JOINT COMMITTEE ON TAXATION
March 16, 2011
JCX-18-11

TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE HOUSE COMMITTEE ON WAYS AND MEANS HEARING ON H.R. 3, THE "NO TAXPAYER FUNDING FOR ABORTION ACT," AS REPORTED BY THE HOUSE COMMITTEE ON THE JUDICIARY[1]

MARCH 16, 2011

My name is Thomas A. Barthold. I am Chief of Staff of the Joint Committee on Taxation. It is my pleasure to present the testimony of the staff of the Joint Committee on Taxation today concerning the potential effects on the Internal Revenue Code of H.R. 3, the "No Taxpayer Funding for Abortion Act," as reported by the House Committee on the Judiciary and H.R. 358, the "Protect Life Act."

I. OVERVIEW

H.R. 3, the "No Taxpayer Funding for Abortion Act," as reported by the House Committee on the Judiciary, (hereinafter the "bill") does not amend the Internal Revenue Code (the "Code"). The bill does, however, directly affect the Code by prohibiting certain tax benefits from being used to pay for abortions or for health benefit plans that cover abortions. In particular, section 303 of the bill seeks to prevent abortions from being paid for with Federal tax credits or deductions or with funds withdrawn on a tax-preferred basis from certain trusts and accounts.

The bill provides that, for taxable years beginning after date of enactment:

1. No tax credit is allowed with respect to amounts paid or incurred for an abortion or with respect to amounts paid or incurred for a health benefits plan (including premium assistance) that includes coverage of abortion (subsection 303(1) of the bill);

[1] This document may be cited as follows: Joint Committee on Taxation, Testimony of the Staff of the Joint Committee on Taxation Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means Hearing on H.R. 3, the "No Taxpayer Funding for Abortion Act," as Reported by the House Committee on the Judiciary (JCX-18-11), March 16, 2011. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

2. Amounts paid or incurred for an abortion may not be taken into account for purposes of determining any tax deductions for expenses paid for the medical care of a taxpayer or the taxpayer's spouse or dependents (subsection 303(2) of the bill); and

3. Any amount paid or distributed from certain tax-preferred trusts or accounts for an abortion must be included in gross income (subsection 303(3) of the bill).

The purpose of my testimony today is to outline some of the key tax-related features of the bill, to explain which provisions of the Code are clearly implicated by the bill and which provisions might be implicated, and to discuss certain questions raised by ambiguities in the bill's language.

As mentioned above, the bill does not directly amend the Code. Consequently there is some uncertainty about which Code provisions are affected by the bill. This uncertainty relating to the scope of the bill is increased because the bill does not define certain key terms. These undefined terms include: which Code sections count as "credits" under the internal revenue laws, what vehicles are considered to be "tax-preferred trusts or accounts" from which funds may not be withdrawn on a tax-preferred basis, and which "taxpayers" are intended to be prohibited from using tax benefits to pay for abortions.

Certain health-benefits related sections of the Code are definitely impacted by the bill. These sections include the health care tax credit, the premium assistance credit, the Indian employment credit, the small business health care credit, and the individual deduction for medical expenses. All of these sections contain tax credits and deductions that are clearly defined in the Code and that directly relate to the taxation of health benefits and medical expenses.

It is also clear that if a taxpayer withdraws funds from an Archer Medical Savings Account ("Archer MSA") or a Health Savings Account ("HSA") to pay for an abortion then the amount of the withdrawn funds must be included in income. This is because both Archer MSAs and HSAs are tax-exempt, that is, "tax-preferred," trusts or accounts the funds of which are held exclusively for the payment of qualified medical expenses. They thus come directly under the aegis of the bill.

Other sections of the Code may be impacted by the bill as well, depending on the interpretation of the bill's language. These sections include COBRA premium assistance, the deduction for general business expenses, and the research credit. Whether COBRA premium assistance is affected by the bill depends on whether repayment of the premium assistance amount to employers by the Internal Revenue Service ("IRS") is better understood as a tax "credit" or as a procedural device for purposes of the bill. Whether the deduction for general business expenses is affected by the bill depends on whether the term "taxpayer" is, for purposes of subsection 303(2) of the bill, understood to mean only an individual or both individuals and entities. Whether the research credit is affected depends both on how broadly the phrase "amounts paid or incurred for an abortion" is interpreted and on the intended scope of the legislation.

Under the bill, distributions or payments under employer sponsored health plans using integral governmental trusts, retiree medical accounts, welfare benefit funds (including voluntary employee beneficiary associations ("VEBAs")) health flexible spending arrangements ("health FSAs") and health reimbursement arrangements ("HRAs") might need to be included in income if used to pay for an abortion. Whether employer sponsored health plans using these arrangements are affected depends on the interpretation of the bill's language; in particular it is unclear whether these vehicles are "tax-preferred trusts or accounts" for purposes of the bill.

H.R. 358, the "Protect Life Act," amends the Patient Protection and Affordable Care Act, as amended ("PPACA"), [2] to prohibit use of premium assistance credits for qualified health plans that offer abortion coverage.

[2] Pub. L. No. 111-148.

II. EXPLANATION OF THE TAX-RELATED PROVISIONS OF THE BILL

A. Introduction

Section 303 of the bill prohibits the use of certain tax benefits to pay for abortions, and, in some cases, to pay for health benefits plans that include abortion coverage. In particular, the bill provides that for taxable years beginning after date of enactment:

1. No tax credit is allowed with respect to amounts paid or incurred for an abortion or with respect to amounts paid or incurred for a health benefits plan (including premium assistance) that includes coverage of abortion (subsection 303(1) of the bill);

2. Amounts paid or incurred for an abortion may not be taken into account for purposes of determining any tax deductions for expenses paid for the medical care of a taxpayer or the taxpayer's spouse or dependents (subsection 303(2) of the bill); and

3. Any amount paid or distributed from certain tax-preferred trusts or accounts for an abortion must be included in gross income (subsection 303(3) of the bill).

