PRESENT LAW AND ANALYSIS RELATING TO THE TAX TREATMENT OF HEALTH SAVINGS ACCOUNTS AND OTHER HEALTH EXPENSES

Scheduled for a Public Hearing
before the
SUBCOMMITTEE ON HEALTH CARE
of the
SENATE COMMITTEE ON FINANCE
on September 26, 2006

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of the
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INTRODUCTION

The Subcommittee on Health Care of the Senate Committee on Finance has scheduled a public hearing on September 26, 2006, on health savings accounts. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the present-law provisions relating to health care expense and health savings accounts and a discussion of issues.

[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Analysis Relating to the Tax Treatment of Health Savings Account and Other Health Expenses* (JCX-45-06), September 25, 2006.

I. EXECUTIVE SUMMARY

Present-law taxation of health care expenses

Present law includes a variety of provisions that provide tax benefits for health expenses. The specific tax treatment of such expenses depends in part on whether the taxpayer is covered under a health plan paid for by an employer, whether the taxpayer has self-employment income, or whether an individual itemizes deductions and has medical expenses that exceed a certain threshold.

An employer's contribution to a plan providing health coverage for an employee, and his or her spouse and dependents, is excludable from the employee's income for both income and payroll tax purposes. Self-employed individuals may deduct the cost of health insurance for themselves and their spouses and dependents. Individuals may claim an itemized deduction for unreimbursed medical expenses, to the extent that such expenses exceed 7.5 percent of adjusted gross income. Individuals who are covered by a high deductible health plan are able to contribute to a health savings account ("HSA"). Contributions to an HSA are deductible (or excludable from income and wages if made by the employer). Earnings on contributions to an HSA are not currently includible in gross income (i.e., "inside buildup" is not currently taxable) and distributions from an HSA for qualified medical expenses are not includible in income. Nonqualified distributions are includible in income and may be subject to an additional 10-percent tax. Certain limited classes of individuals are eligible to receive a refundable tax credit of 65 percent of the cost of health insurance coverage.

Discussion of issues

The appropriateness of the present-law Federal tax treatment of health expenses has been the subject of much debate. The exclusion for employer-provided health care is typically a focal point of such debate. The present-law favorable tax treatment of employer-provided health coverage has been justified on the grounds that it encourages employees to prefer health coverage over taxable compensation, thereby increasing health insurance coverage and reducing the number of uninsured. Proponents of the exclusion also argue that the employer market provides a natural pooling mechanism which can result in more affordable coverage. However, others argue that the present-law rules are inequitable because they do not provide a consistent tax benefit for health coverage and that the exclusion may lead to other utilization of health care.

The present-law favorable tax treatment of high deductible health plans and HSAs is also the subject of debate. Proponents of HSAs believe that the use of high deductible plans promotes responsible health policy by making individuals more conscious of their health care costs because fewer expenses are paid by a third party insurer; thus, reducing overall health care costs. Critics believe that such plans are likely to be more attractive to healthier individuals, with the result that adverse selection will occur which will erode the group market and result in higher insurance costs for individuals with greater health risks. In addition, many believe that it is inappropriate to provide greater tax advantages for a certain type of health plan.

II. PRESENT-LAW TAX TREATMENT OF HEALTH CARE EXPENSES

In general

Present law includes a variety of provisions that provide tax benefits for health expenses. The specific tax treatment of such expenses depends in part on whether the taxpayer is covered under a health plan paid for by an employer, whether the taxpayer has self-employment income, or whether an individual itemizes deductions and has medical expenses that exceed a certain threshold. Individuals who are covered by a high deductible health plan are able to contribute to a health savings account ("HSA"). Certain limited classes of individuals are eligible to receive a refundable tax credit of 65 percent of the cost of health insurance coverage. Table 1, below, provides a comparison of the various tax provisions of present law. Each provision is discussed in more detail, below.[2]

Exclusion for employer-provided accident and health coverage[3]

An employer's contribution to a plan providing health coverage for an employee and his or her spouse and dependents is excludable from the employee's income for both income and payroll tax purposes. In addition, active employees participating in a cafeteria plan may pay their share of premiums on a pre-tax basis through salary reduction. Such salary reduction contributions are treated as employer contributions and thus are also excluded from gross income and payroll taxes. Reimbursements under an employer plan for medical expenses are also excludable from gross income and wages. There is no limit on the amount of employer-provided health coverage that is excludable.

