

An Analysis of the Recommendations of the President's Advisory Panel on Federal Tax Reform

On November 1, 2005, President Bush's Advisory Panel on Federal Tax Reform issued its final report. Established in January 2005, the Panel was chaired by former Senators Connie Mack and John Breaux. It was charged with making recommendations to simplify tax laws in order to reduce compliance costs, share the burdens and benefits of the tax code in a progressive manner, and promote long-term economic growth and savings.

A primary objective of the Panel is to repeal the Alternative Minimum Tax (AMT). The AMT was designed to prevent the highest-income taxpayers from escaping taxation by using complex deductions or other tax-avoidance methods. However, because the AMT was not structured and indexed properly when it was enacted, it is projected to affect millions of middle-class taxpayers. To repeal the AMT, however, would mean losing an estimated \$1.2 trillion in tax revenues over ten years. The Panel, charged with developing budget-neutral recommendations, needed to find offsetting savings. Consequently the Panel has recommended reducing tax incentives for the purchase of health insurance and reducing the tax deduction for home mortgage interest.

The Panel's Health-Related Recommendations

The Tax Panel recommendations included the following four proposals that change existing incentives for the purchase of health insurance:

- A cap on the exclusion of employer-based health benefits from workers' taxable wages at \$11,500 for family coverage and \$5,000 for single coverage. Employee contributions would count toward the cap. If the sum of the employer and employee contributions exceeded the cap, the excess would be reported as taxable income on employees' W-2 forms. The cap would be indexed to the Consumer Price Index (CPI).
- Elimination of the exclusion from employees' incomes for employer-provided dental, disability, and long-term care insurance, as well as other fringe benefits. Again, workers would also be notified on their W-2 forms of the amounts provided by employers for these benefits, and these amounts would then count toward employees' taxable incomes. Employee contributions for these benefits -- which are sometimes paid in pre-tax dollars under current law -- would become fully taxable in all cases.
- A new tax deduction for individually purchased health insurance for those not offered coverage at work. The deduction would be capped at the same levels as employer-based coverage: \$11,500 for families and \$5,000 for single coverage. Presumably, the self-employed would also be subject to the cap, although the report was unclear on that point.

- Health Savings Accounts (HSAs) and other tax-preferred savings accounts for individuals, such as Flexible Spending Accounts (FSAs), education savings accounts, and Individual Retirement Accounts (IRAs) would be rolled-up into a single tax-preferred "Save for Family" account. These accounts also could be used for certain housing expenses.

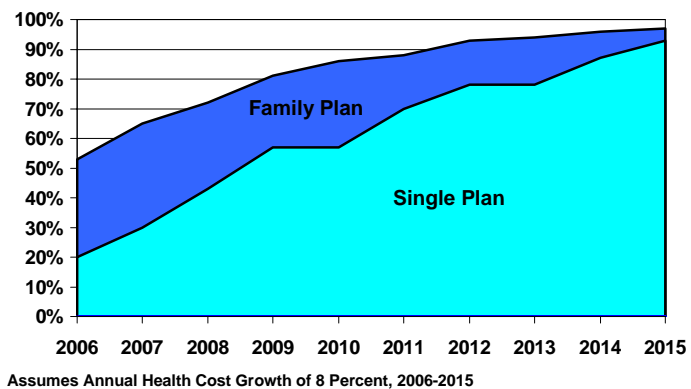
This issue brief provides details on the proposed changes in the tax treatment of employer-provided health coverage and health savings accounts (HSAs), and it analyzes their impact.

Impact of the Cap on Deductible Health Benefits

In discussing how to set a cap on health benefits, the Panel noted that its proposal is equivalent to the average cost of coverage provided in the Federal Employees Health Benefits Program (FEHBP). While some Panel members characterized that level of coverage as a “Cadillac” benefit, estimates using average premium costs and projections for health cost increases indicate otherwise, suggesting that many workers would see a substantial tax increase in the short term.

In 2006, over 50 percent of covered workers are projected to be in firms where family premiums are over the cap; about 20 percent are in firms with single premiums over the cap. By 2015, premiums for virtually all employer-based health plans would be higher than the cap (see Figure 1). These estimates are based on data from the 2004 Kaiser Family Foundation/HRET survey of employer health benefits, extrapolated to 2015.

