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HOUSE PASSES HEALTH TAX PACKAGE THAT PROVIDES LITTLE ASSISTANCE TO PEOPLE WITH LONG-TERM CARE NEEDS

by Edwin Park

On July 25, the House of Representatives passed tax legislation (H.R. 4946) that includes two provisions related to long-term care. The first provision would provide a deduction for the purchase of long-term care insurance. The second provision would permit taxpayers who care for family members with long-term care needs in their homes to claim an additional personal exemption on their tax return.

Both provisions are likely to be ineffective in helping lower and middle-income people address long-term care needs. The House bill also includes a provision that would establish a tax shelter for some wealthy Medicare beneficiaries.

Deduction for Long-Term Care Insurance

This provision would provide a deduction to certain taxpayers for the purchase of long-term care insurance, primarily in the individual insurance market. It is a scaled-back version of a proposal included in the Administration's fiscal year 2003 budget.[1]

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. The deduction would start to be available in tax year 2003; in that year, taxpayers could deduct 25 percent of the cost of long-term care premiums, up to certain dollar limits. The size of the deduction would slowly increase over ten years.[2] By 2012, taxpayers could deduct 50 percent of long-term care premium costs. Both those who itemize deductions and those who do not could use the deduction.

The deduction would start to phase down for single filers at adjusted gross incomes of $20,000 and phase out fully at $40,000. For married taxpayers filing jointly, the deduction would begin to phase down at incomes of $40,000 and phase out fully at $80,000. The cost of the proposal would be $2.4 billion over 10 years. The cost is held at this level by the slow phase-

[1] For a discussion of the Administration's proposal, see Edwin Park, *Administration's Budget Includes Additional Health Tax Cuts that Primarily Benefit Higher-Income Individuals*, Center on Budget and Policy Priorities, February 5, 2002. The cost of the Administration's proposal would be $20.3 billion over 10 years.

[2] The deduction would be equal to 25 percent of premium costs in tax years 2003 to 2005, 30 percent in 2006 and 2007, 35 percent in 2008 and 2009, 40 percent in 2010 and 2011, and 50 percent in 2012 and thereafter.

in of the provision; by 2012, when the provision would be fully in effect, its annual cost would be $560 million.

Although targeted on lower and middle-income taxpayers, the deduction would do little for those families. This is because 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 quarter of tax filers with the largest incomes is in a higher bracket.

- When phased in fully in 2012, the deduction would defray no more than five cents to 7.5 cents of each dollar that most of the taxpayers eligible for the deduction had spent out-of-pocket for long-term care insurance. (If a taxpayer was in the 15 percent tax bracket and 50 percent of the costs for long-term care insurance were deductible, the deduction would provide a subsidy equal to 7.5 percent of the taxpayer's expenditures for such insurance in the previous year.)

- From 2003-2005, when the deduction would equal 25 percent of premium costs, the deduction would be worth no more than 2.5 cents to 3.75 cents of each dollar that most eligible taxpayers would spend on long-term care insurance.

- Furthermore, because taxpayers could deduct premium amounts only up to specified dollar limits that vary by age, the value of the deduction would be even smaller for some taxpayers. And as noted, it would be of no value to the one-third of tax filers who do not earn enough to incur income tax liability.

As a result, the deduction is likely to have no significant effect in making long-term care insurance affordable for lower and middle-income taxpayers who cannot afford it today. Nearly the entire cost of the deduction would go to subsidize taxpayers who already have long-term care insurance.

- According to the Joint Committee on Taxation, in 2003, more than 99.9 percent of people receiving tax benefits through the deduction are expected to be already covered by long-term care insurance. Less than *one-sixth of one percent* of the 3.8 million participants — 6,000 people — would be newly insured as a result of the deduction.[3]

- Even when the deduction is fully implemented in 2012, only 1.2 percent of all participants in the deduction would be newly insured.[4]

The proposal also fails to include adequate insurance market reforms. In the absence of such reforms, large numbers of individuals would be shut out of the market for individual long-term care policies. In particular, companies selling long-term care insurance can vary the

[3] Letter from Lindy L. Paull, Chief of Staff, Joint Committee on Taxation, to Representative Fortney Stark, July 22, 2002.

