

REPORT OF THE COUNCIL ON MEDICAL SERVICE

CMS Report 5 - I-07

Subject: Tax Treatment of Health Insurance: Comparing Tax Credits and Tax Deductions (Resolution 104, A-07)

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Referred to: Reference Committee J
(Liana Puscas, MD, Chair)

1 At the 2007 Annual Meeting, the House of Delegates referred Resolution 104 to the Board of
2 Trustees. Introduced by the Kansas and Oklahoma Delegations, Resolution 104 calls for the AMA
3 to “support the idea of both tax deductions and tax credits being used to encourage the individual
4 ownership of health insurance and...use the necessary resources to obtain passage of federal
5 legislation to achieve that end.” The Board of Trustees referred Resolution 104 (A-07) to the
6 Council of Medical Service for study and report back at the 2007 Interim Meeting.

7
8 This report provides a broad overview of the tax code for health insurance and expenditures,
9 including the income tax exclusion; compares tax credits and tax deductions; elaborates on current
10 health insurance and tax reform proposals; and summarizes AMA policy and efforts with regard to
11 the tax treatment of health insurance.

12
13 CURRENT TAX BENEFITS FOR HEALTH INSURANCE

14
15 In 2004, the amount of tax revenue forgone by the federal government to subsidize health benefits
16 totaled \$188.5 billion, of which \$125 billion was due to the federal income tax exclusion for
17 employment-based health insurance. The income tax exclusion allows employee compensation
18 provided in the form of health benefits to be tax-exempt for workers. As such, the income tax
19 exclusion decreases the taxable income for employees with employment-based health insurance. In
20 the United States, the amount of subsidy received by individuals and families is based on their tax
21 bracket, the cost of their health insurance, and whether their health insurance is job-related. Health
22 insurance is subsidized in accordance with the US tax code in the following ways as well:

- 23
24 • Employment-based health benefit payments made by employers are deducted as a business
25 expense. Large employers generally pay about 80% of an employee’s health insurance costs.
26
27 • The self-employed can deduct 100% of their health insurance expenditures from their income
28 tax.
29
30 • Section 125 Cafeteria Plans, also known as Flexible Benefit Plans, allow employees to pay for
31 certain benefits with pretax dollars, including medical expenses that are not reimbursed and
32 insurance premiums. In general, larger firms are more likely to offer cafeteria plans than
33 smaller firms.

- 1 • Four tax-advantaged accounts subsidize the health care expenses of individuals and families:
2 Flexible Spending Accounts (FSAs), Health Reimbursement Accounts (HRAs), Health Savings
3 Accounts (HSAs), and Medical Savings Accounts (MSAs).
4
- 5 • Those who spend more than 7.5% of their adjusted gross incomes (AGI) on health care and
6 health insurance can deduct the excess expenditures from their income tax. This method can
7 be useful to individuals with individual market policies, individuals who pay for employment-
8 based health insurance with after-tax dollars, or individuals with very high health expenses.
9 However, this medical expense deduction is not widely used because very few individuals have
10 unreimbursed expenses that exceed 7.5% of their AGI.
11
- 12 • Employees eligible for Trade Adjustment Assistance or that receive pension paid by the
13 Pension Benefit Guarantee Corporation can obtain an advanceable, refundable health coverage
14 tax credit (HCTC) to purchase health insurance.
15

16 These tax benefits help extend health care coverage to most people, as well as allow the insured
17 population to receive additional health care coverage options. However, individuals receive no
18 subsidy if they purchase health insurance on their own through the individual market. Many of the
19 current tax subsidies benefit only higher-income workers and those who are employed in large
20 firms, and do not address gaps in coverage that many small firms and low-income workers face.
21 For example, 16% of Americans are uninsured, and more than 80% of these individuals come from
22 working families that pay taxes but do not have access to health insurance subsidies.
23