The bill does not define certain key terms, and as a result the scope of the Federal tax law changes made by the bill is not entirely clear. For example, the term "abortion" is not defined in the legislative language.[3] The scope of the term determines the applicability of the bill in specific situations – for example, whether the health care tax credit may be used to pay for health plans that cover emergency contraception – but it does not, for the most part, affect the analysis of which Federal tax provisions are affected by the bill. Other terms that are essential for understanding the scope of the bill – including "taxpayer" and "tax-preferred trust or account" – are important for our tax analysis and are discussed in detail below.

The bill explicitly disallows the use of tax credits and tax deductions to pay for abortions and requires income inclusion when payments for abortion are made from tax-favored medical trusts and accounts. The bill does not, however, generally attempt to change present law with respect to tax exclusions for employer provided health care. Thus, Code sections 104 (relating to the exclusion for compensation for injuries or sickness), 105 (relating to the exclusion for amounts received under accident and health plans), and 106 (relating to the exclusion for contributions by an employer to accident and health plans) are not implicated by subsections 303(1) or 303(2) of the bill. Subsection 303(3) does, however, override the exclusion from income under sections 104 and 105 for payments to reimburse the cost of medical care in the form of abortion services made from a tax-preferred trust or account.

[3] Certain obstetric treatments are expressly carved out of the bill's purview, including the treatment of any infection, injury, disease, or disorder caused or exacerbated by the performance of an abortion, abortions of pregnancies resulting from rape or incest, and abortions where the woman would be in danger of death were the pregnancy not terminated. Secs. 308 and 309 of the bill.

B. Tax Credits (Subsection 303(1) of the Bill)

Subsection 303(1) of the bill provides that, for taxable years beginning after the date of enactment, "no credit shall be allowed under the internal revenue laws with respect to amounts paid or incurred for an abortion or with respect to amounts paid or incurred for a health benefits plan (including premium assistance) that includes coverage of abortion."

There are several tax credits relating to health benefit plans definitely impacted by the bill. There are certain other credits for which the implications of the bill, if any, are uncertain. I will discuss both categories of credits: first those health related credits that are definitely affected and then those credits which might arguably be affected.

1. Health related credits affected by the bill

In the opinion of the staff of the Joint Committee on Taxation ("Joint Committee staff") the application of the following Code sections are definitely affected by subsection 303(1):

Health insurance costs of eligible individuals ("HCTC")

Present Law

Section 35 provides for a health care 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 who receive a trade adjustment allowance (and individuals who would be eligible to receive such an allowance but for the fact that they had not exhausted regular unemployment benefits), individuals eligible for the alternative trade adjustment assistance program, and individuals over age 55 who receive pension benefits from the Pension Benefit Guaranty Corporation. The credit is available for "qualified health insurance," which includes certain employer-based insurance, State-based insurance, and in some cases, insurance purchased in the individual market.

Implications of the Bill

Under subsection 303(1), the HCTC is disallowed for qualified health insurance plans that include abortion coverage. For at least some eligible individuals, there may not be a choice of qualified health insurance available to them that does not include abortion coverage and, thus, subsection 303(1) may effectively deny access to the credit for those individuals.

Refundable credit for coverage under a qualified health plan

Present Law

Section 36B, added to the Code by PPACA provides a refundable tax credit (the "premium assistance credit") for eligible individuals and families who purchase health insurance

through a health insurance exchange.[4] The premium assistance credit, which is refundable and payable in advance directly to the insurer, subsidizes the purchase of certain health insurance plans through an exchange.

The premium assistance credit is generally available for individuals (single or joint filers) with household incomes between 100 and 400 percent of the Federal poverty level for the family size. Individuals who are eligible for certain other health insurance, including certain health insurance provided through an employer or a spouse's employer, may not be eligible for the credit.

Section 1303 of PPACA includes a provision that disallows the application of the premium assistance credit to the cost of abortion coverage. To prevent the premium assistance credit from being used for the cost of abortion coverage, section 1303 requires that the portion of any premium attributable to the cost of abortion coverage be paid for separately, either with a separate check or, in the case of payroll deductions, a separate deduction. Section 1303 further requires that the separate payments be allocated to a segregated account under the health plan and that the cost of abortion services covered under the plan only be reimbursed from funds in the segregated account. Under preexisting law this separate payment of premiums and segregation of the assets alone is not sufficient to treat abortion coverage as being offered under a separate health plan. Rather, there must also be a separate election to purchase the coverage of abortion and a separate election to purchase the portion of the plan that does not cover abortion.[5]

Implications of the Bill

Under subsection 303(1) of the bill, the premium assistance credit may not be applied towards the purchase of health insurance plans that include abortion coverage. This provision could effectively preclude individuals from having access to the premium assistance credit unless their exchange offers plans that do not include abortion coverage. If providers decide to offer comprehensive medical plans that do not offer abortion coverage and separate plans that only offer abortion coverage, rather than following the allocation procedures laid out in section 1303, then the credit could presumably be used for the plans that do not provide abortion coverage.

Indian employment credit

Present Law

Section 45A provides a credit to employers against income tax liability for, among other costs, qualified employee health insurance costs paid or incurred by the employer with respect to certain employees who are either enrolled members of an Indian tribe or the spouse of an

[4] Under PPACA, States are required to establish American Health Benefit Exchanges, commonly referred to simply as "exchanges." These exchanges will be governmental agencies or nonprofit entities that, among other services, facilitate the purchase of health plans that meet certain minimum enrollment and benefit requirements.

[5] See Treas. Reg. sec. 54.9831-1(c)(3) for the rules for determining when limited excepted benefits are not an integral part of a group health plan.

enrolled member.[6] Qualified employee health insurance costs are any amounts paid or incurred by an employer for health insurance to the extent that such amounts are attributable to coverage provided to any qualified employee.

Implications of the Bill

Subsection 303(1) of the bill would disallow the Indian employment credit for qualified employee health insurance that includes abortion coverage.