[4] In 2012, JCT estimates that only 100,000 people would be newly insured out of a total participation of 8.2 million people.

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.[5]

The House bill does not include insurance reforms to require that every applicant have access to a long-term care insurance policy or that such a policy be affordable. In addition, it does not provide protections against unaffordable premium increases that an insurer may impose when a policy is subsequently renewed. Without adequate reforms to address such problems in the individual long-term care insurance market, the usefulness of the deduction would be diminished further.

The House bill does, however, include some insurance market reforms in other areas, most notably requiring the disclosure of plan information to consumers and that long-term care insurance plans include options for inflation adjustments and the non-forfeiture of benefits.[6]

A much 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 — to subsidize long-term care *expenses* that low- and middle-income families incur (not simply to subsidize the cost of purchasing long-term care insurance policies), coupled with insurance market reforms. In addition, states 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.

Additional Personal Exemption for Caregivers

This provision of the House bill would permit taxpayers who care for family members with long-term care needs to claim an additional personal exemption on their tax return. (Like the deduction for long-term care insurance, this provision is similar to a proposal included in the Administration's fiscal year 2003 budget). The family member would have to live in the taxpayer's household and be a spouse or dependent of the taxpayer. As determined by a physician, the family member also would have to need substantial assistance with at least two Activities of Daily Living (ADLs), such as eating and toileting. The proposal would phase in very slowly, with the additional exemption being limited to $500 in 2003 and 2004 and rising to

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

[6] Currently, many plans do not include options for inflation adjustments and non-forfeiture of benefits. Most policies pay fixed dollar amounts per day, say $200 per day of nursing home care. Without any adjustment for inflation, the value of such policies can erode significantly over time. In addition, many plans do not include non-forfeiture provisions under which an individual still receives partial benefits if the individual can no longer afford the premiums over time. The House bill would require that insurers provide these benefit options (and information about the options) as part of any long-term care insurance plan.

the full personal exemption amount in 2012.[7] The provision would cost $2.9 billion over 10 years. Its cost when fully effective in the tenth year would be $700 million.

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

- 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. It would be worth the most to those in higher tax brackets.[8] 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 to higher-income households that have less need for such a subsidy.

  For example, in tax year 2003, the additional exemption would be $500. 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 $25,000, which would place the family in the 10 percent tax bracket, would receive a small $50 tax benefit in 2003 to help offset the costs of taking care of a dependent family member at home. If the full exemption were in effect in 2002 (rather than not until 2012), such a family would receive a $300 tax benefit.[9] By comparison, a higher-income family of four that earns $180,000 and is in the 30 percent tax bracket in 2002 would receive a $900 tax benefit if the exemption were fully in effect this year.

As noted above, a much more equitable tax-based alternative would be a refundable tax credit to help subsidize a family's long-term care expenses. A tax credit for individuals who care for family members with long-term care needs would provide the full 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.

Establishing Tax Shelters for Wealthy Medicare Beneficiaries

Another provision in the House bill would open up new tax sheltering opportunities for some wealthy Medicare beneficiaries. This provision would alter the rules relating to Medical Savings Accounts (MSAs) to allow certain Medicare beneficiaries who participate in the

[7] The exemption would be equal to $500 in tax years 2003 and 2004, $1,000 in 2005 and 2006, $1,500 in 2007 and 2008, $2,000 in 2009 and 2010, and the full personal exemption amount for 2012 and thereafter.

[8] As with the general personal exemption, the additional exemption would appear to phase out by two percentage points for each $2,500 ($1,250 if married taxpayers file separately) by which adjusted gross income exceeds certain thresholds based on filing status. For tax year 2002, the thresholds are $137,300 for single filers, $206,000 for joint filers, $171,650 for heads of households, and $103,000 for married taxpayers filing separately. The thresholds are indexed for inflation.

[9] The personal exemption is $3,000 for tax year 2002.

Medicare+Choice program to establish MSAs.[10] (The Medicare+Choice program provides managed care options for Medicare beneficiaries outside of traditional fee-for-service Medicare.)

Currently, beneficiaries in the Medicare+Choice program can opt for a high-deductible insurance plan, coupled with a savings account from which the beneficiaries can draw funds for out-of-pocket medical costs. These plans bear some similarities to MSAs.[11] The deductibles under these plans can be very high (as high as $6,000 or more). No Medicare beneficiaries have elected this option.

