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ADMINISTRATION PROPOSES LONG-TERM CARE INSURANCE DEDUCTION AND OTHER HEALTH TAX CUTS THAT ARE LIKELY TO BE INEFFECTIVE AND PRIMARILY BENEFIT HIGHER INCOME INDIVIDUALS

by Edwin Park

Summary

As part of its fiscal year 2004 budget, the Administration has proposed a deduction for the purchase of long-term care insurance.[1] This proposal would provide little or no assistance to most low- and middle-income families, and thus is unlikely to be very effective in helping more people secure long-term care coverage. Instead, it would primarily serve as another tax-cut benefit disproportionately geared toward high-income individuals.

- Most low- and middle-income families that cannot afford to purchase long-term care insurance either do not earn enough to owe income tax or are in one of the two lowest tax brackets — the 10 percent bracket or 15 percent bracket. More than 70 percent of all tax filers either are in the 10 percent or 15 percent brackets or do not earn enough to owe income tax.

  The proposed deduction would do little for these people. Low-income families that do not earn enough to incur income tax liability would receive no benefit whatsoever from the deduction. For middle-class families in the 10 percent or 15 percent tax brackets, the deduction would defray no more than 10 cents to 15 cents of each dollar they would have to spend to purchase a long-term care insurance policy.

- The proposed deduction would be of greatest value to higher-income taxpayers. The higher an individual's tax bracket, the greater the subsidy the proposed deduction would provide. For individuals in the highest tax bracket, the deduction would, when fully phased in, subsidize 35 percent of the cost of long-term insurance.

- The people in the top tax brackets are the individuals who are most likely already to have long-term care insurance or to have sufficient assets to be able to afford to meet their long-term needs directly, without government help. They also are the taxpayers who gained the most from the 2001 tax legislation and would benefit

[1] U.S. Department of Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals*, February 3, 2003.

most from the other tax cuts the Administration is now proposing, such as a dividend exclusion.

The Administration's fiscal year 2004 budget also includes a second tax cut related to long-term care. The Administration proposes to allow families caring for a family member with long-term care needs to claim an additional personal exemption. This proposal, as well, would be of greatest benefit to higher-income individuals, since the value of the additional personal exemption — like the value of the proposed long-term care deduction — would vary depending on a taxpayer's tax bracket. This proposal, too, ultimately would provide the largest subsidies to those in the highest tax brackets, much less assistance to most middle-income families, and no assistance to low-income working families that do not owe enough to earn income tax.

As a result, the Administration's long-term care proposals would have perverse effects. These proposals would consume a substantial amount of federal budget resources to provide new subsidies for long-term care to the very Americans who need such subsidies least, while doing little to address the large long-term care costs that millions of Americans face. A much better way to help defray a portion of long-term care costs through the tax code would be to institute a refundable tax credit for long-term care expenses. Such a credit would assist households in caring for a family member living in their homes. Unlike with a deduction, the value of a refundable tax credit would not vary with an individual's tax bracket.

Deduction for the Purchase of Long-Term Care Insurance

This proposal would provide a deduction for the purchase of long-term care insurance, primarily in the individual insurance market. This deduction could be taken both for the premium costs that tax filers paid to purchase policies in the individual market, as well as for the employee's share of premium costs for long-term care insurance offered through an employer if the employee pays at least 50 percent of the cost. The deduction would start to be available in tax year 2004 and be phased in over four years. Starting in 2007, taxpayers could deduct 100 percent of the cost of long-term care insurance premiums, up to certain dollar limits. Both those who itemize deductions and those who do not could take this deduction.

The cost of the proposal is $22.6 billion over 10 years, according to the Joint Committee on Taxation. This cost is held down because of the slow phase-in. The Joint Committee on Taxation estimates that the proposal would cost $16.6 billion in the second five years of the ten-year period, when it would be in full effect. This is nearly triple the proposal's cost in the first five years.

While the proposal is intended to help more people secure long-term care insurance, the deduction is actually a subsidy, delivered through the tax system, that is targeted to those with higher incomes who least assistance and does little or nothing to help those who cannot currently afford long-term care insurance. This is because the proposed deduction would offer little or no assistance to low- and middle-income families. Most low- and middle-income families either do not earn enough to owe income tax (in which case they would receive no benefit from the

deduction) or are in the 10 percent or 15 percent income tax brackets. Only the top 30 percent of tax filers is in brackets higher than the 15 percent bracket.

