insurance in the individual market, see Edwin Park, "Administration's Proposed Tax Credit for the Purchase of Health Insurance Could Weaken Employer-Based Health Insurance," Center on Budget and Policy Priorities, February 18, 2004.

- The credit covers 65 percent of health insurance premium costs. The target population, however, consists largely of individuals who have been displaced from their jobs (as well as early retirees who are receiving reduced pensions). Low- and moderate-income individuals who have recently lost their jobs generally have insufficient income or resources to pay the remaining 35 percent of premium costs.

- For many individuals who lack access to COBRA coverage, no other health insurance options are available for which they can use the tax credit. The legislation establishing the tax credit provides that states may sponsor other health insurance coverage options for eligible individuals, but there is no requirement that states do so, and many do not.

- Of the states that do sponsor coverage options for individuals eligible for the tax credit, most provide options only for the purchase of insurance in the individual market or through "high-risk" pools. Insurance companies that sell insurance in the individual market, however, typically vary premiums based on age and/or health status. Policies offered through the individual market also tend to exclude older and sicker individuals entirely or exclude coverage for preexisting conditions for a period of time. Individuals who are able to secure coverage in the individual market often obtain coverage that provides limited benefits and requires very substantial cost-sharing.

  The legislation establishing the HCTC requires that the health insurance options that states make available to tax-credit users provide coverage to all eligible individuals who apply for insurance and also cover preexisting medical conditions, but the Treasury Department has interpreted these requirements in a narrow fashion that effectively denies these protections to many eligible individuals. In addition, high-risk pools often require substantial premiums and vary premiums based on age, do not cover pre-existing medical conditions for at least six months, impose significant deductibles, and provide limited coverage of benefits like mental health and prescription drugs.

- The HCTC is supposed to be available to eligible individuals at the time they pay their monthly health insurance premiums, to ensure that individuals do not have to pay the full premiums themselves and wait to be reimbursed until they file their tax returns the following winter or spring. The feature of the tax credit under which the credit is to be made available to individuals at the time they pay their monthly premiums is known as "advance payment." Unfortunately, the Internal Revenue Service has created substantial barriers to effective use of the advance payment mechanism. The IRS is requiring that individuals pay at least one month's premium themselves before receiving any advance payment. Many eligible individuals are unlikely to have the income or resources to pay one month's premium on their own since they have lost their jobs and are now unemployed.

Considering the paltry use of the tax credit to date, which appears to stem from the credit's design and implementation problems, policymakers should defer consideration of expanding the credit beyond the existing TAA and PBGC population until these problems are addressed. Deferring an expansion also would enable policymakers to ascertain whether the tax credit can succeed in providing affordable, comprehensive health insurance to its target populations on a significant scale. The early experience with the HCTC suggests that an individual tax credit of this nature may not be effective in expanding coverage to substantial numbers of the uninsured.

Description of the HCTC

In 2002, Congress established a new refundable tax credit for the purchase of health insurance. This credit can be used to cover 65 percent of premium costs and is available to individuals who have lost their jobs due to trade and are eligible for Trade Adjustment Assistance. The credit also is available to individuals who receive pension assistance through the Pension Benefit Guaranty Corporation.

An eligible individual may use the HCTC to purchase certain types of qualified health insurance for himself or herself and for his or her family. Such an individual can use the tax credit to buy COBRA coverage through a former employer or to purchase coverage through his or her spouse's employer, if that employer subsidizes less than 50 percent of the premium.[2] In addition, tax-credit recipients who were enrolled for at least 30 days prior to losing their jobs in a health insurance plan purchased in the individual insurance market may use the tax credit to subsidize the purchase of insurance in that market.

