Healthcare Reform and Expense Deductions: The Path Not Taken

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Making healthcare affordable and making sure everyone has health insurance are separate concepts, yet they seem to be inextricably woven together as problem and solution in recent healthcare initiatives. A simpler solution might be to (1) change the medical expenses deduction in section 213 to eliminate the floor; (2) install a ceiling on the medical expenses deduction that operates inverse to income (ceiling lowers as income rises); (3) make the deduction an above-the-line deduction; (4) encourage employers to offer health insurance for financially catastrophic medical care, and with the savings realized in insurance costs; and (5) have employers fund health savings accounts.

Income tax deductions are usually not of a personal nature, but the medical expenses deduction is a notable exception. Most tax deductions relate to the production of income, the implied policy being that if it costs something to generate income, then that cost should be a deduction against the income generated (for example, broker's fees on an investment). Personal expenses, on the other hand, have mainly been considered costs of living and as a general rule are usually excluded from any tax deduction.

When the government wishes to promote something, like homeownership, it may give some tax breaks or deductions, like the home mortgage interest deduction. Homeownership is a personal living expense and does not generate income. It could be argued that home ownership is actually a drain on income. Still, Congress deems it desirable or of the public good for people to own homes and, to help its citizens to become homeowners, gives a tax deduction for home mortgage interest paid. As Congress searches for a solution toward healthcare reform, it might consider changing the deduction for medical expenses contained in section 213.

Brief History of the Medical Expense Deduction

A brief review of the medical expense deduction will help to understand the history of the floor and ceiling in section 213. The deduction for medical expenses has been around for over 65 years. Over the life of the deduction, there have been amendments to the code that have changed the deduction, but those changes have mostly been an attempt to keep up with the times and refine a three-way balancing act between the government's need to raise revenue, the public's need to afford medical care, and the public's ability to pay their taxes. Overall, the changes to this tax code section have never been too drastic.

Congress first enacted the medical expenses as section 23(x)[1] in 1942, codifying the deduction for medical expenses subject to a 5 percent floor of the ''aggregate net income'' and generally a ceiling of $1,250/$2,500 (single/married filing jointly). In enacting the deduction, Congress said it was a response to the exigencies of that period in America (the war effort) and to keep up the public health and morale.[2]

In 1944 Congress changed the floor to 5 percent of the ''adjusted gross income,'' which decreased the deductibility of medical expenses.[3] In 1951 Congress removed the floor for taxpayers 65 or older.[4] Also, the range of the ceiling was doubled from $1,250/$2,500 to $2,500/$5,000.

In 1954, the medical expense deduction was given a new code section, moving it to section 213. Although the language was generally identical, three of the more notable changes were (a) the floor was changed from 5 percent to 3 percent, (b) the ceiling was changed, $2,500/$5,000 to $5,000/$10,000, and (c) language was added to permit medically related travel expenses.[5] Circuit Judge Collodner, in *Bilder v. Commissioner of Internal Revenue*,[6] cited testimony given by the Undersecretary of the Treasury Marion Folsom, who appeared before the Senate Finance Committee at a hearing to consider the 1954 code ''medical expense'' provisions. That testimony said the ''overall effect of proposed changes [to the medical expenses deduction] is to liberalize and extend relief in real hardship situations due to heavy medical expense but curb deductions of ordinary or luxury living expenses in guise of medical costs.''

By 1960 Congress eliminated the floor for dependent parents over age 65.[7] In 1962 Congress again raised the ceiling amounts on the medical expenses deduction to $10,000 for filers claiming single status and $20,000 for filers claiming married filing jointly or head of household.[8]

In 1965 Congress removed the ceiling limitations altogether and made the deduction subject to a 3 percent floor for everyone.[9] This was in response to a perceived hardship imposed on taxpayers when they incurred

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[1]Section 127 of the Revenue Act of 1942, ch. 619, 56 Stat. 798 (Oct. 21, 1942).

[2]Report of the Senate Finance Committee, 77th Congress, 2d Sess., Senate Report 1631, as reported in 1 *Seidman's Legislative History of Federal Income and Excess Profit Tax Laws*, 1397.

