GROOM LAW GROUP

MEMORANDUM

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Health Proposals in New Bush Administration Budget

As part of its fiscal year 2008 budget proposal, the Bush Administration has proposed to completely reform the tax treatment of health insurance coverage and make additional changes to the rules that apply to Health Savings Accounts ("HSAs"). Below is a brief overview of the new proposals.

New Standard Deduction for Health Insurance Coverage

Current Tax Treatment for Health Insurance. Under current law, if an individual receives health coverage through his employer, the entire amount of that coverage is excludable for both income and employment tax (Social Security, Medicare and federal unemployment) purposes. An outgrowth of the exclusion for employer-provided health care is the favorable tax treatment of expenses paid through a cafeteria plan, health flexible spending account ("FSA") or health reimbursement arrangement ("HRA"). Self-employed individuals who purchase health insurance are able to deduct the full cost of health insurance for income tax (but not employment tax) purposes. Individuals who purchase their health insurance on their own rather than through their employer can only deduct their health care premiums for income tax purposes to the extent that they itemize their tax deductions and their health care costs exceed 7.5 percent of adjusted gross income; they do not receive any tax relief for employment tax purposes. Consequently, certain lower income individuals who purchase insurance on their own may not receive any income or employment tax relief on those purchases.

Administration's Proposal. The Administration proposes to add a new "standard deduction" for those who are covered by health insurance and to generally eliminate the other tax preferences that are available for health coverage. The Administration believes that providing a standard deduction to all individuals who have health insurance -- regardless of whether it is acquired through one's employer -- will result in an increase in the number of individuals covered by health insurance. The Administration also believes that providing a uniform standard deduction that is not based on the amount of health care coverage purchased will provide an incentive for individuals to move to less comprehensive and less costly insurance, including high deductible health plans with lower premiums. The Administration believes that this will promote more cost consciousness in health care decision making and make individuals more engaged consumers of health services.

New Standard Deduction for Health Insurance Coverage. Effective in 2009, the Administration proposes that all individuals who have qualifying health insurance coverage be provided a standard deduction of up to $15,000 for those with family coverage and $7,500 for those with individual coverage, based on the number of months that the individual is covered by the qualifying health coverage. The deduction amount would be indexed to increases in inflation based upon the rise in the consumer price index (CPI), not based upon health care cost inflation.

The amount of the standard deduction would not depend on the cost of the insurance purchased, but the insurance would have to meet certain minimum coverage requirements in order to qualify, including:

- A limit on out-of-pocket exposure for covered expenses that is not higher than that currently allowable for HSAs (e.g., $5,500 for single coverage and $11,000 for family coverage);
- A reasonable annual and/or lifetime benefit maximum;
- Coverage for inpatient and outpatient care, emergency benefits and physician care; and
- Guaranteed renewability by the provider.

Although the health coverage could contain coverage exclusions and limitations - thereby lowering the cost -- it would have to "meaningfully limit individual economic exposure to extraordinary medical expenses" under regulations issued by the Treasury Department in order to be considered qualifying health coverage. Coverage under a long-term care plan or under Medicare would not count as qualifying health insurance. State laws mandating certain insurance coverage would not be preempted by the proposal.

Individuals and their dependents who are enrolled in Medicare, Medicaid or the State Children's Health Insurance Program (SCHIP) would not be eligible for the new standard deduction. If an individual pays for his health insurance through a distribution from an HSA or Medical Savings Account (MSA), or uses the health care tax credit to purchase coverage, he or she also would not be eligible for the new standard deduction.

How the Standard Deduction Would Operate. The new standard deduction would reduce an individual's income for both income tax and employment tax purposes. Qualifying individuals apparently would be permitted to reduce their tax withholding so that the deduction is reflected in their regular paycheck rather than having to wait until filing their tax return and receiving a refund. If an employee is eligible for the new standard deduction due to health care coverage acquired through the employer, the employer could reduce the employee's employment taxes to reflect the new standard deduction. If an employee purchases qualifying health insurance on his or her own outside the employment context, the employer apparently could adjust the employee's employment taxes if the employee provides proof of coverage under qualifying health insurance. Self-employed individuals also could take the standard deduction for both income and employment tax purposes and could adjust estimated tax payments accordingly.

Impact on Current Tax Law. Under the Administration's proposal, employers could still offer their employees health coverage, but the value of that coverage would have to be included in the employee's wages for income and employment tax purposes. Employees could not purchase health coverage on a pre-tax basis or make contributions to a health FSA though a cafeteria plan. Amounts paid for medical expenses from an HRA would be currently taxable to the individuals, which would make HRAs less attractive and likely eliminate their use. Contributions could still be made on a pre-tax basis to an HSA; however, it is not clear whether a contribution could be made through a cafeteria plan. Earnings in the HSA would continue to be tax-deferred and distributions from the HSA for qualified medical expenses would still not be taxable. Self-employed individuals would no longer have a separate deduction for premiums paid for health insurance. Further, the itemized deduction for medical expenses would be eliminated, except for taxpayers enrolled in Medicare. Employers could, however, continue to deduct the premiums paid for employee health insurance as a business expense.