- When the deduction is phased in fully in 2007, it would defray no more than 10 cents to 15 cents of each dollar that most middle-class taxpayers spend to purchase a long-term care insurance policy. For lower-income individuals, it would be of no value at all; the one-quarter of tax filers who do not earn enough to incur income tax liability would receive no benefit. The deduction would thus do little to make long-term care insurance affordable for the large majority of American households.

  Moreover, in 2004, when the deduction would equal 25 percent of insurance premium costs, the deduction would be worth no more than 2.5 cents to 3.75 cents of each dollar that most middle-class taxpayers spent on long-term care insurance.

- By contrast, for those individuals in the highest tax bracket — which is 38.6 percent in tax year 2003 and is scheduled to drop to 35 percent by 2006 — the deduction would be worth at least 35 cents on the dollar. Only the most affluent five percent of tax filers are in any of the top three tax brackets — what are now the 30 percent, 35 percent, and 38.6 percent brackets.

- Because taxpayers could deduct insurance premium amounts only up to specified dollar limits regardless of the actual premium amounts they paid, the percentage of premium costs that the deduction would defray could be even smaller for some taxpayers. (These dollar limits would vary by age and be adjusted annually.)

- Higher income taxpayers — the group that would receive the largest tax subsidies from the deduction — are the individuals who already are most likely to have long-term care insurance or to possess (or be able to accumulate) sufficient assets to pay future long-term care costs directly. As a result, the deduction turns out to be another tax cut that primarily benefits those at higher income levels.

The proposal also appears not to include the insurance market reforms necessary to make long-term care insurance accessible and affordable. In the absence of significant reforms, large numbers of individuals would be shut of the market for individual long-term care policies. This is because companies selling long-term care insurance can generally vary the premiums they charge, based on age and medical history, and can deny coverage entirely. According to a study by the Commonwealth Fund, up to 23 percent of applicants for long-term care insurance at age 65 are rejected outright.[2]

- The Administration's proposal does not include a requirement that every applicant have access to a long-term care insurance policy or that such a policy be affordable. Such a reform is desirable because older and sicker individuals may be denied coverage entirely or charged prohibitively expensive premiums.

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[2] Mark Merlis, *Financing Long-Term Care in the Twenty-First Century: The Public and Private Roles*, Commonwealth Fund, September 1999.

Similarly, the proposal does not provide protections against unaffordable premium increases an insurer may impose when a policy is renewed.

- Most long-term policies also pay fixed dollar amounts per day, such as $200 per day of nursing home care. Without any adjustment for inflation, which many plans do not include, the value of such policies can erode significantly over time. Many plans also do not include non-forfeiture provisions by which an individual receives partial benefits if the individual can no longer afford the premiums over time. The Administration's proposal contains no reforms in these areas.

- The proposal does call for long-term care policies to meet some new federal standards to qualify for the deduction, but the standards are unspecified. There is no indication that to be eligible for the deduction, for example, long-term care plans would need to comply with the model law and regulations of the National Association of Insurance Commissioners, which are intended to address some (although not all) of these problems. It should be noted that the model law and regulations do not guarantee access to a long-term care policy for all individuals.

A more equitable and effective tax-based alternative would be a refundable tax credit to help subsidize a family's long-term care *expenses*. Unlike a deduction, the value of a tax credit does not vary by tax brackets. A refundable tax credit for individuals who care for family members with long-term care needs could provide the full tax credit subsidy to taxpayers who most need help in covering these costs, rather than shutting out those most in need and providing a subsidy that grows as a taxpayer's income rises.

Over time, states also could take advantage of the increased flexibility that federal regulations issued last year have given states to expand Medicaid coverage to elderly and disabled individuals who are incurring catastrophic long-term care costs. Under these regulations, states can reduce substantially the size of the "medically needy" spenddown amount — the amount of out-of-pocket costs for long-term care expenses that individuals must incur before they qualify for Medicaid coverage. This would have the effect of making it easier for elderly and disabled people with substantial long-term care costs to qualify for Medicaid.

Additional Personal Exemption for Caregivers

The Administration also proposes to permit taxpayers who care for family members with long-term care needs to claim an additional personal exemption on their tax returns. The dependent family member would have to live in the taxpayer's household and be a spouse, ancestor, or spouse of an ancestor. As determined by a physician, the dependent also would have to need assistance with at least two Activities of Daily Living (ADLs), such as eating or toileting. The proposal would be effective starting in tax year 2004 and cost $3.4 billion over 10 years.

