

TAX POLICY CONSIDERATIONS

Discussion around health care reform is heating up in the Capital. We are now seeing proposals and policy papers emerging from the various committees and sub-committees of the House and Senate. We anticipate proposals will continue to surface over the next few months, reflecting a wide variety of options, ideas, and perspectives on the U.S. health care system. This is all part of our normal legislative process. While the process provides the opportunity for many different voices to be heard on health care reform, it also creates the opportunity for confusion. As we go through the process, proposals will become more refined and detailed and ultimately we should have a clearer picture of what changes we may expect. As the landscape develops, we will continue to provide information and education on these topics.

PROPOSED CHANGES TO THE TAX TREATMENT OF EMPLOYER-SPONSORED GROUP HEALTH PLANS

On May 20, 2009, the Senate Finance Committee released a document outlining a number of potential policy options for financing health care reform in the United States. Some of the options revolved around changes to the current tax treatment of employer provided group health plan coverage. We spotlight some of these proposed changes in the discussion below. It is important to remember that these proposals are intended to highlight a wide variety of options and to stimulate discussion. They are not final and we anticipate a very lively debate on this topic as a part of the legislative agenda this summer.

EMPLOYER-SPONSORED GROUP HEALTH PLAN COVERAGE

Current Law

- Generally, employees are not taxed on the value of employer provided group health plan coverage.¹ Any employer contribution to a group health plan for the employee (or the employee's spouse or tax dependent) and all the benefits received are excludable from the employee's gross income.
- An employee may elect to pay his/her share of the cost of group health plan coverage for the employee, the employee's spouse and tax dependents on a pre-tax basis through the employer's cafeteria plan.

Proposed Options

- Modify the exclusion for employer provided health coverage by imposing a limitation on the value of health coverage that is excludable from gross income.
- This may include setting a base value of "tax-free" health coverage (for example, using the value of the Federal government plan as the base value) and taxing the

¹ Excludable for income tax and FICA tax purposes.

difference in value between the base plan and the actual coverage provided to the individual under an employer-sponsored arrangement.

- Another option would make the value of employer-sponsored health coverage taxable to individuals with an adjusted gross income of \$200,000 or more as a single filer – \$400,000 or more as a joint filer.
- A combination of the above approaches is also possible.
- Generally, the proposal uses the COBRA rate (less the 2% administration charge) to determine the value of the group health plan coverage. Any contributions to a health FSA, HRA or HSA may also be included in determining the total value of the health coverage provided by the employer.

ITEMIZED DEDUCTION FOR MEDICAL EXPENSES

Current Law

- Individuals may claim an itemized deduction for unreimbursed medical expenses if such expenses exceed 7.5% of adjusted gross income.

Proposed Options

- Raise the 7.5% adjusted gross income threshold for the itemized medical expense deduction, or eliminate the deduction entirely.

HEALTH SAVINGS ACCOUNTS (HSA)

Current Law

- Eligible individuals with a qualified high deductible health plan (HDHP) may establish and make either tax deductible or pre-tax contributions to an HSA.
- Individuals may contribute to the HSA on an annual basis up to the statutory maximum (\$3,000 for single, \$5,950 for family in 2009).
- Distributions from the HSA for qualified medical expenses are “tax-free”. Distributions made for nonqualified medical expenses are treated as income to the HSA owner and subject to a 10% penalty.
- There is no third-party substantiation requirement for distributions from the HSA.

Proposed Options

- Return to the “old” HSA rule where the HSA contribution is limited to the lesser of the individual’s deductible under the qualified high deductible health plan or the statutory maximum.
- Increase the penalty from 10% to 20% on HSA distributions for nonqualified medical expenses.
- Require substantiation of a qualified medical expense by a third party in order to take a tax-free distribution from the HSA.

HEALTH FLEXIBLE SPENDING ACCOUNTS (FSA) AND HEALTH REIMBURSEMENT ARRANGEMENTS (HRA)

Current Law

- An employer may offer a Health FSA under a cafeteria plan. The health FSA is funded by pre-tax salary reductions. The FSA may reimburse otherwise unreimbursed qualified medical expenses of an employee, the employee’s

spouse and tax dependents. The reimbursement is not taxable to the employee. The maximum amount of reimbursement available is based on the employee's FSA election, up to a maximum reimbursement level set by the employer.

- The HRA is an entirely employer-funded qualified medical expense reimbursement arrangement. Reimbursements from the HRA are excludable from the employee's income.
- Both the FSA and HRA may allow over-the-counter drugs as a reimbursable expense.

Proposed Options

- Impose a limit on the amount of salary reduction contributions that may be made to a health FSA (much like the limitation placed on the dependent care FSA).
- Eliminate the tax benefit associated with a health FSA or HRA.
- Limit the definition of a qualified medical expense for purposes of the FSA/HRA/HSA to once again exclude over-the-counter medications.

More information on these policy proposals is available on the Finance Committee's Web site <http://finance.senate.gov/sitepages/legislation.htm>.

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