Employee health insurance expenses of small employers

Present Law

The small business health care tax credit under Code section 45R, added to the Code by PPACA, is generally available to qualified small employers paying at least half of the premiums for single health insurance coverage for their employees. Small businesses can claim the credit for tax years 2010 through 2013 and for any two years after that. For tax years 2010 to 2013, the maximum credit is 35 percent of premiums paid by eligible small businesses and 25 percent of premiums paid by eligible tax-exempt organizations. Beginning in 2014, the maximum tax credit will increase to 50 percent of premiums paid by eligible small business employers and 35 percent of premiums paid by eligible tax-exempt organizations.

For any taxable year beginning in 2010, 2011, 2012, or 2013, qualifying health insurance for purposes of claiming the credit is health insurance coverage within the meaning of section 9832, which is generally health insurance coverage purchased from an insurance company licensed under State law. For taxable years beginning in years after 2013, the credit is only available to a qualified small employer that purchases health insurance coverage for its employees through a State exchange.

Implications of the Bill

Subsection 303(1) of the bill would disallow the small business health care tax credit for employee health insurance that includes abortion coverage. This provision could effectively preclude some small employers from having access to the credit for years after 2013, unless the exchange in an employer's State offers plans that do not include abortion coverage.

2. Credits potentially affected by the bill

The application of the following Code sections could be affected by subsection 303(1):

[6] Section 38 provides the operative rules for claiming general business credits including the Indian employment credit. Section 39 provides the operative rules for carrying forward and carrying back to future or prior taxable years unused general business credits. Because certain business related credits may involve amounts "paid or incurred for a health benefits plan…that includes coverage of abortion" (e.g., the Indian employment credit), application of sections 38 and 39 is necessarily implicated by the bill in such instances.

COBRA premium assistance

Present Law

The Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA")[7] gives employees who lose health coverage as a result of termination of employment a limited right to elect to purchase group health coverage sponsored by their former employer. Premiums for COBRA continuation coverage may not exceed 102 percent of the cost to the plan for similarly situated individuals who are not covered under COBRA.

The American Recovery and Reinvestment Act of 2009 ("ARRA")[8] provides a temporary COBRA premium reduction for eligible individuals who were involuntarily terminated from employment on or prior to May 31, 2010 (Code section 6432). For up to 15 months, eligible individuals are entitled to a subsidy equal to 65 percent of their monthly COBRA premium. (The last month that any individual would be eligible for an ARRA COBRA subsidy is August 2011.)

Subsidy eligible individuals pay 35 percent of their premiums, and the government reimburses the remaining 65 percent to the person to whom the COBRA premiums are payable, usually the subsidy eligible individual's former employer. Procedurally, the reimbursement is accomplished through treating the person seeking reimbursement as having paid payroll taxes to the IRS in an amount equal to the amount the person is owed in COBRA premium reimbursements. Persons seeking reimbursement may claim a credit on Forms 941, 943 or 944.

Implications of the Bill

The Joint Committee staff believes that the COBRA payroll "credit" is best viewed as a form of bookkeeping rather than a tax credit in the narrowest sense, because the amount of money paid out by an employer is not reduced by virtue of Code section 6432. The employer pays 65 percent of its former employees' COBRA continuation coverage costs and is then made whole by the government via a reduction in payroll tax owed. Because the bill does not define the term "credit" and does not amend Code section 6432 directly, it is possible that the language of subsection 303(1) could be interpreted as reaching section 6432, and thus as disallowing a reduction in payroll tax in connection with COBRA costs associated with health plans offering abortion coverage.

Credit for increasing research activities

Present Law

In general, under Code section 41, a taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses exceed a base

[7] Pub. L. No. 99-272.

[8] Pub. L. No. 111-5.

amount.[9] The base amount reflects past research expenditures, so the research credit is generally available with respect to incremental increases in qualified research. An alternative simplified credit calculation is available in lieu of the traditional research credit at a 14 percent credit rate. The alternative simplified credit uses a different base period and is only partially incremental. With some limitations, the research credit is available for both in-house and contract research expenses. Generally, qualified research comprises processes of experimentation conducted in the United States (including U.S. possessions) aimed at developing new or improved business components of the taxpayer. Research does not qualify if it relates to style, taste, cosmetic, or seasonal design factors. In addition, research does not qualify if it (1) is conducted after the beginning of commercial production of a business component, (2) relates to the adaptation or duplication of certain existing business components, or (3) relates to certain efficiency surveys, market research, management techniques, routine data collection, or routine quality control. Additional research credits are available with respect to qualified energy research and university basic research under different credit structures. The research credit (including the energy research credit and the university basic research credit) expires at the end of 2011.

Implications of the Bill

The bill could implicate the research credit in the following way. Under present law, costs associated with clinical trials are qualified research expenses for purposes of the credit. Depending on the scope of the language "an amount paid or incurred for an abortion," subsection 303(1) of the bill could prohibit the research credit for clinical trials researching new contraceptives (if taking drugs that prevent implantation of fertilized eggs qualifies as an abortion), new abortifacients (if chemical termination of a pregnancy qualifies as abortion), or new surgical procedures or surgical equipment.

On the other hand, it is not clear that costs associated with clinical trials are "amounts paid or incurred for an abortion," and if they are not, then the bill does not affect section 41.

[9] Section 38 provides the operative rules for claiming general business credits including the research credit. Section 39 provides the operative rules for carrying forward and carrying back to future or prior taxable years unused general business credits. Because certain business related credits may involve amounts "paid or incurred for an abortion" (e.g., the research credit), application of sections 38 and 39 is necessarily implicated by the bill in such instances.

C. Tax Deductions (Subsection 303(2) of the Bill)

Subsection 303(2) of the bill provides that, "for purposes of determining any deduction for expenses paid for medical care of the taxpayer or the taxpayer's spouse or dependents, amounts paid or incurred for an abortion shall not be taken into account."