[3]Section 8(o) of the Public Health Service Act, 2d Sess., ch. 373, 58 Stat. 682 (July 1, 1944).

[4]Section 307 of the Mutual Security Act, 1st Sess., ch. 479, 65 Stat. 373 (Oct. 10, 1951).

[5]Internal Revenue Act of 1954, ch. 736, 68A Stat. 3 (Aug. 16, 1954).

[6]289 F.2d 291 (3d Cir. 1961).

[7]Section 3 of P.L. 86-470 (procedure for assessing certain tax additions, and other purposes) (May 14, 1960).

[8]Section 1(a) of P.L. 87-863 (increasing the amounts allowable on medical and dental expense deductions), 72 Stat. 1647 (Oct. 23, 1962).

[9]Social Security Amendments of 1965, P.L. 89-97, 79 Stat. 286 (July 30, 1965).

extraordinary medical expenses but were obliged to pay income taxes on funds used to defray those expenses.[10]

In 1982 Congress raised the floor for the medical expense deduction to 5 percent of the taxpayer's AGI.[11] In 1986 the floor was raised to 7.5 percent[12]:

> The Congress concluded that, as part of the approach of the Act in reducing tax rates through base-broadening, it was appropriate to increase the floor under the itemized deduction for medical expenses. A floor under this deduction has long been imposed in recognition that medical expenses essentially are personal expenses and thus, like food, clothing, and other expenditures of living and other consumption expenditures, generally should not be deductible in measuring taxable income. . . . In raising the deduction floor to 7.5 percent of the taxpayer's adjusted gross income, the Act retains the benefit of deductibility where an individual incurs extraordinary medical expenses — for example, as a result of major surgery, severe chronic disease, or catastrophic illness — that are not reimbursed through health insurance or Medicare. Thus, the Act continues deductibility if the unreimbursed expenses for a year are so great that they absorb a substantial portion of the taxpayer's income and hence substantially affect the taxpayer's ability to pay taxes. The Congress also believed that the higher floor, by reducing the number of returns claiming the deduction, will alleviate complexity associated with the deduction, including substantiation and audit verification problems and numerous definitional issues.[13]

It is interesting that Congress believed they had simplified taxes by taking the deduction away from a portion of the taxpaying population. Since this time, section 213 has changed very little regarding floors and ceilings.

The existence of a floor in section 213 is to some degree a matter of legislative policy against deductions of a personal nature that are not incurred while generating income. On the other hand, Congress has sought to help the public both afford medical care and be able to pay their taxes. When Congress has lowered tax rates, thereby lowering the individual's tax bill, they have increased the floor. But to a large degree, the floor is a self-fulfilling prophecy — because there always has been a floor, Congress continues to institute the floor. If the focus of our government is to reform healthcare, making it affordable to more Americans, it should consider eliminating the floor on the medical expense deduction.

As the floor rises, the lower- and middle-income taxpayers get less benefit from the deduction. After all, a married couple with one child living on $40,000 would have to incur medical expenses in excess of $3,000 before the medical expenses deduction would provide them any assistance. Even then, they would have to have combined itemized deductions in excess of $10,000 (today's standard deduction). Absent any other deductions, that family would have to have medical expenses in excess of $13,000, nearly 30 percent of their income, for the medical expense deduction to provide them any benefit.

A ceiling on the medical expenses deduction, on the other hand, was removed in response to the perceived financial difficulties of paying the income tax liability when medical losses had already decimated a taxpayer's financial well being. However, the elimination of the ceiling likely benefitted upper-income level families more than lower and middle-income level taxpayers. Overall, lower and middle-income families simply cannot pay exorbitant medical expenses, and are more likely to wind up in bankruptcy as a result of those costs. In the same vein, those families are unlikely to be able to afford either a pool or to rent a second home in a different climate as a result of a doctor's order, abuses that have previously been cited to support the need for a ceiling. A properly set ceiling should be set inverse to income, decreasing and phasing out as income rises. This would have the effect of bypassing lower and middle-income families. The upper-income individual could avoid the ceiling by buying insurance to cover catastrophic medical events. But if their insurer chose not to pay for a pool or a rental home, then the ceiling would be there to do its job.