The exclusion for employer-provided health coverage applies to medical expenses not covered by insurance as well as health insurance expenses. Arrangements commonly used by employers to reimburse medical expenses of their employees (and their spouses and dependents) include health flexible spending arrangements ("FSAs") and health reimbursement arrangements ("HRAs").

[2] Some of the tax provisions described below apply to long-term care as well as health care. For example, the deduction for health insurance expenses of self-employed individuals applies to qualified long-term care insurance. The tax treatment of long-term care is not addressed in this pamphlet.

[3] Secs. 104, 105, 106, 125, and 3121(a)(4). All section references are to the Internal Revenue Code of 1986 ("the Code") unless otherwise indicated.

Table 1.–Comparison of Present-Law Tax Benefits for Health Expenses[1]

Provision	Tax Benefit	Class Eligible	Maximum Dollar Limit on Tax Benefit	Qualified Costs/Expenses
1. Employer contributions to an accident or health plan (sec. 106)	Exclusion from gross income and wages.	Employees (including former employees).	No limit on amount excludable.	Contributions to health plan for the taxpayer, spouse and dependents.
2. Employer reimbursement of medical expenses (sec. 105)	Exclusion from gross income and wages.	Employees (including former employees).	No limit on amount excludable.	Medical care expenses (as defined under section 213(d)) of the taxpayer, spouse and dependents.
3. Employer-provided health benefits offered under a cafeteria plan (sec. 125)	Exclusion from gross income and wages (for salary reduction contributions).	Employees.	No limit on amount excludable.	Coverage under an accident or health plan (secs. 105 and 106).
4. Health reimbursement arrangements (secs. 105 and 106)	Employer-maintained arrangement providing exclusion from gross income and wages for amounts used to reimburse employees for medical expenses. Amounts remaining at the end of the year can be carried forward to reimburse medical expenses in later years. There is no tax-free accumulation of earnings.	Employees (including former employees).	No limit on amount excludable.	Medical care expenses (as defined under section 213(d)) of the taxpayer, spouse and dependents.
5. Health flexible spending arrangements (secs. 105, 106, and 125)	Employee salary-reduction arrangement providing exclusion from gross income and wages for amounts used to reimburse employees for medical expenses.	Employees.	No limit on amount excludable.	Medical care expenses (as defined under section 213(d)) of the taxpayer, spouse and dependents (but not premium payments for other health coverage).

[1] The table describes the legal limits that apply under present law. Employers may establish rules and limitations consistent with those under present law. For example, it is common for employers to place a limit on the amount of expenses that may be reimbursed through an FSA or HRA.

Provision	Tax Benefit	Class Eligible	Maximum Dollar Limit on Tax Benefit	Qualified Costs/Expenses
6. Deduction for health insurance expenses of self-employed individuals (sec. 162(l))	Income tax deduction for cost of health insurance expenses of self-employed individuals. Deduction does not apply for self-employment tax purposes.	Self-employed individuals.	No specific dollar limit; deduction limited by amount of taxpayer's earned income from the trade or business.	Insurance which constitutes medical care for the taxpayer, spouse and dependents.
7. Itemized deduction for medical expenses (sec. 213)	Itemized deduction for unreimbursed medical expenses to extent expenses exceed 7.5 percent of adjusted gross income (10 percent for alternative minimum tax purposes).	Any individual who itemizes deductions and had unreimbursed medical expenses in excess of 7.5 percent of adjusted gross income.	No maximum limit.	Expenses for medical care (as defined under section 213(d)) of the taxpayer, spouse and dependents. Medicine or drugs must be prescribed or insulin.
8. Health Savings Accounts ("HSAs") (sec. 223)	Contributions are deductible if made by an eligible individual and excluded from gross income and wages if made by an employer (including contributions made through a cafeteria plan through salary reduction). Distributions used for qualified medical expenses excludable from gross income. Earnings on amounts in the HSA accumulate on a tax-free basis.	Individuals with a high deductible health plan and no other health plan other than a plan that provides certain permitted coverage. High deductible health plan is a plan with a deductible of at least $1,050 for self-only coverage and $2,100 for family coverage (for 2006). Out-of-pocket expense limit must be no more than $5,250 for self-only coverage and $10,500 for family coverage (for 2006).	Maximum annual contribution is the lesser of (1) 100 percent of the annual deductible, or (2) $2,700 for self-only coverage or $5,450 for family coverage (for 2006). Additional contributions permitted for individuals age 55 or older. No limit on the amount that can be accumulated in the HSA.	Qualified medical expenses include those for medical care (as defined under section 213(d)), but do not include expenses for insurance other than certain limited exceptions.
9. Archer Medical Savings Accounts ("Archer MSAs") (sec. 220)	Contributions are deductible if made by an eligible individual and excluded from gross income and wages if made by an employer. Distributions used for qualified medical expenses are excludable from gross income. Earnings on	Employees of small employers who are covered under an employer-sponsored high-deductible health plan (and no other health plan other than a plan that provides certain permitted coverage) and self-employed individuals	Maximum annual contribution is 65 percent of the annual deductible under the high-deductible health plan in the case of self-only coverage, and 75 percent of the annual deductible in the case of family coverage. No limit on the amount that can	Qualified medical expenses include those for medical care as defined under section 213(d), but do not include expenses for insurance other than certain limited exceptions.