Subsection 303(2) of the bill affects the deduction for medical expenses, and it may also affect the general trade or business deduction. I will discuss both deductions: first the deduction for medical expenses and then the deduction for general trade or business expenses.

Note that the deduction for health insurance costs for self-employed individuals is likely not affected by the bill. Medical expenses paid by self-employed individuals for themselves and their families are deductable under subsection 162(l) of the Code. Unlike subsection 162(a), subsection 162(l) only permits deductions for payment of medical insurance and not for payments for drugs, procedures, or medical care. Thus, amounts paid for an abortion, as opposed to costs for insurance that includes abortion coverage, are not deductable by self-employed individuals under present law.

Medical expenses

Present Law

Section 213 allows a deduction for certain expenses paid for medical care of the taxpayer, the taxpayer's spouse, and the taxpayer's dependents to the extent that such expenses exceed 7.5 percent of the taxpayer's adjusted gross income (10 percent for tax years beginning after December 31, 2012).

Medical care is defined for purposes of the deduction as amounts paid for "the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting the structure or function of the body," for certain transportation costs associated with such care, and for insurance covering such care. Under applicable guidance, operations or treatments affecting any portion of the body, including obstetric expenses, but excluding illegal procedures or treatments, are considered to be for the purpose of affecting the structure or function of the body, and thus constitute medical care.[10] Thus, costs associated with legal abortions are medical care expenses that are deductible under section 213.[11]

Implications of the Bill

Subsection 303(2) of the bill disallows a deduction under section 213 for the cost of an abortion. A possible interpretation of the bill's language is that payments for transportation in connection with an abortion also might qualify as paid or incurred "for an abortion" and would thus also not be allowable as a deduction.

[10] Treas. Reg. sec. 1.213-1(e).

[11] Rev. Rul. 73-201, 1973-1 C.B. 140.

Trade or business expenses

Present Law

Subsection 162(a) generally provides a deduction for all ordinary and necessary expenses directly connected with or pertaining to the operation of a trade or business, provided such expenses are not otherwise capitalized or disallowed under another provision of the Code. Such expenses include, among other things, compensation, supplies, incidental repairs, advertising, insurance, rent, utilities, and general and administrative costs. Payments of health insurance premiums for present or former employees and their families are generally deductible as ordinary and necessary business expenses of the employer.

Implications of the Bill

Subsection 162(a) is affected by subsection 303(2) of the bill only if the term "taxpayer" is interpreted to include both entities and individuals. Although the bill does not defined the term "taxpayer," this term is defined in Code section 7701(a) as any person subject to any internal revenue tax. The term "person" includes, for these purposes, individuals and corporate and unincorporated entities (such as trusts, estates, and unincorporated associations). The references in subsection 303(2) to medical care, spouses, and dependents could be interpreted as narrowing the class of potentially affected taxpayers to individuals; that is, those persons traditionally understood as being capable of having medical care, spouses, and dependents. Under this reading of the language, the bill would have no effect on subsection 162(a).

An alternative, more expansive, interpretation of the bill's language would include entities in the definition of taxpayer. Such a reading would require addressing the meaning of an entity having medical care, a spouse, or dependents.

If the expansive reading of the term "taxpayer" is used, subsection 303(2) requires disallowance of tax deductions taken by employers in conjunction with health plans with abortion coverage offered to their employees. If the term "taxpayer" is interpreted to include entities, however, a possible consequence could be that insured and self-insured plans are treated differently with respect to identical costs. Subsection 162(a) deductions might not be allowed for the reimbursement of incurred medical expenses associated with abortions for employers with self-insured plans because those expenses might include "amounts paid or incurred for an abortion." A deduction might be allowed, however, for the cost of insured employee health insurance that includes abortion coverage because such costs would be amounts paid for a health benefits plan rather than for an abortion. In the case of an employer that self-insures, no deduction is allowed under the bill for the cost of the reimbursement of amounts paid or incurred for an abortion, and the employee must include the amount of the reimbursement in gross income. However, for an employer that purchases health insurance coverage from an insurance company, the full premium is deductible by the employer, and the actual reimbursement is excluded from the employee's gross income.

D. Tax-Preferred Trusts and Accounts (Subsection 303(3) of the Bill)

1. Overview

Subsection 303(3) of the bill provides that "in the case of any tax-preferred trust or account the purpose of which is to pay medical expenses of the account beneficiary, any amount paid or distributed from such an account for an abortion shall be included in the gross income of such beneficiary." The bill does not provide a definition of the terms "tax preferred" or "trust or account." The Joint Committee staff believes that in the context of "Archer MSAs) and HSAs, the application of subsection 303(3) is unambiguous. Both Archer MSAs and HSAs are required under the Code to be established as separate accounts, the income of which is taxed a preferential manner.

However, the applicability of subsection 303(3) of the bill to reimbursements for medical expenses under employer sponsored health coverage is not clear and depends on the interpretation of terms "tax-preferred" and "trust or account." Generally, the tax treatment of amounts paid or distributed under an employer sponsored health plan for medical care are excludible from the employee's gross income under Code section 105(b) regardless of the form of the employer sponsored health plan. The application of subsection 303(3) to these distributions depends on the form of the employer sponsored health plan. It only applies to an employer sponsored health plan structured so that distributions or payments for medical care are made from a "tax-preferred trust or account."

As an initial matter, it appears that, in the context of an employer sponsored health plan, subsection 303(3) of the bill would only apply to a self-funded health plan. Fully insured health plans purchased from an insurance company do not generally maintain accounts for the particular health plan (or individual participants in the health plan) from which distributions are made. However, as discussed below, not all self-funded plans include tax-preferred accounts under any interpretation of those terms.

Which distributions from a self-funded health plan for abortion services are implicated depends on the meaning of the terms "tax-preferred" and "account or trust." How these two terms are interpreted and applied together arguably can lead to different answers to the question whether a payment or distribution for medical expenses for an abortion under an employer sponsored health plan is includible in the gross income of the beneficiary.