Figure 1. Percent of Covered Workers in Firms with Premiums Above Caps



The extent of the impact on today’s workers, as well as on future employees, underscores the degree to which this proposal may result in a disruption to the existing system sufficient to cause many workers or employers to drop job-based coverage. Moreover, economists generally agree that tax increases should be carefully phased-in to avoid economic disruption. However, the proposed caps are near what most health insurance already costs. The result could be a steady rise in the number of employees who decline coverage.

Employers may also change their behavior as a result of the cap. In an effort to control health costs and avoid hitting the cap, employers may increase cost-sharing. Alternatively, employers could pass through amounts over the cap to employees, increasing their taxable income (but not their take-

home pay) and thereby providing an incentive for younger and healthier workers to decline coverage.

Further exacerbating the negative impact of this proposal is the provision indexing it to the Consumer Price Index. The value of the cap would erode quite quickly even if health spending continues in its more favorable trend with slower cost increases. The resulting tax impact would force many middle-income taxpayers to trade the consequences of a failure to index the AMT for an arbitrary cap on health insurance.

Tax Increase on Employee Benefits for a Hypothetical Worker

Limiting tax incentives for employer-provided benefits would undermine the employer's effort in tailoring packages to retain valuable employees, as well as the stability provided to the employee by many of these products. The policy consequences could be particularly negative for public programs since disability and long-term care insurance help mitigate the government's obligation to assist aging and disabled citizens.

The Panel's recommendation to make employer-sponsored benefits for disability, long-term care, vision, and dental insurance fully taxable may reduce employee access to those benefits as the tax impact rises, and disposable income falls. Moreover, industry surveys suggest that employer-sponsored coverage for disability, dental and long-term care would be especially vulnerable to "crowding out" from a dramatic increase in overall costs for employee benefits. Indeed, small businesses could be discouraged from offering basic health benefits for the same reason.

The proposed changes may alter employer behavior to the point of making employee benefits less affordable. Some employers may decide that offering dental, disability, or long-term care benefits is less economically viable if their employees decided not to purchase coverage since they would not be permitted to use pre-tax dollars. Other employers may decide that the added impact of FICA taxes justifies paying the cost of benefits in wages. By making benefits fully taxable as income, the employer would encounter additional costs from the Social Security and Medicare wage tax, perhaps making the employer rethink whether wage income would be more recognizable to the employee.

Consider a hypothetical medium-wage worker with a full range of employer-based benefits. Under current law, her employer-paid benefits are not included in her taxable wages. Likewise, her employee share of the premium for health, dental, and vision care insurance is sheltered from taxation via an FSA or Section 125 cafeteria plan. However, assume her employee contributions for long-term care and life insurance premiums are not (current law provides a limited shield for employer-paid life insurance).

For this case, we used the health premiums for federal employees in the largest available plan: Blue Cross and Blue Shield Standard Option. The premium for life insurance was also based on basic federal employees' coverage, which requires employees to pay two-thirds of the cost. The premium for long-term care insurance was based on federal employees' coverage for a 30-year old worker, with a \$100 daily benefit and inflation protection. The dental, vision, and disability premiums are

based on typical coverage in large groups; we assumed the employer contributed a significant percentage of the dental premiums, all of the disability premiums, and none of the premium for vision or long-term care coverage.

Under current law, the hypothetical employee's tax liability for her employment-based benefits would be \$178, assuming her marginal income tax rate was 15 percent. By 2015, tax on her benefits would grow to \$305, assuming health costs grew by 8 percent a year, and the cost of her other benefits grew by 6 percent a year (see Table 1).

Table 1.
Tax Liability of Hypothetical Employee, 15% Tax Bracket

Benefit	2006				2015			
	Contribution to Premium		Taxable Benefits		Contribution to Premium		Taxable Benefits	
	Employer	Employee	Current Law	Tax Panel Proposal	Employer	Employee	Current Law	Tax Panel Proposal
Health	\$8,218	\$3,525		\$243	\$16,428	\$7,042	-	\$9,070
Dental	\$953	\$238		\$1,191	\$1,611	\$403	-	\$2,014
Vision	\$0	\$263		\$263	\$0	\$444	-	\$444
Disability	\$426	\$0		\$426	\$719	\$0	-	\$719
Life	\$105	\$211	\$211	\$316	\$178	\$356	\$356	\$534
LTC	\$0	\$384	\$384	\$384	\$0	\$649	\$649	\$649
Taxable Benefits			\$595	\$2,823			\$1,005	\$13,430
Tax			\$180	\$855			\$305	\$4,069
Net Tax Increase				\$675				\$3,764

Calculations for taxable benefits under the tax panel proposal is based on a cap of \$11,500 for employee benefits in 2006; for subsequent years the cap is inflated by the CPI (2.5%) to derive a cap of \$14,400 in 2015. Tax liability is derived from a 15% federal income tax rate plus FICA tax of 15.3%.