24 EMPLOYEE INCOME TAX EXCLUSION

25

26 The income tax exclusion is a tax exemption given to employees for the purchase of employment-
27 based health insurance and is not reported as income on employee tax returns. The tax exclusion
28 allows higher income individuals to receive greater tax advantages than lower income individuals.
29 As an example, consider two employees with the same employer, but different incomes, who select
30 the same health benefits. Family One has an income of \$50,000 and Family Two has an income of
31 \$150,000. The higher income family is in the 28% tax bracket and receives a greater share of the
32 subsidy (i.e., tax break) than the lower income family, which is in the 15% tax bracket. For both
33 employees, the employer pays 75% or \$7,500 of the total premium cost of \$10,000. Family One
34 receives a subsidy of \$1,125 ($\$7,500 \times 15\%$) or 11% of the premium by not paying taxes on the
35 portion of compensation given as the employer's share of the health insurance premium. In
36 comparison, Family Two receives a subsidy of \$2,100 ($\$7,500 \times 28\%$) or 21% of the premium.
37 Under the current system, a family with an income of \$150,000 effectively pays a lower premium
38 for their health insurance, than a family with an income of \$50,000 for the same coverage.
39

40 The income tax exclusion for employment-based health insurance totals \$125 billion of forgone
41 revenue for the federal government. The Employee Benefit Research Institute reports that the
42 income tax exclusion total is more than three times as much to families in the 35% tax bracket than
43 it is to families in the 10% bracket. Furthermore, the US tax code provides no tax benefits for
44 families who purchase health insurance and have no taxable income. Accordingly, the income tax
45 exclusion for the purchase of employment-based health insurance is widely regarded as socially
46 inequitable.

1 COMPARING TAX CREDITS AND TAX DEDUCTIONS

2
3 Given the large and regressive nature of the income tax exclusion for employment-based health
4 coverage, the AMA and a number of other reform proposals seek to eliminate or limit the
5 exclusion. Doing so would create tax neutrality between employment-based health insurance and
6 nongroup coverage. There is a growing interest in reforming the tax treatment of health insurance
7 in order to make it easier for all individuals, including those with lower incomes, to obtain health
8 insurance at an affordable cost. In the last year, several proposals have been introduced with
9 provisions for the use of premium subsidies to extend coverage. Health care premium subsidies are
10 targeted toward the payment of health insurance premiums, and can be funded by the use of tax
11 credits and/or tax deductions.

12
13 Tax Credits

14
15 Tax credit proposals have steadily gained momentum since 1998, when the AMA House of
16 Delegates adopted the recommendations contained in Council on Medical Service Report 9 (A-98),
17 (Policy H-165.920, AMA Policy Database). Several organizations, such as the Federation of
18 American Hospitals and the Health Care Coverage for the Uninsured (HCCU), have provisions that
19 advocate for the use of tax credits as a means to expand health insurance coverage. The HCCU
20 coalition, which announced its consensus agreement in January 2007, brought together 16
21 organizations, including the AMA, Families USA, and the US Chamber of Commerce.

22
23 Tax credits are defined as the amount of money subtracted directly from the income tax one owes.
24 Therefore, tax credits can offset the cost of health insurance coverage dollar for dollar. Council on
25 Medical Service Report 4 (A-00) recommended a series of principles for structuring tax credits
26 (Policy H-165.865), including the principles that health insurance tax credits should be inversely
27 related to income and be both advanceable and refundable. Tax credits that are inversely related to
28 income can be targeted toward those who otherwise would be most likely to be uninsured. In
29 general, the size of tax credits should be large enough to ensure that health insurance is affordable
30 to most people. Advanceable tax credits would provide funding to low-income individuals and
31 families that would enable them to afford the monthly out-of-pocket premium costs of coverage.
32 Refundable tax credits would be available for those who owe no taxes or who have tax liabilities
33 less than the value of the credits.