Provision	Tax Benefit	Class Eligible	Maximum Dollar Limit on Tax Benefit	Qualified Costs/Expenses
	amounts in the Archer MSA accumulate on a tax-free basis.	covered under a high-deductible health plan. Definition of high-deductible health plan differs from that for HSAs. No new contributions may be made after 2005 except for individuals who previously had an MSA or work for an employer that made MSA contributions.	be accumulated in the MSA.	
10. Health Coverage Tax Credit (sec. 35)	Refundable tax credit of 65 percent of the cost of qualified health insurance coverage.	Individuals receiving trade adjustment assistance and certain individuals receiving benefits from the PBGC.	Limited to 65 percent of the cost of qualified health insurance. No specific dollar limit.	Qualified health insurance as defined in section 35(e).

Health FSAs are funded on a salary reduction basis, meaning that employees are given the option to reduce current compensation and instead have the compensation used to reimburse the employee for medical expenses. If the health FSA meets certain requirements, the compensation that is forgone is not includible in gross income or wages and reimbursements for medical care from the health FSA are excludable from gross income and wages. Health FSAs are subject to the requirements relating to cafeteria plans generally, including a requirement that a cafeteria plan generally may not provide deferred compensation.[4] This requirement is often referred to as the "use-it-or-lose-it-rule." Until May of 2005, this requirement was interpreted to mean that amounts remaining in a health FSA as of the end of a plan year must be forfeited by the employee. In May 2005, the Treasury Department issued a notice that allows a grace period not to exceed two and one-half months immediately following the end of the plan year during which unused amounts may be used.[5] Health FSAs are subject to certain other requirements, including rules that require that the FSA have certain characteristics similar to insurance.

Health reimbursement arrangements ("HRAs") operate in a manner similar to health FSAs, in that they are an employer-maintained arrangement that reimburses employees for medical expenses. Some of the rules applicable to HRAs and health FSAs are similar, e.g., the amounts in the arrangements can only be used to reimburse medical expenses and not for other purposes. Some of the rules are different. For example, HRAs cannot be funded on a salary reduction basis and the use-it-or-lose-it rule does not apply. Thus, amounts remaining at the end of the year may be carried forward to be used to reimburse medical expenses in the next year.[6]

Deduction for health insurance expenses of self-employed individuals[7]

Self-employed individuals may deduct the cost of health insurance for themselves and their spouses and dependents. The deduction is not available for any month in which the self-employed individual is eligible to participate in an employer-subsidized health plan. The deduction may not exceed the individual's self-employment income. The deduction applies to the cost of insurance, i.e., it does not apply to out-of-pocket expenses. The deduction does not apply for self-employment tax purposes. For purposes of the deduction, more than two-percent shareholder-employees of an S corporation are treated the same as self-employed individuals.[8] Thus, the exclusion for employer-provided health coverage does not apply to such individuals, but they are entitled to the deduction for health insurance costs as if they were self employed.

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[4] Sec. 125(d)(2).

[5] Notice 2005-42, 2005-23 I.R.B. 1204.

[6] Guidance with respect to HRAs, including the interaction of FSAs and HRAs in the case an individual is covered under both, is provided in Notice 2002-45, 2002-2 C.B. 93.

[7] Sec. 162(l).

[8] Sec. 1372.