Under the Tax Panel's proposal, her health insurance premium of \$11,743 (employer plus employee) would slightly exceed the cap of \$11,500, and that excess would be counted toward her taxable income. All of her employee contributions for dental, vision, and life insurance would be counted as taxable income. In 2006, her taxable benefits would grow from \$595 under current law to \$2,823 under the Panel's proposal. Assuming a marginal tax rate of 15 percent and a FICA tax of 15.3 percent, her net tax increase in 2006 would be \$675.

By 2015, her health benefits would greatly exceed the cap, increasing taxable income by \$9,000 in health benefits alone. Her total taxable benefits in 2015 would approach \$13,500, and her net tax increase compared with current law would be almost \$3,800. The impact of the Panel's proposal over time would be compounded by the fact that many taxpayers would be pushed into a higher tax bracket – without any rise in net income. The result is that many workers with income sufficient to be considered “middle class” and having employer-sponsored health insurance could see their economic fortunes deteriorate over time.

An analysis of the 25 percent tax bracket that captures income above \$29,000 for a single person and \$59,400 for married filers demonstrates just how profound that impact could become. The same \$13,500 increase in taxable benefits would correspond to a tax increase of \$5,000, 33 percent greater than for filers in the 15 percent bracket. (see Table 2). The added income would undeniably swell the 25 percent bracket (even under the Panel’s reforms) and ultimately lead to the same “bracket creep,” characterized by the AMT. That loss of disposable income would represent a significant blow toward savings for retirement, a new home, or higher education.

Table 2.
Tax Liability of Hypothetical Employee, 25% Tax Bracket

Benefit	2006				2015			
	Contribution to Premium		Taxable Benefits		Contribution to Premium		Taxable Benefits	
	Employer	Employee	Current Law	Tax Panel Proposal	Employer	Employee	Current Law	Tax Panel Proposal
Health	\$8,218	\$3,525		\$243	\$16,428	\$7,042		\$9,070
Dental	\$953	\$238		\$1,191	\$1,611	\$403		\$2,014
Vision	\$0	\$263		\$263	\$0	\$444		\$444
Disability	\$426	\$0		\$426	\$719	\$0		\$719
Life	\$105	\$211	\$211	\$316	\$178	\$356	\$356	\$534
LTC	\$0	\$384	\$384	\$384	\$0	\$649	\$649	\$649
Taxable Benefits			\$595	\$2,823			\$1,005	\$13,430
Tax			\$240	\$1,138			\$405	\$5,412
Net Tax Increase				\$898				\$5,007

Calculations for taxable benefits under the tax panel proposal is based on a cap of \$11,500 for employee benefits in 2006; for subsequent years the cap is inflated by the CPI (2.5%) to derive a cap of \$14,400 in 2015. Tax liability is derived from a 25% federal income tax rate plus FICA tax of 15.3%.

The Value of a Deduction for Individual Health Insurance

The proposed deduction for individual coverage is a positive step. In today’s economy, where many workers are self-employed, work on a contract basis, and change jobs frequently, it makes sense to provide incentives for purchasing individual coverage just as employees and employers receive tax benefits for group coverage.

However, it represents a modest incentive for the uninsured, the majority of which are from households with moderate income. For example, in a household whose marginal tax rate is 15 percent, the annual deduction would be worth as much as \$750 (\$5,000*.15) for single coverage or \$1,725 (\$11,500*.15) for family coverage. For the 2005 tax year, the 15 percent bracket extends to \$29,700 for individuals and \$59,400 for married taxpayers.

A more effective approach would be to offer a tax credit to those purchasing insurance in the individual market that is both advanceable (available to people before they buy coverage) and

refundable (available even if people do not earn enough income to pay taxes). This approach would expand the number of eligible individuals, while building on the existing private coverage system.