First, it is unclear under subsection 303(3) whether an account includes only a segregated set of assets, or separately accounted for share of assets, in a trust or fund to which investment gains and losses are allocated, such as a separate account under a defined contribution plan.[12] Even if that interpretation prevails, it is not clear that "account" only includes a separate account that is only available for the benefit of an individual and the individual's dependents (similar to an HSA) or whether it includes a separate account for the health plan, such as a welfare benefit fund. An alternative interpretation might be that an account for this purpose means a dollar amount (which may or may not be adjusted for investment experience) that is available to

[12] See definition of defined contribution plan in section 414(i).

reimburse the incurred expenses for medical care of an individual (and the individual's dependents).

2. Archer MSAs and HSAs

Present Law

Archer MSA

Under section 220, an Archer MSA is a tax-exempt trust or custodial account created or organized in the United States as a medical savings account exclusively for the purpose of paying the qualified medical expenses of the account holder. Eligibility for an Archer MSA is limited; only employees (and their spouses) of a small employer that maintains a high deductible health plan ("HDHP") and self-employed persons (and their spouses) who maintain an HDHP qualify for an Archer MSA.

An account holder's contributions to an Archer MSA are tax deductable, interest and other earnings on the Archer MSA's assets accrue tax free, and distributions for "qualified medical expenses" are not taxed. Contributions made to an Archer MSA by an employer on behalf of an employee are excluded from the employee's gross income.

HSA

Under section 223, an HSA is a tax-exempt trust or custodial account established with a qualified HSA trustee to pay or reimburse qualified medical expenses. Eligibility for an HSA is limited to individuals who are covered under an HDHP (and, generally, not covered under other insurance) and who are not claimed as a dependent by another taxpayer.

An account holder's contributions to an HSA are tax deductible, contributions by an employer on behalf of an employee are generally excluded from the employee's income, and interest and other earnings on HSA assets accrue tax-free. Distributions from an HSA are excludible from gross income if they are made for qualified medical expenses.

Qualified medical expenses

For both Archer MSAs and HSAs, the term "qualified medical expenses" means amounts paid by the account holder for medical care (as defined in section 213(d)) for the account holder, the account holder's spouse, and his dependents, but only to the extent such amounts are not otherwise compensated (e.g., by insurance).

Implications of the Bill

The Joint Committee staff believes that Archer MSAs and HSAs are tax-preferred trusts or accounts within the meaning of subsection 303(3) of the bill regardless of how those terms are interpreted. The assets in an Archer MSA or an HSA are required to be held in a separate trust or custodial account; all investment gains and losses on the assets held in the trust or accounts are allocated to the trust or account; and the trust or account under an Archer MSA and HSA is

generally exempt from tax. Distributions from these accounts for qualified medical expenses are excludible from gross income.

Although under present law, distributions from an Archer MSA to cover costs associated with an abortion are excludible from gross income, subsection 303(3) of the bill results in the inclusion in income of funds withdrawn from an Archer MSA or HSA to pay for the cost of an abortion (and, as discussed above, possibly also certain transportation costs incurred in connection with an abortion).

3. Tax preferred trusts and accounts under employer sponsored health plans

Present Law

General principles for tax treatment of employer sponsored health plans

Section 106 generally provides that the value of coverage under an employer-provided health plan for employees (including retirees) and their dependents[13] is excludible from gross income.[14] The exclusion applies both to coverage under a self-funded health plan (self-insured coverage) and health insurance purchased from an insurance company insurance. In addition, under section 105(b), any reimbursements under the health plan for incurred medical care expenses for employees (including retirees) and their dependents (such as when the plan pays the doctor and the hospital for an employee's surgery) generally are excluded from gross income.[15]

Reimbursements for incurred costs of medical care under a health plan that is not attributable to excludible employer provided coverage (such as health insurance purchased privately) are excludable from gross income under section 104(a)(3). If premiums for employer-sponsored coverage include any after-tax contributions by employees, reimbursements for medical care (such as payments to the hospital and doctor for surgery) under the employer sponsored health plan are excludable from gross income based on a combination of sections 104(a)(3) and 105. However, many employers maintain cafeteria plans which allow employees

[13] For purposes of employer sponsored coverage, the term dependents when used with respect to an individual (including an employee) is intended to include the individual's spouse, dependents (as defined in section 152, determined without regard to section 152(b)(1), (b)(2), and (d)(1)(B)), and any child (as defined in section 152(f)(1)) of the individual who as of the end of the taxable year has not attained age 27.

[14] Health coverage provided to active members of the uniformed services, military retirees, and their dependents is excludable under section 134. That section provides an exclusion for "qualified military benefits," defined as benefits received by reason of status or service as a member of the uniformed services and which were excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice then in effect.

[15] A similar rule under section 3121(a)(2) and 3306(a)(2) excludes employer-provided health insurance coverage and reimbursement for incurred expenses for medical care from the employees' wages for payroll tax purposes. See also sec. 3231(e)(1) for a similar rule with respect to compensation for purposes of Railroad Retirement Tax.

to pay their portion of any cost of the health plan through pre-tax salary reduction contributions.[16]

Under present law, legal abortions are medical care within the meaning of section 213(d), and thus are medical care for purposes of both sections 104(a)(3) and 105(b). Reimbursements (including direct payment to the provider) under an employer sponsored health plan for the incurred cost of an abortion (and perhaps certain transportation costs incurred in connection with an abortion) are thus excludable from gross income.

Self-funded health plans

General rules

Employers provide health coverage to employees either by purchasing an individual or group policy issued by a licensed insurance company or by self-funding the coverage.[17] In some cases, an employer maintaining a self-funded health plan simply pays for the cost of its employees' covered medical care from the general assets of the company as the medical expenses are incurred during the coverage period. In other cases, an employer will make contributions to a welfare benefit fund to self fund the health plan.