In addition, states may (but are not required to) offer other health insurance coverage options for individuals eligible for the tax credit. In so doing, states can enter into new arrangements with private insurers for group health insurance coverage for tax-credit recipients, can allow recipients to "buy in" to the health insurance plan for state employees or a similar such plan, and can allow recipients to purchase insurance through state "high risk" pools.[3]

Certain consumer protections are supposed to apply to coverage offered under these state options. The legislation establishing the tax credit requires that any eligible individual who applies for a state-sponsored coverage option must be offered insurance through that option, irrespective of the individual's health status. In addition, state-sponsored health insurance

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[2] Under COBRA, individuals can continue to obtain health insurance offered by their former employer for 18 months if they are willing to pay up to 102 percent of the full unsubsidized premium cost of such insurance. COBRA applies only to employers with 20 or more workers. It does not apply if the former employer ceases operation or if the employer no longer offers health insurance coverage to its current workers.

[3] Other state-sponsored options include so-called "mini COBRA" coverage (under which some states have extended COBRA benefits to workers formerly employed by a firm that has fewer than 20 employees), health insurance purchased through a private purchasing pool, and health insurance provided through a state-operated health plan that receives no federal funding.

options are supposed to cover preexisting conditions and not to treat tax-credit recipients differently from other people who already receive coverage through these options.

Finally, the HCTC can be issued in "advance," so that eligible individuals do not have to wait to secure the benefits of the credit until they file a tax return after the year is over. The federal government reduces the premium cost for health insurance by the amount of the individual's tax credit and collects the remaining monthly premium cost from the individual. It then reimburses the insurance company directly for the cost of the health insurance coverage.

Minimal Enrollment in HCTC Due to Flaws in Credit's Design and Implementation

The HCTC has received significant attention in recent months, as it has been promoted by some Members of Congress and Administration officials as an effective model for expanding coverage to the uninsured. Early reports indicate, however, that the credit has had little success to date. The *New York Times* recently reported that "a program offering tax credits to jobless workers to buy health insurance has gotten off to a slow, sputtering start, despite energetic efforts by Bush Administration officials who want the program to succeed as a model for a much more ambitious effort to help the uninsured."[4]

Enrollment so far is minimal. According to Treasury Department data, at the end of November 2003, about 7,100 individuals were participating in the HCTC out of an estimated eligible population of 232,000.[5] This constitutes a participation rate of about three percent. Even if each of the health insurance plans purchased is assumed to also cover two dependents, total enrollment — including family members — would be only about 21,000.

This extremely low enrollment was reflected as early as last summer in revised budget estimates that the Office of Management and Budget issued of the cost of the tax credit. In the "mid-session" budget review that OMB issued in July 2003, OMB substantially reduced its estimate of the costs of the HCTC.[6] In its most recent estimate, included in the Administration's fiscal year 2005 budget, OMB projects the costs of the HCTC at $920 million over the next five years (2005-2009).[7] This is only a little more than one-third of the cost that the Joint Committee on Taxation projected for the same five-year period at the time that the tax credit was enacted.[8]

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[4] Robert Pear, "Sluggish Start for Offer of Tax Credit for Insurance," *New York Times*, January 25, 2004.

[5] The 7,100 figure represents the number of individuals participating in the tax credit on an advance payment basis. It does not include individuals who may have participated in 2003 but will not receive the tax credit until they file their tax returns in early 2004. The tax-credit-eligible population, estimated by the Treasury Department, includes both TAA recipients and PBGC recipients.

[6] Office of Management and Budget, *Fiscal Year 2004: Midsession Review*, p.18. OMB reduced the estimated cost of the tax credit by $1 billion over five years.

[7] Office of Management and Budget, *Analytical Perspectives: Fiscal Year 2005*, p.288-289. This estimate includes both revenues and outlays.

[8] Congressional Budget Office, "H.R. 3009: Trade Act of 2002," August 21, 2002.

The HCTC has enjoyed little success to date, apparently because of its flaws. These flaws reflect shortcomings both in how Congress designed the credit and in how the Treasury Department and the Internal Revenue Service have interpreted the authorizing legislation and implemented the credit.