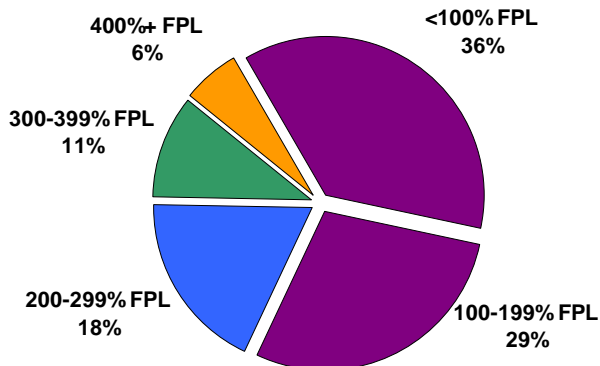
The advanceable feature would simplify the path to coverage and ease the burden for eligible taxpayers by allowing direct transfer through an intermediary (a third-party financial institution that collects and pays premiums on behalf of the government). This system of direct transfer would secure the administrative efficiency of

scale, generally unavailable to individuals, but of significant benefit to the group insurance market. The refundable nature would preserve eligibility for those lacking federal income tax liability, a critical factor for the vast majority of the uninsured, 65 percent of whom are from households with incomes less than 200 percent of the federal poverty level (see Figure 2). In fact, many of these low-to-moderate income taxpayers would be unlikely to benefit from the Panel’s proposal since, by definition, a deduction lacks value to a taxpayer who does not owe taxes.

In addition, because the credit would reduce one’s tax liability “dollar per dollar” as opposed to a deduction linked to marginal tax rates, the credit would be more likely to encourage moderate income workers to purchase health insurance. This is particularly important to reducing the uninsured in a measurable manner since, as previously noted, approximately two-thirds of the uninsured reside in households with incomes less than 200 percent of poverty, or roughly \$30,500 for a family of three.

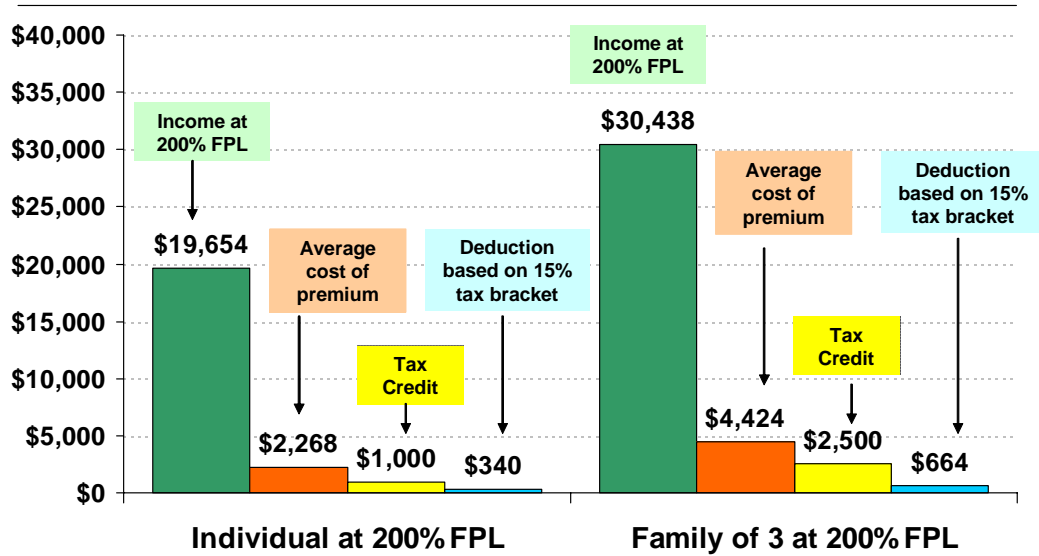
As Figure 3 illustrates, a deduction for a family of three with income of \$30,500 would bring the effective cost of health insurance to approximately \$3,800 annually – roughly 12 percent of household income. By comparison, a credit of \$2,500 for family coverage would reduce the effective cost of insurance for that family to less than \$2,000 or approximately seven percent of household income.

Figure 2. Two-Thirds of All Non-Elderly Uninsured Individuals Are Below 200% FPL (2004)



The Kaiser Commission on Medicaid and The Uninsured, 2005

Figure 3. Low Income Non-Elderly Individuals, Cost of Individually-Purchased Health Insurance, and Proposed Incentives



Average premiums are from "Individual Health Insurance: A Comprehensive Survey of Affordability, Access, and Benefits"; AHIP, 2005. Income levels are from the U.S. Census Bureau Poverty Thresholds 2004.