Healthcare reform proposals center largely on establishing health insurance for every American. The prevalent notion is that health insurers can manage to pay both the costs of catastrophic medical events as well as day-to-day costs of routine medical care. It is difficult to understand how we can expect to pay $1,000 to an insurer and then receive $2,000 or $3,000 in medical care. Historically, insurance has not been aimed at payment of routine expenses.

Insurance, from its inception, was aimed at covering financially catastrophic occurrences. It began with cargo loss coverage for shippers and was later expanded to cover building loss because of fires.[14] The earliest form of modern health insurance covered hospitalization, not routine medical care. From a historical perspective, there is no basis or plausible long-term financial policy that health insurance can make healthcare affordable for most of the American population.

Recent trends in the health insurance industry show that fewer Americans are insured. This was in large part because of rapidly increasing costs of insurance premiums between 1988 and 2007.[15] Health insurers responded by trying to decrease the cost of health

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[10] *Ferris v. Commissioner*, 582, F.2d 1112 78-2 USTC (USAC7, 1978) citing H. Conf. Rep. No. 89-682, 89th Cong., 1st Sess., at 48 (1965); *reprinted in* 1965 U.S.C.C.A.N. 1943.

[11] 1982 Tax and Equity Fiscal Responsibility Act, P.L. 97-248, 96 Stat. 324 (Sept. 3, 1982).

[12] Section 133 of the Tax Reform Act of 1986, P.L. 99-514, 100 Stat. 2085 (Oct. 22, 1986).

[13] Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1986," JCS-10-87 (May 4, 1987).

[14] *See* "History of Insurance," *available at* http://en.wikipedia.org/wiki/History_of_insurance.

[15] *Employer Health Benefits 2007 Annual Survey*, Henry J. Kaiser Family Foundation, (2007), *available at* http://www.kff.org/insurance/7672/sections/ehbs07-1-1.cfm.

insurance by offering less coverage.[16] When an insurance policy covers less, it leaves a gap within which Americans do not get needed healthcare. Health insurers see clearly that they cannot keep premiums low and provide coverage for all our healthcare needs. Insurers never should have been providing that type of coverage. Historically, insurance that covers all costs is unheard of and is financially unsound. If health insurers were able to get back to the product that they were meant to offer, that is coverage for financially catastrophic events, we could expect better performance from those insurers and substantially lower premiums.

The elimination of the floor from the medical expense deduction is an immediate and direct assist to Americans to make healthcare more affordable. Further, moving the deduction above the line so that it is no longer necessary to itemize the deduction would make the deduction available to every American who pays medical expenses. If Americans were able to pay the basic, routine costs of their heathcare, employers could provide health insurance to cover financially catastrophic medical events, instead of routine medical care, at a substantial savings. Because employers would realize a great reduction in group medical premiums, they could take some of that savings and offer to fund HSAs on behalf of their employees.

[16]*The Uninsured: A Primer, Key Facts About Americans without Health Insurance,* Henry J. Kaiser Family Foundation (Apr. 2009).

If both a floor-free medical expenses deduction and the health savings account contribution deduction were above the line, a sort of ''double deduction'' would be created. However, the double deduction could be easily avoided by creating a ''moving'' floor, which would permit a deduction for paid medical expenses only to the extent they exceed contributions into a health savings account. This would also be easy to administer because all reporting would be put on the same form (an easily modified Form 8889). But it is the lure of a double deduction, along with the savings businesses would realize by switching over to this system, that would cause many Americans to flock to this system and rapidly build their health savings accounts to sustainable levels, helping to make routine health care affordable for many Americans without reliance upon health insurers. Once the healthcare affordability crisis has been contained, Congress could revisit this area as they do so many tax areas to limit or eliminate the double deduction and modify this law to better balance the public's needs versus the government's need to raise revenue.

Until Congress can figure out how to reduce the cost of medical care — without draining the public coffers or derailing the financial juggernaut that causes the American healthcare system to proffer leading advances in the field of medicine — we still must be able to afford health. A tax break on basic medical costs and minor catastrophic healthcare costs would help to achieve those goals. The cost of the increased deduction would be offset to some degree by the resulting shifting of income to individuals in higher tax brackets and the installation of a ceiling on the deduction.