Itemized deduction for medical expenses[9]

Individuals may claim an itemized deduction for unreimbursed medical expenses, but only to the extent that such expenses exceed 7.5 percent of adjusted gross income.[10] Thus, an individual (other than a self-employed individual) may deduct health insurance premiums only to the extent that aggregate unreimbursed medical expenses exceed 7.5 percent of adjusted gross income.

Refundable credit for health insurance expenses of certain classes of individuals[11]

Under the Trade Adjustment Assistance Reform Act of 2002,[12] certain individuals are eligible for the health coverage tax credit ("HCTC"). The HCTC is a refundable tax credit equal to 65 percent of the cost of qualified health coverage paid by an eligible individual. In general, eligible individuals are individuals receiving a trade adjustment allowance (and individuals who would be eligible to receive such an allowance but for the fact that they had not exhausted their regular unemployment benefits), individuals eligible for the alternative trade adjustment assistance program, and individuals over age 55 and receiving pension benefits from the Pension Benefit Guaranty Corporation. The credit is available for "qualified health insurance," which includes certain employer-based insurance, certain State-based insurance, and in some cases, insurance purchased in the individual market. The credit is available on an advance basis through a program established by the Secretary of the Treasury. Persons entitled to Medicare and certain other governmental health programs, covered under certain employer-subsidized plans, or with certain other specified coverage are not eligible for the credit.[13]

Health savings accounts[14]

Present law provides that individuals with a high deductible health plan (and no other health plan other than a plan that provides certain permitted coverage[15]) may establish an HSA.

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[9] Sec. 213.

[10] For alternative minimum tax purposes, the itemized deduction is calculated using a floor of 10 percent of adjusted gross income. Sec. 56(b)(1)(B).

[11] Sec. 35.

[12] Pub. L. No. 107-210, sec. 201(a), 202 and 203 (2002).

[13] Sec. 35(f).

[14] Sec. 223.

[15] An individual with other coverage in addition to a high deductible health plan is still eligible for an HSA if such other coverage is certain permitted insurance or permitted coverage. Permitted insurance is: (1) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such other similar liabilities as the Secretary may prescribe by regulations; (2) insurance for a specified disease or illness; and (3) insurance that

An HSA is a tax-exempt trust or custodial account. Subject to certain limitations, contributions to an HSA are deductible above-the-line if made by the individual and are excludable from income and wages if made by the employer (including contributions made through a cafeteria plan through salary reduction). Earnings on amounts in an HSA accumulate on a tax-free basis. Distributions from an HSA that are for qualified medical expenses are excludable from gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 10 percent. However, the additional 10 percent tax does not apply if the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65). Thus, HSAs provide the opportunity to pay for current out-of-pocket medical expenses on a tax-favored basis, as well as the ability to save for future medical and nonmedical expenses. To the extent that amount in an HSA are not used for qualified expenses, an HSA provides tax benefits similar to an individual retirement arrangement ("IRA").[16]

Qualified medical expenses generally are defined as under section 213(d) and include expenses for diagnosis, cure, mitigation, treatment, or prevention of disease, including prescription drugs, transportation primarily for and essential to such care, and qualified long-term care expenses. Qualified medical expenses do not include expenses for insurance other than for (1) long-term care insurance, (2) premiums for health coverage during any period of continuation coverage required by Federal law, (3) premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law, and (4) premiums for individuals eligible for Medicare, other than premiums for Medigap policies.

A high deductible health plan is a health plan that has a deductible that is at least $1,050 for self-only coverage or $2,100 for family coverage (for 2006) and that has an out-of-pocket expense limit that is no more than $5,250 in the case of self-only coverage and $10,500 in the case of family coverage (for 2006).[17]

The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100 percent of the annual deductible under the high deductible health plan, or (2) for 2006, $2,700 in the case of self-only coverage and $5,450 in the case of family coverage.[18] The annual

provides a fixed payment for hospitalization. Permitted coverage is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

[16] Other tax-favored vehicles may also be used to save for future medical expenses, but do not provide the same tax benefits. For example, funds in an IRA may be used to pay medical expenses, but distributions for medical expenses are includible in gross income to the same extent as other IRA distributions.

[17] These amounts are indexed for inflation.