34
35 The effect of replacing the tax exclusion with tax credits based on income level can be
36 demonstrated using the same two hypothetical families previously mentioned in this report, with
37 incomes of \$50,000 and \$150,000 and health insurance premiums of \$10,000. Eliminating the tax
38 exclusion would raise the taxable income of Family One to \$57,500 and Family Two to \$157,500
39 because both families are now taxed on the employer's contribution to the premium. Family One
40 qualifies for a hypothetical tax credit of \$6,500, and Family Two does not qualify for a tax credit
41 because \$157,500 exceeds the income eligibility cap for this hypothetical tax credit. The tax credit
42 effectively reduces the premium for Family One from \$10,000 to \$3,500, which now represents 6%
43 of the family's taxable income. The premium for Family Two totals \$10,000, or 6% of that
44 family's taxable income. Thus, the proportion of income that each family spends on health
45 insurance is now equivalent in this hypothetical example, demonstrating the social equity of using
46 tax credits rather than the tax exclusion to subsidize health insurance.

47
48 A growing number of congressional proposals have expressed support for the use of tax credits to
49 cover the uninsured. In addition, tax credit simulations demonstrate the viability of tax credit

1 proposals for expanding coverage. According to a 2000 tax simulation conducted by Gruber and
2 Levitt and published in *Health Affairs*, specific types of tax credits could reduce the number of
3 uninsured as well as increase access to affordable health insurance coverage.

4 5 Tax Deductions

6
7 Tax deductions are another form of premium subsidy for health insurance coverage.
8 Mathematically equivalent to tax exclusions, but administratively different, tax deductions are
9 defined as the amount of money included in gross (reported) income but subtracted from adjusted
10 (taxable) income. Tax deductions provide unequal benefits per dollar spent because the benefit
11 varies by tax rate. Specifically, the value of a tax deduction increases with the marginal tax rate of
12 a taxpayer.

13
14 In 2007, the Bush Administration proposed replacing the employee income tax exclusion for
15 employer-sponsored health insurance with a standard tax deduction of \$7,500 per individual and
16 \$15,000 per family, regardless of whether coverage is purchased through an employer or the
17 nongroup health insurance market. The effect of these tax deductions varies widely based on
18 income. For example, the tax deduction would be worth \$5,250 for a family in the 35% income tax
19 bracket, but only \$1,500 for a family in the 10% income tax bracket. In the Administration's
20 proposal, individuals and families with low or zero marginal tax rates would be unable to claim the
21 deduction.

22 23 Impact on the Uninsured

24
25 Recently, the Lewin Group modeled a number of cost and coverage estimates of the AMA proposal
26 for expanding coverage by replacing the employee tax exclusion with a system of tax credits
27 targeted to those with low incomes. In addition, the Lewin Group has modeled the 2007 proposal
28 of the Administration to replace the employee tax exclusion with a standard deduction. The
29 Appendix to this report, "Comparison of Tax Deductions and Tax Credits," illustrates the impact of
30 both approaches on the percent of reduction in the number of the uninsured by income level.

31
32 The chart illustrates that high-income individuals fare better from tax deductions than low-income
33 individuals. For example, tax deductions reduce the number of uninsured individuals with incomes
34 under \$10,000 by just 3.8%, and by 38.6% for individuals with incomes of \$100,000 or more. By
35 comparison, tax credits reduce the number of uninsured individuals with incomes under \$10,000 by
36 45.1%, and by 42.3% for individuals with incomes of \$100,000 or more. In this example, tax
37 credits show consistent gains in coverage across income groups, whereas tax deductions primarily
38 subsidize the health insurance costs of high-income groups.

39 40 AMA POLICY

41
42 The AMA proposal for expanding health insurance coverage is based on extensive policy adopted
43 by the House of Delegates. Various policies delineate a comprehensive proposal that supports
44 individually owned health insurance using a system of tax credits and changes to the tax treatment
45 of health insurance.