- **Eligible individuals are finding it difficult to afford COBRA coverage with a tax credit that covers 65 percent of premium costs.** According to the Kaiser Family Foundation, the average annual cost of employer-based family coverage is $9,068. With a 65 percent tax credit, unemployed individuals eligible for the credit would still have to pay an average of $3,174 themselves (35 percent of the health insurance premium cost) to secure COBRA coverage through their former employer. That is likely to be beyond the means of many low- or moderate-income workers who have recently lost their jobs due to trade. State officials have expressed concerns that the 35-percent premium cost is unaffordable for many workers.[9]

- **States are not required to offer state-sponsored health insurance options to individuals who lack access to COBRA coverage.** Many unemployed workers are ineligible for COBRA coverage because they worked for small firms that are not subject to COBRA or their former firm has ceased operation. According to the Commonwealth Fund, 35 percent of all workers would be ineligible for COBRA if they lose or leave their jobs, and 60 percent of workers with incomes below 200 percent of the poverty line would be ineligible.[10] Many individuals who are eligible for the HCTC consequently need another comprehensive health insurance option.

  There is no statutory requirement under the HCTC, however, that states provide a state-sponsored option for individuals who are eligible for the tax credit but lack access to COBRA coverage. According to the Treasury Department, as of December 2003, some 29 states were offering a state-sponsored health insurance option for eligible individuals.[11] Workers who lack access to COBRA and live in a state that does not offer a state-sponsored health insurance option have no place to go to use their tax credit to purchase comprehensive group insurance.

- **The Treasury Department has allowed states to provide health insurance through the individual market to individuals who are eligible for the tax credit.** To limit the use of the tax credit in the individual market, the authorizing legislation requires that the tax credit may be used to purchase coverage in the individual health insurance market only if the eligible individual already was enrolled in an individual-market plan for at least one month prior to losing

[9] Pear, *op. cit*.

[10] Michelle M. Doty and Cathy Schoen, "Maintaining Health Insurance During a Recession: Likely COBRA Eligibility," The Commonwealth Fund, December 2001.

[11] U.S. Department of Treasury, "Health Coverage Tax Credit: Public-Private Partnerships," January 2004.

employment. This limitation was designed to protect workers — especially older and less healthy workers — from the vagaries of the individual market and to increase the likelihood that states would sponsor group insurance options for these workers. The Treasury Department (which is the lead federal agency for overseeing the state-sponsored options, with the Internal Revenue Service in charge of the tax credit itself) has construed the statutory language of the legislation, however, to permit states to sponsor options that make coverage available in the individual market to *any* individual eligible for the HCTC.[12]

Individual-market options are problematic for eligible individuals who are older or sicker. The individual market is largely unregulated and permits medical underwriting; in other words, insurers can vary premiums based on age and medical history, and in some cases, can deny coverage altogether. Moreover, coverage offered in the individual market tends to impose higher deductibles and cost-sharing and to cover fewer benefits than employer-based group coverage typically does. Many plans in the individual market do not cover preventive services, mental health coverage, or maternity care, and/or place dollar caps on the amount of coverage they provide for certain benefits.

- **The Treasury Department has encouraged states to use the individual market (as well as high-risk pools) over options that could provide more affordable, comprehensive group health insurance.** In providing guidance to states in electing coverage options, the Treasury Department has favored the use of the individual market and high-risk pools.[13] Treasury guidance documents declare that the state-sponsored option could be "met most easily by selecting as the state option... a high risk pool or individual coverage." As noted, coverage through the unregulated individual market often provides little assistance to older and sicker individuals.

  High-risk-pools also have limitations; they generally provide more limited coverage, similar to the type of coverage common in the individual market. In addition, high-risk pools frequently charge high premiums, vary premiums based on age, impose high deductibles and co-payments, and often exclude coverage for preexisting conditions for at least six months and up to a year.

[12] In explaining the legislative intent of the conference agreement on the tax-credit legislation, Senator Max Baucus stated that "we did not intend to allow states to enter into arrangements with individual insurers through the state-based coverage options." *Congressional Record*, November 12, 2002. While the intent of some TAA negotiators like Senator Baucus was for states to offer only group health insurance options, the Treasury Department has determined that states can provide individual market coverage as a state-sponsored option, and indeed, may make such coverage the *only* option that the state makes available.