The House bill seeks to promote this option by allowing Medicare beneficiaries with substantial income and assets who elect this option to receive the benefits of a tax shelter. The bill would allow such beneficiaries to make tax-deductible contributions into MSAs, something that Medicare beneficiaries cannot do under current law. Beneficiaries would be allowed to make these deductible contributions regardless of how high their incomes may be. (There would be no income limit on the use of MSAs for these Medicare beneficiaries.) Moreover, funds could be drawn from these MSAs for *non*-medical purposes as well as medical ones. As a result, this provision would establish a lucrative tax shelter.

Indeed, one of the key effects of this provision would be to circumvent the income limits that Congress has placed on tax-deductible contributions to individual retirement accounts (IRAs) by individuals who already participate in other pension plans. Congress imposed these income limits — which affect only quite high-income taxpayers — both to limit the cost of IRAs and in recognition of the fact that for high-income taxpayers, making deductible contributions to IRAs primarily entails shifting assets to avoid taxes, rather than increasing the amount that they save. The new House provision would effectively circumvent these IRA income limits for high-income Medicare beneficiaries who enroll in the Medicare+Choice program and elect the high deductible option, since it would enable wealthy beneficiaries whose incomes are too high to

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[10] Medical Savings Accounts are tax-advantaged personal savings accounts that may be used in conjunction with high-deductible health insurance policies. Participating individuals can make tax-deductible contributions to these accounts, and the funds in MSAs may be used to pay for a wide range of health care expenditures. The funds also may be retained in MSA accounts and invested in stocks and bonds or other investment vehicles, with the investment earnings accumulating free of tax. Eventually, the funds in the accounts may be withdrawn not only for medical purposes but also for *non*-medical purposes, such as retirement. Currently, only small business workers and the self-employed can participate in MSAs, with total enrollment in MSAs capped at 750,000.

People eligible for Medicare may not currently make tax-deductible contributions to their MSAs. For further background on MSAs and an analysis of proposals before Congress that would broadly expand the availability of MSAs but could have the effect of increasing the ranks of the uninsured, see Edwin Park and Iris J. Lav, *Medical Savings Account Provisions in House-Passed Patients' Bill of Rights Could Drive Up the Price of Health Insurance Premiums and Increase the Number of Uninsured*, Center on Budget and Policy Priorities, February 25, 2002.

[11] While this nomenclature may be confusing, these accounts are known as Medicare MSAs. Under current law, only Medicare can contribute funds to Medicare MSA accounts. The contributions are equal to the difference between the average payment that Medicare provides to other Medicare+Choice plans on behalf of beneficiaries and the payment that Medicare provides on behalf of beneficiaries enrolled in a high deductible plan. Because the high deductible plan does not cover up-front costs, the cost of such a plan is expected to be less than that of the average Medicare+Choice managed care plan. The contributed funds can then be used to pay for out-of-pocket costs incurred under the Medicare high-deductible plan. Beneficiaries may *not* contribute their own funds to these accounts and take tax deductions for them.

make tax-deductible contributions to IRAs to make deductible contributions to MSAs and use their MSAs for essentially the same purposes.

This provision thus would provide certain wealthy Medicare beneficiaries a new way to accumulate assets over time on a tax-advantaged basis, in addition to the substantial assets they already have.

The tax-shelter advantages that MSAs would hold for affluent Medicare beneficiaries would be substantial. Beneficiaries would be able to make very large tax-deductible contributions into these accounts. Annual contributions of more than $6,000 a year would be permitted.[12]

[12] Under the House provision, beneficiaries could make tax-deductible contributions to MSAs equal to the full amount of the deductible charged under the Medicare+Choice high-deductible plan in which the beneficiaries are enrolled. The deductible may be over $6,000. The maximum high deductible was set at $6,000 for 1999 and is subsequently adjusted upwards for the annual rate of growth in Medicare+Choice costs.

In fact, the tax shelter benefits of MSAs could be more than three times higher for a Medicare beneficiary than for self-employed individuals or small business workers currently eligible to participate in MSAs. Current MSA participants may only make tax-deductible contributions up to $1,625 for individuals and $3,713 for families (these levels are for 2002).