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## LIMITATION ON USE OF TAX-ADVANTAGED HEALTH ACCOUNTS SHOULD NOT BE REPEALED

By Paul N. Van de Water

The House will consider legislation this week to repeal the health reform law's limitation on the use of flexible spending accounts (FSAs) and other tax-advantaged accounts to buy over-the-counter medicines. The limitation makes sense both as tax policy and as health policy and should not be repealed. (The bill, H.R. 436, would also repeal the excise tax on medical devices, a provision we have analyzed elsewhere,<sup>1</sup> and allow participants to cash out up to \$500 in unused FSA balances at the end of a year. To offset the loss in tax revenues, the bill would reduce in some cases the tax credits that will be provided under health reform to help low- and moderate-income families purchase health insurance, another problematic aspect of the bill.<sup>2</sup>)

The 2010 health reform law raises \$4 billion over the 2013-2022 period by conforming the definition of medical expenses that individuals can cover with FSAs, Health Savings Accounts (HSAs), and other tax-advantaged accounts with the long-standing definition in the income tax code for the itemized deduction for medical expenses. As a result, starting in 2011, individuals may no longer receive reimbursements from these accounts for the cost of over-the-counter medications and other over-the-counter items without a prescription or a letter of medical necessity from a physician.

Only a minority of workers benefits from these tax-advantaged accounts. In 2010, 39 percent of all workers had access to flexible spending accounts and only 37 percent of those with access chose to participate.<sup>3</sup> Thus, just one worker in seven has an FSA. An even smaller fraction of workers is enrolled in other tax-favored accounts.<sup>4</sup>

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<sup>1</sup> See Paul N. Van de Water, *Excise Tax on Medical Devices Should Not Be Repealed*, Center on Budget and Policy Priorities, May 31, 2012, <http://www.cbpp.org/cms/index.cfm?fa=view&id=3684>.

<sup>2</sup> See Judith Solomon and Robert Greenstein, *Provision in House Reconciliation Bill Would Cause 350,000 People to Forgo Health Coverage and Could Jeopardize Health Reform*, Center on Budget and Policy Priorities, June 5, 2012, <http://www.cbpp.org/cms/index.cfm?fa=view&id=3748>.

<sup>3</sup> Janemarie Mulvey, *Health Care Flexible Spending Accounts*, Congressional Research Service Report RL32656, January 11, 2012.

<sup>4</sup> Kaiser Family Foundation and Health Research and Educational Trust, *Employer Health Benefits, 2011 Annual Survey*, <http://ehbs.kff.org/pdf/2011/8225.pdf>.

People with high incomes benefit disproportionately from tax-advantaged accounts because they are in higher tax brackets, tend to consume more health care, and can afford to deposit larger amounts in their accounts. Middle- and lower-income people benefit much less, if at all. For example, someone in the 15-percent income tax bracket who contributed \$1,420 to an FSA — the average contribution by those who use the accounts — would save \$322 in federal income and payroll taxes. The typical middle-income individual likely contributes much less than the average, however (the average is pushed up by more affluent individuals contributing larger amounts), and therefore receives even smaller tax savings.

Low- and moderate-income households are unlikely to receive *any* income-tax savings from tax-advantaged accounts because they pay little or no income tax. They do receive payroll tax savings, but low-income workers actually lose more in future Social Security benefits by using FSAs than they gain in lower payroll taxes, because their Social Security benefits are based on their taxable earnings.<sup>5</sup>

These modest tax benefits entail relatively large administrative and compliance costs. Employers must manage the accounts themselves or hire a vendor to do so — typically at a cost of about \$60 annually per participant. Accountholders must spend hours complying with onerous recordkeeping requirements to assure that they are using their accounts only for approved items.

FSAs and other tax-advantaged accounts also encourage the overconsumption of health care, which runs counter to bipartisan efforts to slow the growth of system-wide health-care costs in both public programs and the private sector. The accounts make people less price-sensitive and reduce the effectiveness of cost-sharing requirements in controlling health care utilization. Moreover, prior to the health reform law's restriction on over-the-counter items, funds in tax-advantaged accounts could be used to purchase nearly any health care item or service, regardless of whether it was medically necessary, cost effective, or of meaningful health value. As noted, over-the-counter items do not qualify for the itemized medical deduction.

Congress' Joint Committee on Taxation (JCT) in 2005 included changing the definition of medical expenses for tax-advantaged accounts as one option for improving tax compliance and reforming tax expenditures. JCT offered several reasons — which still apply today — for using the same definition of “medical care” for both tax-favored accounts and itemized deductions. First, having different definitions of “medical care” for different provisions caused similarly situated individuals to receive unequal tax treatment. Second, purchases of over-the-counter medicines and other items (such as pain relievers, cold remedies, and sunscreen) constitute routine personal expenses, which are generally not considered deserving of a tax subsidy. Third, “providing a subsidy for over-the-counter medicines may also result in less compliance, as it may be more difficult to distinguish products that are medical from those that are not, such as toiletries and products that promote general health.”<sup>6</sup>

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<sup>5</sup> Chuck Marr and Kris Cox, *Curbing Flexible Spending Accounts Could Help Pay for Health Care Reform*, Center on Budget and Policy Priorities, June 10, 2009, <http://www.cbpp.org/cms/index.cfm?fa=view&id=2829>.

<sup>6</sup> Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005, pp. 105-8, [https://www.jct.gov/publications.html?func=download&id=1524&chk=1524&no\\_html=1](https://www.jct.gov/publications.html?func=download&id=1524&chk=1524&no_html=1).

Purchases of over-the-counter medicines, such as aspirin and cough syrup, are a minor expenditure for most people. According to one survey, about 9.8 million households used an FSA to purchase over-the-counter medications in 2010, spending an average of just \$136<sup>7</sup> — which conveyed a tax benefit of \$14 to \$48, depending on the household's tax bracket. Few people will find it worthwhile to pay to visit a doctor to get a prescription for an over-the-counter medicine, which would allow them to use their FSA.

All in all, the limitation on the use of FSAs and other tax-advantaged accounts is a small price to pay for helping to extend health coverage to 33 million more Americans without increasing the deficit, as CBO estimates the health reform law would do.

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<sup>7</sup> Scott Melville, President, Consumer Healthcare Products Association, *Testimony before the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives*, April 25, 2012, <http://waysandmeans.house.gov/UploadedFiles/Melville.pdf>.