[13] Department of Treasury, "HCTC: State Agencies – Qualify Health Plans," 2003. State high risk pools and the individual market are the options most often chosen by states. Families USA, "The Trade Act Health Insurance: An Update from the States," December 2003.

- **If states choose to sponsor health insurance for tax credit recipients in the individual market, insurers are permitted to vary premiums based on the age and health status of recipients.** The federal legislation does not require that the insurance options a state elects to sponsor for tax-credit users be available for a premium that low- and moderate individuals can generally afford. Nor is there a requirement that such options provide comprehensive coverage. Most important, there is nothing in the legislation to prevent individual-market insurers who offer a state-sponsored insurance option from varying premiums based on individuals' age and/or health status. The only requirement is that HCTC recipients be treated like other participants in such coverage. Unless a state otherwise bars insurers in the individual market from varying premiums based on age and health status, insurers can vary the premiums in this manner when dealing with individuals eligible for the tax credit.

  For example, in states such as Indiana, North Carolina, Ohio and Virginia, which have chosen to use the unregulated individual market for their state-sponsored options for tax-credit recipients, insurers take into account the health status of eligible individuals in setting premiums.[14] This can leave older and sicker individuals facing exorbitant premiums that substantially limit their access to a non-COBRA coverage option in their state, despite the assistance of the tax credit.

- **The Treasury Department has scaled back the scope of the consumer protections in the law, which were intended to provide "guaranteed issue" and coverage of preexisting conditions.** The HCTC legislation requires that state-sponsored health insurance options must accept all applicants (this is known as "guaranteed issue") and may not exclude coverage of preexisting health conditions. The legislation specifies that these protections apply if the individual had some form of continuous health coverage for the previous three months.[15] Senator Max Baucus, the lead Democratic negotiator on the legislation, has noted that this three-month period was intended to refer to the three-month period *prior to the individual's losing his or her job*.[16]

  The Treasury Department, however, has instead defined the previous three-month period as the period *immediately prior to the individual's applying for the tax credit*. This is a critical distinction, and the Treasury ruling largely vitiates these protections. Individuals who are eligible for the tax credit may apply for the HCTC only after having been determined eligible for Trade Adjustment Assistance, and it can take substantial time to apply and qualify for TAA itself, sometimes as long as six months after an individual loses his or her job. To meet the three-month requirement as the Treasury has interpreted it, such individuals

[14] Families USA, *op. cit.*

[15] A break in coverage during this three-month period is permitted but only if the break does not last more than 63 consecutive days.

[16] Letter from Senator Max Baucus to Treasury Secretary Paul O'Neill, October 17, 2002.

consequently must purchase up to six months of unsubsidized COBRA coverage on their own after losing their jobs, a virtual impossibility for most such workers. Individuals who cannot afford to maintain coverage during this period fail to meet the requirement they have had continuous health coverage for the three months prior to being determined eligible for TAA and applying for the tax credit. As a result, many workers eligible for the tax credit are likely to find themselves without these consumer protections.[17]

Older or sicker individuals eligible for the credit who lack access to COBRA and live in a state that provides only an individual-market option for tax-credit users thus may be denied coverage altogether. Other eligible individuals in these states may be able to use the tax credit to purchase health insurance, but receive no coverage for a chronic medical condition for up to six months or a year, even though that condition may be the primary reason they are in poor health and in particular need of coverage. Many high-risk pools also do not cover preexisting conditions for a significant period of time. (Note: the House of Representatives has passed legislation to weaken further these already-very-limited consumer protections.[18])

- **The Internal Revenue Service has undercut the benefits of the advance payment mechanism by requiring individuals first to pay at least one month's full premium themselves.** The intent of the TAA legislation was to make the HCTC refundable (to ensure that individuals with little or no tax liability could take advantage of it) and also to make it available on an advance basis (to ensure that individuals would not have to pay an unaffordable up-front premium that discouraged enrollment).