Types of benefits under self-funded health plans

General rules

From an employee's perspective, in many cases, a self-funded plan may be no different from an insured health plan. The plan has a written set of covered benefits and required co-payments. The employee may or may not be required to pay a portion of the cost ("premium") for the coverage. If an employee contribution to the premium is required, it may be made on an after-tax basis on or on a pre-tax basis.[18]

Reimbursement arrangements

Certain types of benefits arrangements are generally only offered in self-funded plans. Employers may provide a self-funded health plan in the form of an agreement to reimburse

[16] Sec. 125.

[17] A self-funded plan is a self insured plan. Pursuant to Treas. Reg. sec. 105-11(b), generally a self-insured plan is a separate written plan for the benefit of employees which provides for reimbursement of employee medical expenses referred to in section 105(b). A plan or arrangement is self-insured unless reimbursement is provided under an individual or group policy of accident or health insurance issued by a licensed insurance company or under an arrangement in the nature of a prepaid health care plan that is regulated under Federal or State law in a manner similar to the regulation of insurance companies. A plan underwritten by a policy of insurance or a prepaid health care plan that does not involve the shifting of risk to an unrelated third party is considered self-insured for purposes of section 105(b).

[18] If coverage is elective, the pre-tax contributions may be made through a cafeteria plan, or, if coverage is required, the contribution is the equivalent of a required salary reduction.

medical expenses of their employees (and their spouses and dependents), not reimbursed by a health insurance plan including self funded coverage, through flexible spending arrangements that allow reimbursement for medical care not in excess of a specified dollar amount. Health coverage provided in the form of one of these arrangements is also excludible from gross income under section 106 as health coverage under an employer-provided health plan, and the actual reimbursements are also excluded from gross income under section 105(b).[19]

A flexible spending arrangement for medical expenses under a cafeteria plan ("Health FSA") is an arrangement under which employees are given the option to reduce their current cash compensation and instead have the amount made available for use in reimbursing the employee for his or her medical expenses.[20] In the case of a health FSA, the employee makes a choice under a cafeteria plan before the beginning of the coverage period between (1) receiving cash compensation, and (2) a reduction in salary equal to an amount not exceeding the maximum amount of reimbursement. Health FSAs are subject to the requirements for cafeteria plans, including a requirement that amounts remaining under a health FSA at the end of a plan year must be forfeited by the employee (referred to as the "use-it-or-lose-it rule").[21]

Alternatively, the employer may specify a dollar amount that is available for medical expense reimbursement. These arrangements are commonly called health reimbursement arrangements ("HRAs"). 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), but the rules are not identical. In particular, 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 and used to reimburse medical expenses in following years.[22] Because amounts remaining at the end of the year may be carried over to subsequent years, an employer may be more likely to maintain funds dedicated to an HRA in a separate trust.

Neither Treasury regulations nor the Code requires the establishment of a trust account or separate funding for either health FSAs or HRAs, and reimbursements are usually made out of an employer's general assets. Even though the amount of the salary reduction is deducted from the employee's pay, it is generally retained in the general assets of the employer until it is used to reimburse the incurred cost of medical care. Because there is no trust or custodial account required for Health FSAs and HRAs, they are sometimes thought of as bookkeeping records of

[19] Sec. 106.

[20] Sec. 125. Prop. Treas. Reg. sec. 1.125-5 provides rules for Health FSAs. There is a similar type of flexible spending arrangement for dependent care expenses.

[21] Sec. 125(d)(2). A cafeteria plan is permitted to allow 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. Notice 2005-42, 2005-1 C.B. 1204.

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

the maximum reimbursement for the coverage period reduced by the amount of any reimbursements already paid.

Separate trust and accounts used in self funded health plans

Welfare benefit funds

A welfare benefit fund is a separate trust or account with assets that are segregated from the employer's general assets.[23] Generally, all investment gains and losses on the assets held in the trusts or accounts are allocated to the trusts or accounts. A welfare benefit fund used for a self-funded health plan generally may be a VEBA, which is tax exempt under section 501(c)(9), or a taxable trust, including a grantor trust (generally, a trust the assets of which are treated as being owned directly by the grantor for Federal income tax purposes). Absent use of a welfare benefit fund, an employer that self-funds may only deduct the cost of medical care provided through the plan under its general accounting method used for other business expense deductions under section 162(a). One reason an employer may choose to establish a welfare benefit fund is to take advantage of the deduction rules in sections 419 and 419A, which may allow some smoothing of current costs and, in certain limited situations, may allow prefunding of future expected costs.[24]

Even if an employer uses a welfare benefit fund for its self-funded health plan, the employer has limited opportunity to prefund the costs of health care coverage for active employees for future coverage years because the employer may not be able to deduct the contributions.[25] One exception for active employees is where a separate welfare benefit fund is maintained pursuant to a collective bargaining agreement.[26] There are no limits on the deduction for amounts required to be made to a separate welfare benefit fund maintained pursuant to the collective bargaining agreement to pre-fund the health plan. In the case of a welfare benefit fund for retiree medical benefits, section 419A(c)(2) permits an employer to deduct contributions to a welfare benefit fund for retiree medical benefits that generally are funded over the working lives of the covered employees.

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[23] See definition of fund with respect to a welfare benefit fund in section 419(e)(3).

[24] For a plan subject to ERISA, a trust may be required if a self-funded plan includes employee contributions (either pre-tax or after tax). However, in Technical Release No. 92-01, the Department of Labor has stated that it will not assert this requirement in the case of a health flexible spending arrangement under a cafeteria plan.

[25] Secs. 419(c)(3) and 419A(c)(1). The Code generally limits the deductions that may be taken with respect to contributions to a "welfare benefit fund" for active employees to (1) the amount which would have been allowable as a deduction for the benefits provided during the taxable year as if the employer had provided such benefits directly, and (2) claims for benefits incurred but unpaid as of the close of the taxable year (and administrative costs with respect to such claims).