[18] These amounts are the same as the maximum deductible amounts permitted under a high deductible plan for purposes of Archer medical savings accounts ("MSAs") and are indexed for inflation. In the case of individuals who are married to each other, if either spouse has family coverage, both spouses are treated as only having the family coverage with the lowest deductible and the contribution limit is divided equally between them unless they agree on a different division.

contribution limits are increased for individuals who have attained age 55 by the end of the taxable year (referred to as "catch up contributions"). In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by $700 in 2006, $800 in 2007, $900 in 2008, and $1,000 in 2009 and thereafter. Contributions, including catch-up contributions, cannot be made once an individual is eligible for Medicare.

If an employer makes contributions to employees' HSAs, the employer must make available comparable contributions on behalf of all employees with comparable coverage during the same period. Contributions are considered comparable if they are either of the same amount or the same percentage of the deductible under the plan. If employer contributions do not satisfy the comparability rule during a period, then the employer is subject to an excise tax equal to 35 percent of the aggregate amount contributed by the employer to HSAs for that period.

Amounts can be rolled over into an HSA from another HSA or from an Archer MSA.

Archer medical savings accounts ("MSAs")[19]

Like HSAs, an Archer MSA is a tax-exempt trust or custodial account to which tax-deductible contributions may be made by individuals with a high deductible health plan. Archer MSAs provide tax benefits similar to, but generally not as favorable as, those provided by HSAs for certain individuals covered by high deductible health plans.

The rules relating to Archer MSAs and HSAs are similar. The main differences include: (1) only self-employed individuals and employees of small employers are eligible to have an Archer MSA; (2) for Archer MSA purposes, a high deductible health plan is a health plan with (a) an annual deductible of at least $1,800 and no more than $2,700 in the case of self-only coverage and at least $3,650 and no more than $5,450 in the case of family coverage and (b) maximum out-of pocket expenses of no more than $3,650 in the case of self-only coverage and no more than $6,650 in the case of family coverage;[20] and (3) the additional tax on distributions not used for medical expenses is 15 percent rather than 10 percent.

After 2005, no new contributions can be made to Archer MSAs except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer.

Definition of medical care

For purposes of the itemized deduction for medical expenses, section 213(d) defines "medical care" to mean amounts paid for: (1) the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body; (2)

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[19] Sec. 220.

[20] The deductible and out-of-pocket expenses dollar amounts are for 2006. These amounts are indexed for inflation in $50 increments.

transportation primarily for and essential to medical care referred to in (1); (3) qualified long-term care services; and (4) insurance covering medical care referred to in (1) or (2), or for eligible long-term care premiums for a qualified long-term care insurance contract.[21] Expenditures for items that are merely beneficial to the general health of an individual, such as expenditures for vacations or vitamins, are not medical care. Expenditures for "medicines and drugs" are medical care. Toiletries (e.g., toothpaste), cosmetics (e.g., face creams), and sundry items are not "medicines and drugs" and amounts expended for such items are not expenditures for "medical care." In general, cosmetic surgery and similar procedures do not constitute medical care.

For purposes of the exclusions for reimbursements under employer accident and health plans and distributions from HSAs, the limitation (applicable to the itemized deduction) that only prescription medicines or drugs and insulin are taken into account does not apply. Thus, for example, amounts paid from an FSA, HRA, or HSA to reimburse the employee for nonprescription medicines, such as sunscreen, nonprescription aspirin, allergy medicine, antacids, or pain relievers, are excludable from income; however, if the employee paid for such amounts directly (without such reimbursement), the expenses could not be taken into account in determining the itemized deduction for medical expenses.

[21] Sec. 213(d). The amount of long-term care premiums that may be taken into account for purposes of the itemized deduction is subject to a dollar limit based on the age of the covered individual.

III. DISCUSSION OF ISSUES RAISED UNDER PRESENT LAW

The present-law Federal tax treatment of health expenses has been the subject of discussion over time from a variety of perspectives, including as part of debates relating to health care reform and tax reform. The exclusion for employer-provided health care is typically a focal point of such discussions. The exclusion represents a departure from the normal income tax principle that compensation should be included in income, and has consistently been one of the three largest tax expenditure items.[22] With the more recent enactment of HSAs, they have also been the subject of debate.