  In implementing the advance payment provision, however, the IRS has elected to require eligible individuals to enroll in a qualified health insurance plan and to pay the first month's full premium themselves before receiving any advance payment. Individuals must go through the following procedure before they can receive the advance credit. First, they must enroll in a qualified health insurance plan by paying the first month's premium for such coverage. They then must apply to the IRS for the tax credit. The IRS determines whether they are eligible for the tax credit. If it finds an individual to be eligible, the IRS bills the

[17] Stan Dorn, "The Trade Act of 2002," Alliance for Health Reform, December 2003.

[18] Legislation that the House passed in June 2003 (H.R. 1528, the Taxpayer Protection and IRS Accountability Act of 2003) includes a provision to allow individuals eligible for the tax credit to waive the consumer protection requirements if they reside in a state without a state-sponsored option that meets those requirements. Opponents of the provision expressed concern that this provision would make it less likely that states would offer coverage options that comply with the consumer protections, leaving individuals little choice but to waive the protections in order to be able to use the tax credit to purchase whatever coverage otherwise is available, such as individual-market coverage with preexisting condition requirements. This could lead to some older and sicker workers being unable to obtain health insurance coverage at any price even if they are eligible for the limited consumer protections due to having continuous coverage for three months prior to applying for the HCTC.

individual for the 35 percent share of the premium that the individual must pay. Once the IRS collects this premium, the IRS pays the federally subsidized portion of the premium — the other 65 percent of the premium cost — and also forwards the individual's premium to the insurer. All of this is supposed to happen within one month, but tax-credit users could find themselves having to pay two months of full premiums upfront if the IRS takes longer than 30 days to process their tax-credit applications. Treasury Department documents indicate the IRS will guarantee processing within four to six weeks.[19]

It is unlikely that many newly unemployed individuals could afford to pay 100 percent of the cost of one month's premium — about $756 for the average cost of employer-based coverage — on an up-front basis. Early reports suggest this requirement has discouraged enrollment in the HCTC. Last fall, the state of Maine switched to a substantially less comprehensive health insurance policy with lower premiums but with a $2,000 deductible for family coverage ($1,000 for individual coverage) to make it easier for individuals who qualify for the tax credit to afford the full cost of the first month's premium.

- **In implementing advance payment of the HCTC, the IRS has included features that appear to be deterring use of the credit.** Individuals cannot obtain prompt reimbursement for payment of the first month's full premium. They must wait for reimbursement until after they file their taxes the following year. This may be difficult financially for low- and moderate-income individuals who can manage to borrow funds on a temporary basis to pay the first month's premium. In addition, individuals who are late in paying their 35-percent share of the premium in a subsequent month become ineligible for advance payment under the HCTC for a period of time and potentially for the remainder of the tax year.[20] If a low- or moderate-income tax credit recipient is just one day late in paying his or her share of the premium, the individual could effectively lose access to the tax credit for a period of time.

  Another problem is that advance payment is not currently available for the purchase of health insurance through a spouse's employer, even though that is one of the insurance options that is supposed to be guaranteed to all eligible individuals under the tax-credit legislation.

[19] U.S. Department of Treasury, "Health Coverage Tax Credit Program Kit," June 2003.

[20] U.S. Department of Treasury, "Health Coverage Tax Credit: The August 1, 2003 Implementation," June 2003.

Conclusion

Enrollment in the HCTC has been minimal so far. This apparently is due in large part to the substantial flaws in the credit's design and implementation. In addition, no serious evaluation has yet been conducted to determine whether the tax credit is providing affordable, quality health insurance to individuals eligible for the credit; the General Accounting Office is scheduled to release its initial analysis of the HCTC some time this fall. As a result, consideration of expanding the HCTC to more of the uninsured is premature. The prior task is to identify and address the deficiencies in the HCTC that are causing it to produce such disappointing results.

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