[26] See sec. 419A(f)(5) and A-1 of Treas. Reg. sec. 1.419A-2T (which is generally effective until three years after the issuance of final regulations).

VEBAs

VEBAs are tax exempt under section 501(c)(9). A VEBA is a mutual association of employees that can be organized to provide for the payment of life, sick, accident or other benefits to its members or their dependents or designated beneficiaries. A VEBA is exempt from tax (other than unrelated business income tax) if no part of its net earnings, exclusive of benefit payments, inures to the benefit of any private shareholder or individual and it otherwise meets the requirements of section 501(c)(9). A VEBA may be funded by employees or an employer, and funds in the possession of the VEBA are held in trust for the payment of the specified benefits. One common use for VEBAs is a welfare benefit trust for an employer sponsored health plan. Although employers may use VEBAs to self-fund health coverage plans for their active employees and retirees outside the context of a collect bargaining agreement, VEBAs are more commonly used in the case of self-funded (as opposed to insured) health plans maintained pursuant to collective bargaining agreements.

One might expect an employer that establishes a welfare benefit fund to favor a VEBA over a taxable trust. However, in addition to the limits on the deductibility of contributions to prefund a self-funded health plan, section 512(a)(3) provides special rules for calculating unrelated business taxable income that effectively limit the tax benefits of a VEBA (other than separate VEBAs maintained pursuant to collectively bargained plans).[27] Thus, the combination of the limits on the deductibility and the special unrelated trade or business income rules limits the incentives to use VEBAs as welfare benefit funds for active employees outside the context of a collective bargaining agreement.

Other trusts or accounts used for self-funded health plans.

Integral government trusts

Some governments establish trusts (referred to as integral government trusts) to fund a health plan for their employees and retirees that satisfies the requirements of sections 104(a)(3), 105(b) and 106 for the reimbursements for the incurred cost of medical care to be excludible from gross income. Section 115 of the Code provides that gross income does not include income derived from the exercise of any essential government function and accruing to a State or any political subdivision thereof. Providing health benefits to current and former employees of a political subdivision such as a State, city, or municipality constitutes the performance of an essential governmental function. Thus integral governmental trusts are tax exempt. The individual terms and conditions of each trust differ based on the relevant individual trust agreement.

[27] In the case of a VEBA, a portion of the passive investment income of the trust is taxable as unrelated business taxable income. The taxable portion of the income is generally equal to the amount by which the actual amount held in reserve for the fund exceeds the account limit for the fund (disregarding any reserve for retiree medical benefits). Under Treas. Reg. sec. 1.419A-2T, there is no limit on the account limit for a welfare benefit fund, including a VEBA, maintained under a collective bargaining agreement.

Retiree medical account under qualified retirement plans

Section 401(h) permits a qualified pension or annuity plan to provide for payment of benefits for sickness, accident, hospitalization and medical expenses for retired employees, their spouses and dependents. For the pension or annuity plan to meet the provisions of section 401(h), such medical benefits must be subordinate to pension benefits and must be established and maintained in a separate account. These accounts are generally referred to as retiree medical accounts. Although an employer is required to account separately for the funds that are contributed to the pension plan trust for retiree health benefits, no separate physical account typically exists for the contributed funds, and assets of the trust are not usually segregated.

Earnings on the retiree medical account contributions accumulate tax free in the trust (based on the tax-exempt status of the trust under normal retirement plan rules), and distributions from a retiree medical account to a retiree or a retiree's dependents pay for their medical care are excluded from gross income under section 105(b).

Present law requires qualified pension and annuity plans to maintain plan assets in a trust. No separate physical account typically exists solely for the funds contributed to a retiree medical account, however, and assets are not usually segregated. However, the share of the trust assets attributable to the retiree medical account must be separately accounted form including the allocable share of investment gains and losses. The only accounts under retire medical accounts required for individual employees are for key employees within the meaning of section 416(i), if any.[28] This is to prevent discrimination in favor of these employees rather than to protect the interests of these employees.

Implications of the Bill

Definition of tax-preferred trust or account under section 303(3) of the bill

As discussed above, subsection 303(3) provides that, in the case of any tax-preferred trust or account the purpose of which is to pay medical expenses of the account beneficiary, any amount paid or distributed from such an account for an abortion shall be included in the gross income of such beneficiary. The meaning of the terms "tax-preferred" and "trust or account" are unclear. How these two terms are interpreted and applied together arguably can lead to different answers to the question whether a reimbursement for medical expenses for an abortion under an employer sponsored health plan is includible in gross income of the beneficiary.

Implications if tax-preferred trust or account means account or trust itself is tax exempt

The term "tax-preferred" might be interpreted to mean that the funds of the health plan are tax preferred only if such funds are held in a trust or account under which the investment income of the assets of the trust or account are tax exempt or otherwise tax favored. Under this interpretation of tax-preferred, the trust or account must be limited to a fund where the assets are segregated in a separate taxable entity that is tax exempt. The types of accounts and trusts that fit

[28] Sec. 401(h)(6).

into this definition of tax preferred trust or account and thus are at least potentially affected by subsection 303(3) are a VEBA, an integral governmental trust, and a retiree medical account under a qualified retirement plan. If this is the correct interpretation of tax-preferred trust or account, the distributions from these types of trusts to pay for an abortion would be includable in gross income, but distributions from other health plans (self-funded or insured) to pay for an abortion continue to be excludable from gross income. The result of this interpretation is the employer's choice to self fund its health plan and its choice of one of these tax exempt funding vehicles for its self-funded health plan determines the tax treatment of the beneficiaries of the health plan who are reimbursed for the cost of an abortion under the plan.

The term "tax preferred" could be interpreted to mean that (1) the funds of the health plan are tax preferred only if such funds are held in a trust or account under which the investment income of the assets of the trust or account are tax exempt or otherwise tax favored, and (2) if a separate trust or account is maintained for each employee. Under this interpretation, subsection 303(3) would have a very limited application because this is not a common design for employer sponsored health plans. A possible result of this interpretation is that only the accounts of key employees under a retiree medical account are subject to subsection 303(3) of the bill. However, it is possible that an employer might use one of these tax-exempt trusts to fund its health plan and the health plan might be an HRA structured as separate accounts for each employee, similar to a defined contribution plan. In that case, under this interpretation of subsection 303(3), distributions from the separate account to pay for an abortion would be includable in gross income.