The present-law favorable tax treatment of employer-provided health coverage has generally been justified on the grounds that it encourages employees to prefer health coverage over taxable compensation, thereby increasing health insurance coverage and reducing the number of uninsured. Employees in employer-provided health plans not only receive a tax subsidy, but the employer market also provides a pooling mechanism which may make coverage more affordable. From this perspective, the exclusion may be said to be effective. For 2005, approximately 90 million policyholders are estimated to have employer-provided health coverage.[23]

Nevertheless, the present-law rules have been the subject of a number of criticisms. One criticism is that the present-law rules are inequitable because they do not provide a consistent tax benefit for health coverage. Some argue that this inequity provides the worst treatment in some cases for those who need the tax benefit the most, because many individuals who face the highest insurance rates also receive no tax subsidy for the purchase of such insurance (i.e., individuals who are not self employed and who do not receive coverage through their employer, but purchase insurance in the individual market, receive no tax subsidy unless their health expenses exceed 7.5 percent of adjusted gross income). Some argue that this inequity combined with the lack of group rates in the individual market may lead to some persons remaining uninsured.

The most favorable tax treatment under present law generally is provided to individuals who are in an employer plan.[24] Such individuals may exclude from income and wages employer-provided health insurance and, depending on the employer's plan, may also exclude from income amounts expended for medical care not covered by insurance. Self-employed individuals receive the next most favorable treatment, and may deduct 100 percent of the cost of

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[22] For Federal fiscal years 2006-2010, the tax expenditure for the exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums is estimated to be $534 billion. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2006-2010* (JCS-2-06), April 25, 2006.

[23] The number of those insured through the employer market is higher, as many policies cover more than one individual, e.g., the policyholder and his or her family.

[24] The refundable HCTC provides a greater tax benefit than the exclusion. However, the credit is available to only limited classes of taxpayers. Less than one-half million taxpayers per year are estimated to be eligible for the credit.

their health insurance. Individuals who are not self employed and pay for their own health insurance receive the least favorable tax treatment; such individuals may deduct the cost of health insurance only to the extent that aggregate medical expenses exceed 7.5 percent of adjusted gross income and only if they itemize deductions. In the case of individuals covered by a high deductible health plan, the relatively recently-enacted provisions relating to HSAs alter this comparison to some extent; however, those with employer coverage still have the highest potential tax benefit.[25] Table 2, below, shows an example of the various tax treatments of medical expenses for an individual depending on the individual's circumstances. Table 3, below, shows an example of the various tax treatments of medical expenses for an individual with an HSA.

The present-law tax benefits for health coverage have been criticized as contributing to higher health care costs because individuals are not faced with the full cost of health care. That is, the cost of insurance or out-of-pocket expenses paid by the individual is reduced by the tax benefit received, effectively reducing the price of health care relative to other goods.[26] In addition, some argue that the unlimited exclusion for employer-provided coverage leads to very generous insurance coverage, which further contributes to increases in health costs because individuals are not as likely to question medical treatments to the extent the cost is paid by a third party through insurance.

It is also argued that employer-based health coverage may contribute to "job lock" because individuals may be concerned that their health coverage will change if they change employers. The rules relating to continuation coverage, pre-existing conditions limitations and certain other provisions are intended to lessen "job lock" effects.

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[25] With an HSA, both self-employed individuals and those with employer-provided coverage receive a tax benefit for the purchase of the health insurance as well as a tax benefit for out-of-pocket expenses (through the HSA). However, in some circumstances, an employee could, in addition, have an FSA or HRA that provides coverage for additional expenses on a tax-free basis. Thus, for example, an employer plan could provide that the cost of a high deductible plan is paid by the employer and could also allow an FSA that provides certain limited coverage, e.g., for dental or vision benefits. In addition, under Treasury guidance, the individual could also have an FSA or HRA in certain other situations, such as an FSA or HRA that pays expenses in excess of the deductible under the high deductible plan. In such cases, the individual could also have an HSA to which deductible contributions could be made. A self-employed individual, in contrast, would not have the opportunity to have an FSA or HRA. Individuals (other than self-employed individuals) who purchase a high deductible plan may make deductible contributions to an HSA, but would not receive a subsidy for the purchase of the insurance unless aggregate medical expenses exceed the adjusted gross income threshold. There is not always a clear distinction between out-of-pocket expenses and expenses covered by insurance, because insurance policies differ. That is, some insurance policies will cover expenses that are out-of-pocket expenses under other policies.

[26] Specifically, because of the income tax exclusion, a dollar of consumption of tax-favored health care actually costs the taxpayer only \$(1-t), where t is the tax rate of the individual. In other words, the taxpayer is able to convert \$(1-t) dollars of after-tax income into \$1 of health consumption. The last column of Tables 2 and 3 reports the value of the tax subsidy as a percentage of the total health costs.