46
47 The intent of Resolution 104 (A-07) is reflected in Policy H-165.995[2a], which calls for tax code
48 changes to allow persons paying the entire premium for their health insurance to deduct the full
49 cost of their premium separately from their gross income. Nevertheless, Policy 165.920[12]

1 supports rescinding Policy H-165.995[2a] once there is the same tax treatment between employer
2 provided coverage and individually purchased coverage (i.e., once the income tax exclusion is
3 eliminated.)
4

5 In addition, Policy H-165.920[6] supports the individual's right to select his/her health insurance
6 plan and to receive the same tax treatment for individually purchased coverage, for contributions
7 toward employer-provided coverage, and for completely employer provided coverage; and [11]
8 supports a replacement of the present exclusion from employees' taxable income of employer-
9 provided health expense coverage with tax credits for individuals and families. Policy H-165.969
10 supports the implementation of individual tax credits for the purchase of health insurance for
11 specific targeted populations; and incremental steps toward the financing of these tax credits,
12 including but not limited to capping the tax exclusion for employment-based health insurance.
13

14 The AMA also supports efforts to move patients from public programs into the private sector,
15 through the implementation of vouchers or other mechanisms, thereby providing patients with
16 greater choice (Policy H-165.887). Policy 165.920[13] prefers tax credits over public sector
17 expansions as a means of providing coverage to the uninsured, while Policy 290.974 supports
18 eligibility expansions in public sector programs in the absence of private sector reforms that would
19 enable persons with low incomes to purchase health insurance.
20

21 DISCUSSION

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23 According to the Kaiser Family Foundation, 73% of adults favor offering uninsured individuals
24 income tax deductions, tax credits, or other financial assistance to help them purchase private
25 health insurance on their own. With growing public support for subsidizing coverage for the
26 uninsured, a number of health system reform proposals seek to eliminate or limit the tax exclusion,
27 and/or use premium subsidies toward the purchase of coverage.
28

29 The current system for subsidizing health insurance is fragmented and counterintuitive. The
30 amount of subsidy a person receives is based on his or her tax bracket, the cost of his or her health
31 insurance, and whether the health insurance is job-related. The inefficiencies of the US tax code
32 contribute to the growth in the uninsured and the rising cost of health care. The Administration's
33 2007 proposal to eliminate the employee income tax exclusion for employer-sponsored health
34 insurance has been supported by a range of policymakers and analysts as a first step to correct the
35 tax inequity between the employment-based and non-group health insurance markets.
36

37 For purposes of expanding health insurance coverage, however, tax credits are more effective than
38 tax deductions. The primary advantage of tax credits over tax deductions is that tax credits can be
39 designed in a manner that is targeted toward low income individuals and families who have little or
40 no tax liabilities. A health insurance tax deduction would have a similar effect to the existing tax
41 exclusion for employer-based coverage, which provides a larger tax break to people with higher
42 incomes. In the Lewin Group's analysis of the Administration's proposal, 70% of the reduction in
43 taxes was estimated to go to families with incomes above \$50,000 per year and only 20% was
44 estimated to go to those who are currently uninsured. Similarly, analysts Gruber and Levitt
45 estimated that about half of the uninsured do not pay taxes. Of the half of the uninsured who do pay
46 taxes, 90% are in the 15% tax bracket. Accordingly, the majority of tax deductions would likely go
47 to people who already have coverage, rather than to the uninsured population.

1 The implementation of either tax deductions or tax credits in lieu of the tax exclusion can provide
2 tax neutrality between the group and non-group markets. However, tax deductions primarily
3 benefit those with high incomes, whereas tax credits can be targeted to those with low incomes,
4 who are also most likely to be uninsured. The implementation of both tax deductions and tax
5 credits, as called for in Resolution 104 (A-07), is likely to be very expensive and have less impact
6 on expanding coverage to the uninsured. At a time when the uninsured rate continues to grow
7 annually, the Council believes it is important to remain focused on efficient mechanisms for
8 redirecting the federal subsidies to those who need it most.
9

10 The AMA believes that individually owned health insurance, facilitated by changing current
11 provision of tax subsidies for health insurance, and reforming the individual health insurance
12 market, would provide the best opportunity to reduce the number of the uninsured, while also
13 increasing the health coverage choices for individuals and families. The Appendix to this report,
14 which compares the impact of tax deductions and tax credits on the number of the uninsured,
15 illustrates the equity and efficiency of the AMA proposal to expand coverage through a system of
16 refundable and advanceable tax credits that are inversely related to income.
17