Implications if tax preferred trust or account means tax-preferred with respect to beneficiaries of the health plan

If "tax-preferred" means tax preferred from the perspective of the beneficiaries of the health plan and "account" means a fund that holds assets where the investment experience of the assets is allocated to the fund (or an account within the trust where the allocable portion of the investment experience of the trust is allocated to the account), then, in addition to the tax-exempt trusts and accounts described above, arguably any welfare benefit fund maintained for a health plan is a tax-preferred trust or account for purposes of subsection 303(3) of the bill. All disbursements from the welfare benefit trust to reimburse the incurred costs of medical care of employees (and their dependents) are excludable from gross income under either section 104(a)(3) or 105(b).

If this is the correct interpretation of tax-preferred trust or account, the distributions from a welfare benefit fund to pay for an abortion are includable in gross income be reason of subsection 303(3) of the bill, but distributions from other health plans (self funded or not) to pay for an abortion continue to be excludable from gross income. The result of this interpretation is that the employer's choice to self fund its health plan and its choice of a welfare benefit fund as the funding vehicles for its self-funded health plan determines the tax treatment of the beneficiaries of the health plan who are reimbursed for the cost of an abortion under the plan.

Implications if tax preferred trust or account means tax-preferred with respect to beneficiaries of the health plan and a specified dollar amount is an account

Implications if health FSAs and HRAs are tax-preferred trusts and accounts

For health FSAs and HRAs to be "tax-preferred trusts or accounts" for purposes of subsection 303(3), the meaning of tax-preferred must be viewed from the perspective of the beneficiary or employee and the employee's dependents rather than the tax treatment of investment returns of the trust and account, and trust or account must include a dollar amount (which may or may not be adjusted for investment experience) that is available to reimburse the incurred expenses for medical care of an individual (and the individual's dependents). If health FSAs and HRAs are "tax-preferred trusts or accounts," then subsection 303(3) is implicated because, under present law, legal abortions are medical expenses under section 213(d), and payments to reimburse the costs associated with them made under a health FSA or HRA are excluded from gross income under section 105(b). Subsection 303(3) results in the inclusion in income of payments made under a health FSA or an HRA to pay for the cost of an abortion.

Implications if only a health FSA is a tax-preferred trust or account

Finally, it is possible that subsection 303(3) could be interpreted more narrowly. Under a narrower interpretation, a tax-preferred trust or account applies only to a health FSA under a cafeteria plan. It is possible that the intent is to coordinate this interpretation with the less expansive interpretation of subsection 303(2), under which subsection 303(2) only applies to disallow the deduction under section 213 for unreimbursed medical expenses associated with an abortion. Thus, subsection 303(3) could be interpreted only to prevent a taxpayer with an opportunity to make salary reduction contributions under a health FSA through a cafeteria plan from being able to obtain the equivalent of a deduction for the reimbursements of the medical cost incurred for an abortion through the health FSA that is not allowed under section 213. Although this approach might create a rational relationship between these two provisions of the bill, it is difficult to maintain this limited interpretation under the language of subsection 303(3) of the bill as currently drafted.

Further, this interpretation arguably fulfills this purpose only if reimbursements permitted under a health FSA are limited to the amount of employee salary reduction contributions. While this limitation may be typical of health FSAs actually offered through cafeteria plans, such a limitation is not required. The maximum reimbursement under a cafeteria (including the amount attributable to salary reduction) generally is not permitted to exceed 500 percent of the salary reduction contributions by the employee.[29] The maximum reimbursement could be as large as five times the amount of the employee's salary reduction. To the extent that the maximum reimbursement amount for an employee for a coverage period exceeds the employee's salary reduction amount, the health FSA is difficult to distinguish from a HRA.[30] Thus, a provision

[29] Proposed Treas. Reg. sec. 1.125-5(a)(2).

[30] As described in Proposed Treas. Reg. 1.125-5(d), under the uniform coverage rule, the amount of the entire salary reduction for the coverage year must be available on the first day of the coverage period even though the amount of the salary reduction contributions are deducted from the employee's salary ratably over the year.

designed simply to require inclusion in income for reimbursement of medical expenses associated with abortion under a health FSA may have a broader effect than denying the equivalent of a deduction for those medical expenses.

III. EXPLANATION OF THE TAX-RELATED PROVISIONS OF H.R. 358, THE "PROTECT LIFE ACT"

Present Law

As discussed above, section 1303 of PPACA provides that premium assistance credits are not allowed to be applied towards the cost of abortion coverage. The structure of section 1303, which requires separate premium payments and segregation of assets, does not treat abortion coverage as being offered under a separate health plan in all cases.

Provisions of H.R. 358

Under H.R. 358, the premium assistance credit may not be applied to health plans that include abortion coverage even if the cost of the coverage is segregated and paid for separately. Unlike PPACA section 1303, however, H.R. 358 provides that, if an exchange offers a health plan that includes coverage for abortion services, it must also offer an identical plan that does not include abortion services. Thus, H.R.358 does not limit the availability of the premium assistance credit in all cases, because each individual must have the option to purchase a plan that does not include abortion coverage. H.R. 358 could, however, reduce the likelihood that coverage for abortion services will be available in an exchange.

Comparison of H.R. 358 and Subsection 303 of the Bill

Both H.R. 358 and the bill disallow the premium assistance credit to be used for a qualified health plan that covers abortions. The main difference between H.R. 358 and section 303 of the bill is that section 303 of the bill applies to the "internal revenue laws," while H.R. 358 only amends provisions of PPACA, and indirectly the Code section 36B premium assistance credit.