Political Outlook. While there has been much discussion of the Administration's proposal in the press, key Democrats in Congress have generally been very critical of the proposal. Rep. Stark, the chairman of the House Ways and Means Subcommittee on Health has stated that he will not even hold a hearing on the proposal. At this point, it appears very unlikely that this proposal will be enacted. It is possible, however, that the Administration's proposal, when coupled with the lead-up to the upcoming Presidential and Congressional elections, will help jump-start the debate on health care reform.

Expansion of Health Savings Accounts

The Administration, which has been a very strong proponent of HSAs, proposes the following series of changes to the HSA provisions to provide further incentives for individuals to purchase high deductible health plans and contribute to HSAs.

Expand Qualifying High Deductible Health Plans. Under current law, to make a contribution to an HSA, the individual must have a qualifying high deductible heath plan ("HDHP"), defined as a plan with a deductible of at least $1,100 for self only coverage and $2,200 for family coverage and maximum out-of-pocket expenses of no more than $5,500 for self-only coverage and $11,000 for family coverage (for 2007). The Administration's proposal would allow plans with 50 percent or more coinsurance and a minimum out-of-pocket exposure to be considered a qualifying HDHP if, under rules established by the Treasury Department, the resulting policy had the same (or lower) premiums than an already-qualifying HDHP.

Qualifying Medical Expenses. Under current law, qualifying medical expenses can only be paid out of the HSA tax-free if the expenses were incurred after the HSA was established. Under the Administration's proposal, expenses that were incurred after the individual was eligible to contribute to an HSA (i.e., they have enrolled in an HDHP and have no other non-HDHP coverage) could support a tax-free distribution as long as the HSA is established before the filing date of the individual's tax return for the year.

Larger Employer Contributions for the Chronically Ill. The comparable contribution rules generally preclude an employer from making contributions to HSAs on behalf of non-highly compensated employees ("NHCEs") in higher amounts (or higher percentages of deductibles) than to highly compensated employees ("HCEs").[1] Under the recently passed Tax Relief and Health Care Act of 2006 (H.R. 6111), employers are permitted to make larger HSA contributions on behalf of NHCEs, but they must still satisfy the comparability rules with respect to contributions to NHCEs (i.e., each NHCE must get the same dollar amount (or percentage of deductible) of contributions from the employer). The Administration's proposal allows

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[1] For these purposes, HCEs are defined in part under Code section 414(q) as employees with compensation from the employer that is greater than $100,000 (for 2007). Thus, in general, NHCEs are employees with compensation from the employer of less than $100,000 (for 2007).

employers to make HSA contributions on behalf of employees who are chronically ill or who have spouses or dependents who are chronically ill to be excluded from the comparable contribution rules to the extent that these amounts exceed the comparable contributions to other employees.

Deductibles in Family Policies. Under current law, the HDHP deductible must be reached by the entire family, rather than on a per-family member basis. However, plans that have an embedded deductible (where a lesser deductible is applied to expenses incurred by each individual family member) will not be considered a qualifying HDHP for HSA purposes unless the minimum individual deductible is a least equal to the minimum deductible for family coverage ($2,200 for 2007). The Administration's proposal would allow these embedded deductibles as long as the deductible is at least the minimum deductible for individual coverage ($1,100 for 2007) and the overall family coverage deductible is at least equal to the family minimum deductible.

Catch-Up Contributions. Under current law, individuals who are age 55 or over are permitted to make an additional contribution to their HSA annually ($800 for 2007). However if two individuals who are age 55 or over are married, both individuals must have their own HSAs to make this catch up contribution. The Administration's proposal would permit both spouses who are eligible to make catch-up contributions to an HSA to make contributions to a single HSA owned by one spouse.

HSA Contributions of Individuals Covered by FSA or HRA. Generally, individuals who are covered by a health FSA or HRA are not eligible to make contributions to an HSA. The Administration's proposal would allow such individuals to make contributions to an HSA, but the maximum allowable HSA contribution would be reduced by the FSA or HRA coverage amount. The Administration believes that this will make it easier for an individual to transfer to HSA-eligible coverage when he or she was previously participating in an FSA or HRA.

Political Outlook. Democrats have been skeptical of the benefits of HSAs, believing them to be mainly for the benefit of the healthy and wealthy. Consequently, it is unlikely these proposals will get much traction in the Democratically-controlled Congress.

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If you have questions on these legislation proposals or on other health or HSA issues, please contact Bill Sweetnam, Brigen Winters or Chris Keller at (202) 857-0620.