This provision, as well, is poorly designed to respond to the needs of families that need assistance in covering long-term care costs.

- Like the long-term care deduction, the value of this exemption would rise with a taxpayer's income. It would be worth modest amounts or nothing to most middle- and lower-income families, and would be worth the most to those in the highest tax brackets.[3] The additional exemption consequently would be of no or only modest help to lower-income families with long-term care needs, while providing a more substantial subsidy for higher-income households that have less need for such assistance.

- For example, assume the exemption was available in 2003. The personal exemption is $3,050 for 2003. A low-income working family that did not earn enough to owe income tax would be shut out of this new federal subsidy entirely, despite being the type of family most in need of such a subsidy. A moderate-income family of four with income of $30,000, which would place the family in the 10 percent tax bracket, would receive a $305 tax benefit (10 percent of the $3,050 exemption) to help offset the costs of taking care of a dependent family member at home. By comparison, a higher-income family of four that earns $200,000 and is in the 30 percent bracket in 2003 would receive a $915 tax benefit, despite the fact that such a family generally would be financially able to care for a dependent family member without a government tax subsidy.

As noted above, a far more equitable tax-based approach to the difficult problem of financing long-term care costs would be to establish a refundable tax credit (rather than a deduction or an additional exemption) to subsidize long-term care expenses that low- and middle-income families incur, coupled with insurance market reforms.

Expansion of Flexible Spending Accounts

The budget also includes provisions related to flexible spending arrangements (FSAs). FSAs for medical care are accounts into which employees can deposit a portion of their wages and from which they may pay for out-of-pocket health care costs. Funds deposited into these accounts do not count as wages or income for the employee for tax purposes. An employee may not carry over any funds left in an FSA at the end of the year.

The first Administration proposal in this area would permit amounts of up to $500 in a medical care FSA to be carried forward from one year to the next. Under the second proposal, employees could transfer up to $500 in funds that remain in their FSA accounts at the end of the year to their retirement plans or to Medical Savings Accounts. Both proposals would be effective starting in tax year 2004. Their combined cost would be $8.7 billion over 10 years.

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[3] As with the general personal exemption, the additional exemption would phase out by two percentage points for each $2,500 ($1,250 if married taxpayers file separately) by which adjusted gross income exceeds certain income thresholds based on filing status. For tax year 2003, the thresholds are $139,500 for single filers, $209,250 for joint filers, $174,400 for heads of households, and $104,625 for married taxpayers filing separately. The thresholds are indexed for inflation. However, the tax changes enacted in 2001 eliminate the phaseout between 2006 and 2010. By 2010, high-income taxpayers will receive the full personal exemption and under this proposal, they also would receive the full additional exemption.

- As with the long-term care deduction, the value of FSAs rises with a taxpayer's tax bracket. The higher the tax bracket, the greater the tax subsidy that FSAs provide. As a result, the individuals most likely to gain from greater flexibility with FSAs would be higher-income taxpayers who can afford to contribute more of their wages on a tax-free basis to FSAs.

- The purpose of this proposal is to encourage employees to deposit more funds then they currently do into their FSAs by promising them they can make other uses of the funds if they are not needed for medical care. While this may seem benign at first blush (except for its cost and mistargeting of federal resources), it has the potential to affect workers adversely. Such provisions may encourage employers to offer health insurance with higher deductible amounts (and possibly less generous benefits), on the theory that employees can incur greater cost-sharing and pay for services not covered by the insurance through their FSAs. Such steps by employers would be especially disadvantageous for low- and moderate-income workers, for whom FSAs would provide no or only a small tax subsidy to help pay for the resulting increase in out-of-pocket costs for medical care. (This potential is heightened by a provision in the proposal that would allow the transfer of FSA funds to Medical Savings Accounts; to use MSAs, employees must be covered by high-deductible insurance plans.)

The proposal to make FSAs more flexible should be viewed as one more Administration proposal — along with the proposed tax credit for the purchase of health insurance in the individual market and a proposal to expand Medical Savings Accounts — to move away from conventional employer-based health insurance under which employers generally offer comprehensive coverage with relatively low deductibles and cost-sharing and pay a significant majority of the cost, to a system where individuals bear an increasing share of the burden of paying for their own health care.[4]

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[4] 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, Revised March 5, 2003 and Edwin Park, *Administration MSA Expansions Could Drive Up the Price of Health Insurance Premiums and Increase the Number of Uninsured*, Center on Budget and Policy Priorities (forthcoming).