HSAs provide a subsidy specifically for high deductible health insurance. Proponents of HSAs believe that the use of high deductible plans promotes responsible health policy by making individuals more conscious of their health care costs because fewer expenses are paid by a third party insurer. This, in turn, is anticipated to reduce overall health care costs. Some proponents of HSAs believe that many current health insurance policies cover routine medical expenses and that the tax laws should provide a subsidy only for insurance for unpredictable medical expenses.

Those who do not favor providing additional tax benefits for high deductible plans are concerned that such plans are likely to be more attractive to healthier individuals, with the result that adverse selection will occur which will erode the group market and result in higher insurance costs for individuals with greater health risks. This may occur because when insurance is priced on a group basis, individuals with lower health risks in effect subsidize higher risk individuals. Tax-favored high deductible plans are likely to be more attractive to lower risk individuals. If they leave the pool, however, the average cost increases for those remaining. This, in turn, may cause more lower risk individuals to leave the pool, with a concomitant rise in cost for those remaining. Some argue that this effect is likely to occur with a subsidy for high deductible plans.

There is also disagreement regarding the effects of high deductible plans (and HSAs) on health care costs. As noted above, a basic premise underlying high deductible plans is that individuals will make wiser choices if faced with the cost of medical treatments and that this will reduce health care costs overall. On the other hand, some note that the existence of the HSA itself may undermine the goal of making individuals more conscious of heath care costs because it provides a subsidy for the first dollar of medical expenses. Thus, medical expenses not covered by the high deductible plan receive a tax subsidy, even though they are not covered by insurance. Others are concerned that even if individuals do spend less on health costs with a high deductible plan, this may not necessarily result in better health outcomes or a long-term reduction in costs. For example, it is noted that it may be very difficult for an individual to determine whether a particular medical procedure is in fact needed, and that some individuals will forgo needed care if it is not covered by insurance, with the possibility that longer-term medical costs increase.

To the extent that amounts in HSAs are not used for current medical expenses, HSAs provide a tax benefit similar to that of an IRA. HSA proponents argue that this feature may help contribute to lowering medical costs by in effect rewarding lower spending on medical care. Others argue that this feature operates to make HSAs primarily attractive to higher income individuals who can afford to self insure for the higher deductible under the high deductible plan and who are primarily interested in a tax-favored savings vehicle.

Some argue that the present-law tax treatment of health coverage is inappropriate because it is not neutral. That is, the present-law rules create distinctions in both the way the coverage is purchased (e.g., through an employer or the individual market) and the type of insurance (e.g., high deductible policies or another type of policy).

Discussions regarding inequities of the present-law rules typically do not include the itemized deduction for medical expenses that exceed 7.5 percent of adjusted gross income. This is because that deduction is generally viewed as having a different policy rationale than the other provisions relating to health care. While the other provisions are generally intended to provide subsidies in various ways for the purchase of health care, the policy behind the itemized deduction for medical expenses is that such expenses generally are not discretionary and that high levels of such expenses adversely impact the individual's ability to pay taxes.

Table 2.–Comparison of Value of Health Tax Benefits: Non-High-Deductible Health Plan

Assume that husband (H) has a health insurance plan that provides coverage for his wife (W) and dependents. The policy's premium is $850 per month ($10,200 annually) and has a $700 deductible. The family's out-of-pocket expenses are approximately $1,400 for the year. Thus, H's annual medical costs are $11,600. H and W file a joint income tax return and their annual adjusted gross income is $70,000.

Situation	Tax-Subsidized Employer Premiums	Tax-Subsidized Employee Premiums	Tax-Subsidized Out-of-Pocket Expenses	Value of Employment Tax[1] (E) and Income Tax[2] (I) Subsidy	Value of Total Tax Subsidy as a Percentage of Total Health Costs
(a) H's health insurance is provided through his employer. The employer pays 75 percent of the premium for such coverage.	$7,650	$0	$0	$1,086 (E) $1,760 (I) $2,846 total	25%
(b) The employer also allows the employee's share of the annual premium to be paid on a tax-free basis (i.e., through a cafeteria plan).	$7,650	$2,550	$0	$1,448 (E) $2,346 (I) $3,794 total	33%
(c) The employer also offers a reimbursement account (i.e., either a health flexible spending arrangement or a health reimbursement arrangement).	$7,650	$2,550	$1,400	$1,647 (E) $2,668 (I) $4,315 total	37%
(d) H is self-employed.[3]	NA	$10,200	$0	$0 (E) $2,346 (I)	20%
(e) H does not have employer-provided coverage and is not self-employed.[3]	NA	Taken into account in determining itemized deduction of $6,350[4]	Taken into account in determining itemized deduction of $6,350[4]	$0 (E) $1,461 (I)	13%