Health Savings Accounts and Retirement Incentives

Congress should carefully scrutinize — and reject — the Panel’s proposal to merge Health Savings Accounts (HSAs) with incentives for retirement, education and first-time homeownership into a new catch-all “Save for Family Account.”

Health savings accounts have been steadily gaining momentum in the health coverage marketplace. By encouraging employers and individuals to set aside pre-tax dollars for future medical expenses, allowing unused contributions to be rolled over from year, and — in many instances — providing for HSAs to be used in conjunction with lower-premium, high-deductible coverage, they have become an important and attractive option for those who might not otherwise be able to afford coverage. The Panel’s proposal to effectively commingle HSAs with other savings objectives would have the unintended consequence of undermining the growing importance and value of HSAs, in part by creating an incentive for short-term consumption rather than long-term savings for future medical expenses.

The incentive for consumption is evident in the feature that allows the withdrawing of up to \$1,000 annually for any purpose — even if unrelated to health, retirement, or housing. Moreover, a major problem with a catch-all account is that it effectively encourages consumers to postpone medical care by creating incentives to make choices that would result in spending the catch-all funds on other purposes.

Unlike the current HSA structure, which provides a strong incentive for employers to help employees manage health costs, the catch-all approach provides no incentive for employers to contribute. Indeed, the potential to use funding for non-medical purposes could create an impetus to provide such funds in wages.

Additionally, because contributions to Save for Family accounts would be on an “after-tax” basis, many individuals would likely forego saving for health expenses. Moreover, this approach creates a perverse incentive not to purchase health insurance at all. While HSAs are explicitly designed to work in conjunction with a health insurance policy, there would be no such requirement with a catch-all account. Some consumers would be likely to conclude that the opportunity to withdraw \$1,000 without penalty could substitute for health insurance and eliminate the need to purchase it. By taking that approach they would lose the advantage of HSAs in encouraging the use of preventive care services and health management programs, as well as providing access to negotiated discounts. The net effect would be to seriously undermine policymakers’ efforts to help constrain health care cost by encouraging individuals to maintain their health.

For those nearing retirement age and lacking employer-sponsored coverage, the proposed HSA change could make them particularly vulnerable. Rather than benefiting from a new option that enhances health decision-making and has a complementary benefit to one's retirement savings, the Panel's recommendation would force a choice of one type of spending over the other.

Effectively abolishing HSAs by replacing them with a catch-all savings account would be a serious step backward for successful efforts to expand coverage. Industry surveys confirm that HSAs have become an important option for the uninsured, as well as an inducement to small employers who previously did not offer health insurance. Accordingly, the ultimate unintended consequence of the Panel's recommendation could well be consumer frustration that stifles the further development of innovative health insurance products.

Conclusion

The Tax Panel's report concluded that the current tax exclusion for employer-provided health benefits is inequitable because it provides a larger tax break to upper-income workers. That conclusion is certainly debatable. Our analysis suggests, however, that the Panel's proposed solutions would be counterproductive. The proposed cap, for example, would impact approximately 50 percent of workers now and quickly extend to 90 percent of workers, effectively having unintended consequences for the middle class that are similar to those of the AMT.

The Tax Panel's proposal would do little to expand access to coverage or achieve the equity sought for moderate-income individuals. The limited nature of the proposed deduction for individual coverage is insufficient to induce broad change in consumer behavior, and in fact, would fail to reach the majority of the uninsured for whom a deduction is of little, if any value. The proposal would also reduce enrollment in employer-provided coverage. On balance, the net subsidy for private health insurance would fall, and the number of uninsured would almost certainly rise.

The Tax Panel's recommendation to consolidate health savings accounts with individual savings for retirement, education, and homeownership would bring to a halt the initial progress that has been made in using HSAs to improve the health coverage available to millions of Americans. Improved access to coverage would be lost for small businesses, and near-term retirees would lose a flexible option for planning. This change would unquestionably represent a step backward for consumers embracing the new price-conscious approach to health care and would deprive the health system of an important tool to enhance the value of the nation's health care dollars.

The Tax Panel may well have achieved some of the goals of the President's Executive Order. However, in the sphere of health care, the Panel's efforts have collided with the harsh reality that good intentions can have unintended consequences. In considering the Panel's recommendations, Congress must take care to avoid those consequences if we are to sustain the progress made in recent years in designing better ways to extend health care coverage and protection to more Americans.

References

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Information on federal employees health, life, and long-term care benefits and premiums is available at (<http://www.opm.gov/insure/>)



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