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

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

CURRENT TAX BENEFITS FOR HEALTH INSURANCE

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

• Employment-based health benefit payments made by employers are deducted as a business expense. Large employers generally pay about 80% of an employee’s health insurance costs.

• The self-employed can deduct 100% of their health insurance expenditures from their income tax.

• Section 125 Cafeteria Plans, also known as Flexible Benefit Plans, allow employees to pay for certain benefits with pretax dollars, including medical expenses that are not reimbursed and insurance premiums. In general, larger firms are more likely to offer cafeteria plans than smaller firms.
Four tax-advantaged accounts subsidize the health care expenses of individuals and families: Flexible Spending Accounts (FSAs), Health Reimbursement Accounts (HRAs), Health Savings Accounts (HSAs), and Medical Savings Accounts (MSAs).

Those who spend more than 7.5% of their adjusted gross incomes (AGI) on health care and health insurance can deduct the excess expenditures from their income tax. This method can be useful to individuals with individual market policies, individuals who pay for employment-based health insurance with after-tax dollars, or individuals with very high health expenses. However, this medical expense deduction is not widely used because very few individuals have unreimbursed expenses that exceed 7.5% of their AGI.

Employees eligible for Trade Adjustment Assistance or that receive pension paid by the Pension Benefit Guarantee Corporation can obtain an advanceable, refundable health coverage tax credit (HCTC) to purchase health insurance.

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

EMPLOYEE INCOME TAX EXCLUSION

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

The income tax exclusion for employment-based health insurance totals $125 billion of forgone revenue for the federal government. The Employee Benefit Research Institute reports that the income tax exclusion total is more than three times as much to families in the 35% tax bracket than it is to families in the 10% bracket. Furthermore, the US tax code provides no tax benefits for families who purchase health insurance and have no taxable income. Accordingly, the income tax exclusion for the purchase of employment-based health insurance is widely regarded as socially inequitable.
Given the large and regressive nature of the income tax exclusion for employment-based health coverage, the AMA and a number of other reform proposals seek to eliminate or limit the exclusion. Doing so would create tax neutrality between employment-based health insurance and nongroup coverage. There is a growing interest in reforming the tax treatment of health insurance in order to make it easier for all individuals, including those with lower incomes, to obtain health insurance at an affordable cost. In the last year, several proposals have been introduced with provisions for the use of premium subsidies to extend coverage. Health care premium subsidies are targeted toward the payment of health insurance premiums, and can be funded by the use of tax credits and/or tax deductions.

Tax Credits

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

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

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

A growing number of congressional proposals have expressed support for the use of tax credits to cover the uninsured. In addition, tax credit simulations demonstrate the viability of tax credit
proposals for expanding coverage. According to a 2000 tax simulation conducted by Gruber and
Levitt and published in *Health Affairs*, specific types of tax credits could reduce the number of
uninsured as well as increase access to affordable health insurance coverage.

**Tax Deductions**

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

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

**Impact on the Uninsured**

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

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

**AMA POLICY**

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

The intent of Resolution 104 (A-07) is reflected in Policy H-165.995[2a], which calls for tax code
changes to allow persons paying the entire premium for their health insurance to deduct the full
cost of their premium separately from their gross income. Nevertheless, Policy 165.920[12]
supports rescinding Policy H-165.995[2a] once there is the same tax treatment between employer
provided coverage and individually purchased coverage (i.e., once the income tax exclusion is
eliminated.)

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

The AMA also supports efforts to move patients from public programs into the private sector,
through the implementation of vouchers or other mechanisms, thereby providing patients with
expansions as a means of providing coverage to the uninsured, while Policy 290.974 supports
eligibility expansions in public sector programs in the absence of private sector reforms that would
enable persons with low incomes to purchase health insurance.

**DISCUSSION**

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

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

For purposes of expanding health insurance coverage, however, tax credits are more effective than
tax deductions. The primary advantage of tax credits over tax deductions is that tax credits can be
designed in a manner that is targeted toward low income individuals and families who have little or
no tax liabilities. A health insurance tax deduction would have a similar effect to the existing tax
exclusion for employer-based coverage, which provides a larger tax break to people with higher
incomes. In the Lewin Group’s analysis of the Administration’s proposal, 70% of the reduction in
taxes was estimated to go to families with incomes above $50,000 per year and only 20% was
estimated to go to those who are currently uninsured. Similarly, analysts Gruber and Levitt
estimated that about half of the uninsured do not pay taxes. Of the half of the uninsured who do pay
taxes, 90% are in the 15% tax bracket. Accordingly, the majority of tax deductions would likely go
to people who already have coverage, rather than to the uninsured population.
The implementation of either tax deductions or tax credits in lieu of the tax exclusion can provide tax neutrality between the group and non-group markets. However, tax deductions primarily benefit those with high incomes, whereas tax credits can be targeted to those with low incomes, who are also most likely to be uninsured. The implementation of both tax deductions and tax credits, as called for in Resolution 104 (A-07), is likely to be very expensive and have less impact on expanding coverage to the uninsured. At a time when the uninsured rate continues to grow annually, the Council believes it is important to remain focused on efficient mechanisms for redirecting the federal subsidies to those who need it most.

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

RECOMMENDATIONS

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

1. That our American Medical Association support the use of appropriately structured and adequately funded tax credits as the most effective mechanism for enabling uninsured individuals to obtain health insurance coverage.

2. That our American Medical Association study the tax ramifications of eliminating the employee income tax exclusion for employment-based health insurance, including the possible impact of both payroll taxes (e.g., FICA and Medicare tax to employees and employers) and individual income taxes at the state, city and county levels, with a report 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.