[1] The employment tax subsidy includes both the employer and employee portions of old-age, survivors, and disability insurance ("OASDI") and hospital insurance ("HI"). The effective employment tax subsidy rate is the combined employer and employee tax rate divided by gross-of-tax compensation. The effective subsidy is thus 0.153 *(1 + .0765) = 14.2%

[2] This example assumes an effective income tax rate of 23 percent.

[3] This example ignores the fact that this policy in an individual market would either be more expensive or provide less comprehensive coverage.

[4] Medical expenses are deductible to the extent they exceed 7.5 percent of adjusted gross income ($70,000 X 7.5% = $5,250. $11,600 - $5,250 = $6,350). For alternative minimum tax purposes, medical expenses are deductible to the extent they exceed 10 percent of adjusted gross income.

Table 3.–Comparison of Value of Health Tax Benefits: High-Deductible Health Plan

Assume that H has a high-deductible health insurance plan that provides coverage for his wife (W) and dependents. The policy's premium is $765 per month ($9,180 annually) and has a $2,000 deductible. H is eligible to make contributions to a health savings account ("HSA"). The family's out-of-pocket expenses are approximately $2,420 for the year. Thus, H's annual medical costs are $11,600. H and W file a joint income tax return and their annual adjusted gross income is $70,000.

Situation	Tax-Subsidized Employer Premiums	Tax-Subsidized Employee Premiums	Tax-Subsidized Out-of-Pocket Expenses	Tax-Deductible HSA Contribution[1]	Value of Employment Tax[2] (E) and Income Tax[3] (I) Subsidy	Value of Total Tax Subsidy as a Percentage of Total Health Costs
(a) H's health insurance is provided through his employer. The employer pays 75 percent of the premium for such coverage.	$6,885	$0	$0	$2,000	$ 978 (E) $2,044 (I) $3,022 total	26%
(b) The employer also allows the employee's share of the annual premium to be paid on a tax-free basis (i.e., through a cafeteria plan).	$6,885	$2,295	$0	$2,000	$1,304 (E) $2,571 (I) $3,875 total	33%
(c) The employer also offers a reimbursement account (i.e., either a health flexible spending arrangement or a health reimbursement arrangement).	$6,885	$2,295	$2,420[4]	$2,000	$1,647 (E) $3,128 (I) $4,775 total	41%
(d) H is self-employed.[5]	NA	$9,180	$0	$2,000	$0 (E) $2,571 (I)	22%
(e) H does not have employer-provided coverage and is not self-employed.[5]	NA	Taken into account in determining itemized deduction of $6,350[6]	Taken into account in determining itemized deduction of $6,350[6]	$2,000	$0 (E) $1,921 (I)	17%

[1] Amounts contributed to a HSA can be used to pay qualified out-of-pocket expenses on a tax-free basis.

[2] The employment tax subsidy includes both the employer and employee portions of old-age, survivors, and disability insurance ("OASDI") and hospital insurance ("HI"). This example assumes that HSA contributions are made by the taxpayer. HSA contributions made by the employer would also be excluded from wages for employment tax purposes. See footnote 1 to Table 2 for calculation of employment tax subsidy.

[3] This example assumes an effective income tax rate of 23 percent.

[4] Individuals eligible to make contributions to an HSA must have a high deductible health plan and no other health plan, other than certain permitted coverage. The reimbursement account is permitted if it allows reimbursements only for certain limited purposes (e.g., vision or dental) or in certain other limited situations.

[5] This example ignores the fact that this policy in an individual market would either be more expensive or provide less comprehensive coverage.

[6] Medical expenses are deductible to the extent they exceed 7.5 percent of adjusted gross income ($70,000 X 7.5% = $5,250. $11,600 - $5,250 = $6,350). For alternative minimum tax purposes, medical expenses are deductible to the extent they exceed 10 percent of adjusted gross income. Distributions from an HSA are not taken into account in determining the itemized deduction. If H used distributions of $2,000 from his HSA to pay qualified medical expenses, the itemized deduction would be limited to $4,350.