

Key Elements of the U.S. Tax System

How much does the federal government spend on health care?

TAXES AND HEALTH CARE
1/10**Q. How much does the federal government spend on health care?****A. The federal government spent nearly \$1.1 trillion in fiscal year 2018. In addition, income tax expenditures for health care totaled \$225 billion.**

The federal government spent nearly \$1.1 trillion on health care in fiscal year 2018 (table 1). Of that, Medicare claimed roughly \$583 billion, Medicaid and the Children's Health Insurance Program (CHIP) about \$399 billion, and veterans' medical care about \$70 billion. In addition to these direct outlays, various tax provisions for health care reduced income tax revenue by about \$225 billion. Over \$146 billion of that figure comes from the exclusion from taxable income of employers' contributions for medical insurance premiums and medical care. The exclusion of employer contributions to medical care also substantially reduced payroll taxes, though that impact is not included in official tax expenditure estimates. Including its impact on both income and payroll taxes, the exclusion reduced government revenue by \$280 billion in 2018.

TABLE 1**Estimated Federal Spending and Tax Expenditures for Health Care
Fiscal Year 2018**

Program	Cost (millions of dollars)
Spending	
Spending for Medicare net of offsetting receipts	\$583,200
Medicaid and CHIP	\$399,000
Veterans' medical care	\$70,400
Affordable Care Act (ACA) subsidies for nongroup coverage other than premium tax credit	\$6,000
Tax Expenditures^a	
Exclusion of employer contributions for medical insurance premiums and medical care ^b	\$146,100
Premium tax credit for insurance purchased through ACA marketplaces	\$49,200
Deductibility of medical expenses by individuals	\$9,400
Deductibility of medical insurance premiums for self-employed	\$6,400
Health Savings Accounts	\$5,300
Exclusion of workers' compensation medical benefits	\$4,600
Exclusion of medical care for military dependents and retirees	\$3,000
Tax credit for small businesses purchasing health insurance	\$600

Sources: Congressional Budget Office (2018a and b); Joint Committee on Taxation (2018); and Office of Management and Budget (2018).

(a) The Joint Committee on Taxation no longer classifies excluding Medicare benefits from taxable income as a tax expenditure.

(b) Only includes lost income tax revenues. Including income and payroll taxes, the exclusion reduced government revenue by \$280 billion.

Key Elements of the U.S. Tax System

How much does the federal government spend on health care?

Data Sources

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Key Elements of the U.S. Tax System

Who has health insurance coverage?

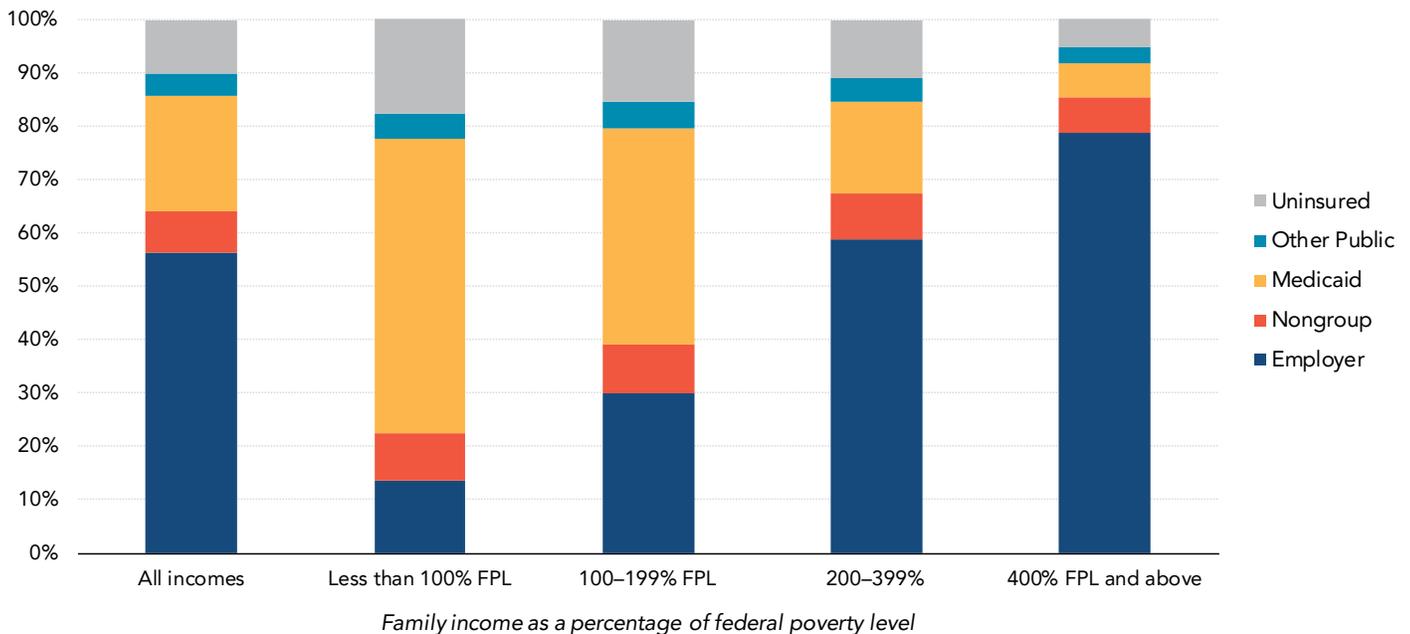
TAXES AND HEALTH CARE
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Q. Who has health insurance coverage?