18 RECOMMENDATIONS

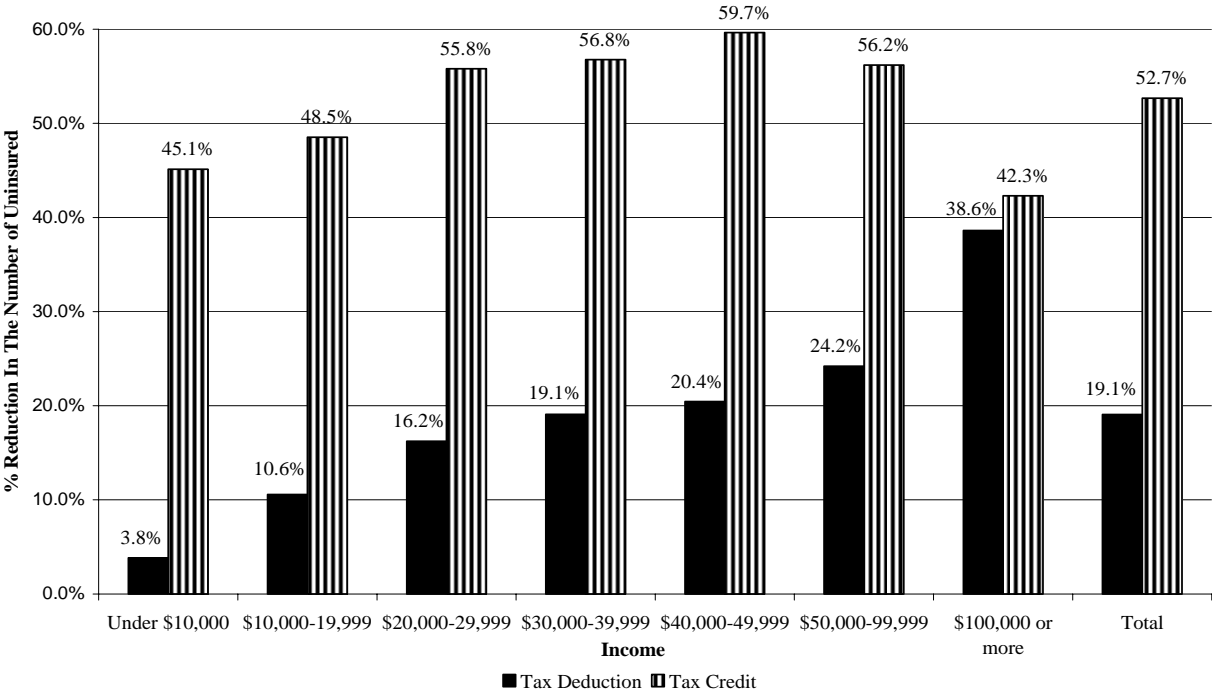
19
20 The Council on Medical Service recommends that the following be adopted in lieu of Resolution
21 104 (A-07) and the remainder of the report be filed:
22

- 23 1. That our American Medical Association support the use of appropriately structured and
24 adequately funded tax credits as the most effective mechanism for enabling uninsured
25 individuals to obtain health insurance coverage.
26
- 27 2. That our American Medical Association study the tax ramifications of eliminating the
28 employee income tax exclusion for employment-based health insurance, including the
29 possible impact of both payroll taxes (e.g., FICA and Medicare tax to employees and
30 employers) and individual income taxes at the state, city and county levels, with a report
31 back at A-08.

References for the report are available from the AMA Division of Socioeconomic Policy
Development

Fiscal Note: Staff cost estimated to be less than \$500 to implement

Appendix 1: Comparison of Tax Deductions and Tax Credits



Source: Lewin Group estimates from the Health Benefits Simulations Model. Tax Deductions: \$7,500 for individuals and \$15,000 per family. Tax Credits: \$5,000 for individuals and \$10,000 for families below 200% FPL. Tax credits are phased out in proportion to income from 200% to 500% FPL. Tax credit model includes a penalty of 2% of income up to \$1,500 for individuals and \$3,000 for families if health insurance is not purchased.