

February 5, 2002

ADMINISTRATION'S BUDGET INCLUDES ADDITIONAL HEALTH TAX CUTS THAT PRIMARILY BENEFIT HIGHER-INCOME INDIVIDUALS

by Edwin Park

The Administration's fiscal year 2003 budget devotes \$128 billion over 10 years for a number of tax cuts related to health care. The principal initiatives — a refundable tax credit for the purchase of private health insurance for people not covered by employer-based coverage and an expansion of Medical Savings Accounts, which are tax-advantaged personal savings accounts used by individuals covered by high-deductible health insurance policies — account for more than 70 percent of the cost and are discussed elsewhere.¹ However, the budget also includes several additional health tax cuts — including a costly deduction for the purchase of long-term care insurance — that are not likely to be effective in helping more people to secure insurance and whose primary effect would be to confer individual tax cuts on relatively affluent individuals.

Deduction for the Purchase of Long-Term Care Insurance

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

The cost of the proposal is \$21 billion over 10 years, but this cost is kept low by the slow phase-in. The cost is \$16 billion just in the second five years of the ten-year period — more than triple the cost in the first five years.

- The proposed deduction would be most valuable to higher income taxpayers. When the deduction is fully effective in 2007, the tax subsidy it provides would be of no value to those who do not earn enough to incur income tax liability and would be worth only 10 cents or 15 cents on the dollar for most middle-income taxpayers, who are in the 10 percent or 15 percent tax bracket. (More than three of every four tax filers either do not owe income tax or are in the 10 percent or 15

¹ Edwin Park, *Health Insurance Proposals in Administration's Budget Could Weaken the Employer-Based Health Insurance System*, Center on Budget and Policy Priorities, February 5, 2002.

percent brackets.) By contrast, for those individuals in the highest tax bracket — which is 38.6 percent today 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.) Higher income taxpayers, the group that thus would receive the largest tax subsidies from the deduction, are the individuals who already are most likely either to have long-term care insurance or to possess (or be able to accumulate) sufficient assets to pay future long-term care costs directly. In short, the very individuals who least need help in affording long-term care would be the major beneficiaries of this tax cut.

- A more equitable tax-based approach to the difficult problem of financing long-term care could use a tax credit (rather than a deduction) to subsidize long-term care expenses incurred by low- and middle-income families. In addition, states could be encouraged to take advantage of greater flexibility provided in recent federal regulations to further expand Medicaid coverage to elderly and disabled individuals who are incurring catastrophic long-term care costs.
- The proposal also appears to fail to include necessary insurance market reforms. Currently, long-term care insurers may vary premiums 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 in the current marketplace. In addition, many long-term care insurance plans do not include essential consumer protections such as inflation adjustments; most policies still pay fixed dollar amounts per day, say \$200 per day of nursing home care. Without any adjustment for inflation, the value of the policies can erode significantly over time. (Similarly, many plans do not include non-forfeiture provisions by which an individual still receives partial benefits if the individual can no longer afford the premiums over time.)

Without reforms to address problems such as these in the individual long-term care insurance market, the deduction would be even less useful. The Administration proposal calls for policies to meet some type of federal standards to qualify for the deduction, but the standards are unspecified. There is no indication that to be eligible for the deduction, 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 of these concerns.

Additional Health Tax Provisions

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 return. 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 2004 and cost \$3.6 billion over 10 years.

- As with the other health tax proposals described here, 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. The additional exemption would provide only modest help at best for lower-income families in meeting their long-term care needs, while providing a more substantial subsidy for higher-income households.

For example, assume the exemption was available this year. The personal exemption is \$3,000 for 2002. If a moderate-income family is in the 10 percent tax bracket, it would receive a \$300 tax benefit to help offset the costs of taking care of a dependent family member at home. But the exemption would result in a \$1,158 tax benefit to an individual in the highest tax bracket (38.6 percent in 2002), despite the fact that such a person generally would be financially able to care for a dependent family member without a government tax subsidy.

- As noted above, a more equitable tax-based alternative would be a tax credit to help subsidize a family's long-term care expenses. For example, a tax credit for individuals who care for family members in their home would provide the full value of the subsidy to any taxpayer eligible for the credit rather than increasing the size of the subsidy as a taxpayer's income climbs, as would be the case under the proposal to create an additional exemption.

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 the account 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 2004. Their combined cost would be \$8.4 billion over 10 years.

- 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 significant portions of their wages on a tax-free basis to FSAs.

- The purpose of this proposal is to encourage employees to deposit more funds than 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. This has the potential to encourage employers to offer health insurance with higher deductible amounts and 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. This potential is heightened by the provision that allows the transfer of FSA funds to MSAs, which require that employees be covered only by high-deductible insurance plans. In short, making FSAs more flexible is one more proposal — along with the tax credit for the purchase of health insurance in the individual market and an expansion of MSAs — to move away from conventional employer-based health insurance (in which employers generally offer comprehensive coverage with relatively low deductibles 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.