A. Ninety percent of nonelderly individuals were covered in 2016, with rates rising sharply with income. The repeal of the individual mandate in 2019 is projected to reduce the percent covered by four percentage points.

In 2016, 56 percent of the nonelderly population obtained health insurance coverage through employment (figure 1). Another 8 percent purchased coverage on their own in the private market, while about 22 percent were covered by Medicaid and 4 percent had coverage from other public sources. That left 10 percent uninsured. Virtually all elderly individuals participate in Medicare, and those with low incomes also receive assistance through Medicaid.

FIGURE 1
Health Insurance Coverage of the Nonelderly by Income
2016



Source: Kaiser Commission on Medicaid and the Uninsured (2017).

Note: "Other public" insurance includes Medicare and military-related coverage; the Children's Health Insurance Program is included in Medicaid.

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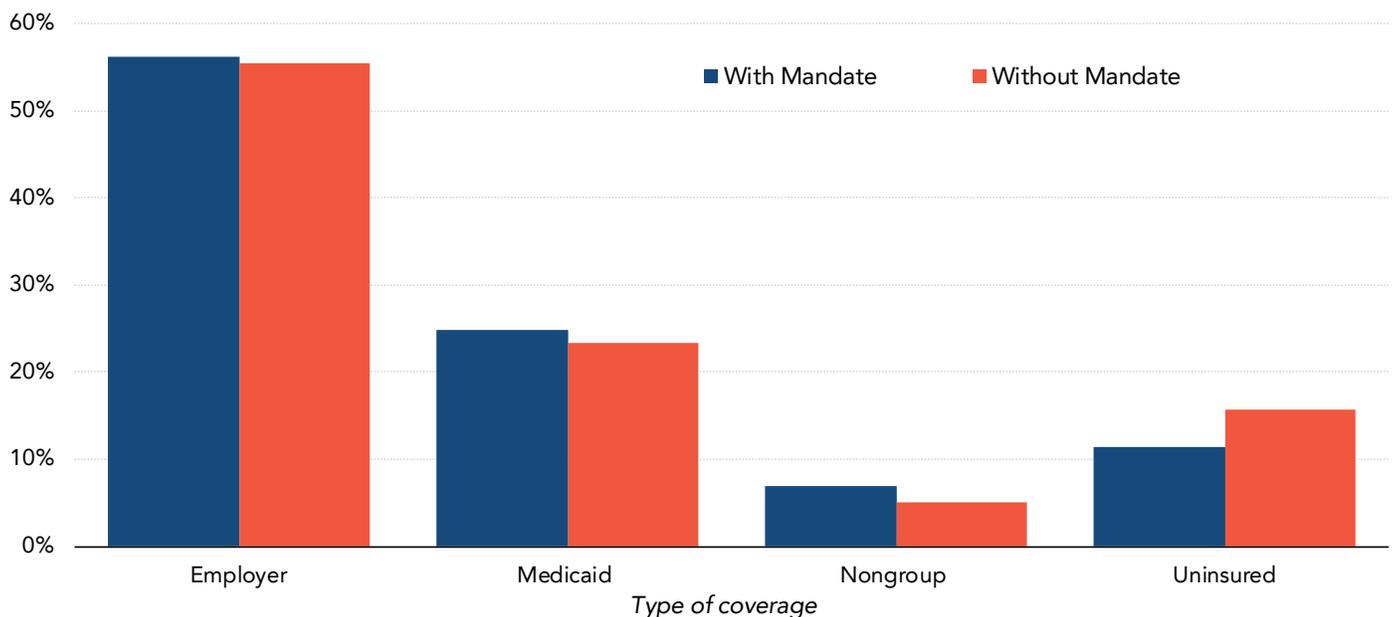
Who has health insurance coverage?

Health insurance coverage rises sharply with income. Less than 23 percent of the nonelderly with family incomes below 100 percent of the federal poverty level had private coverage in 2016; 18 percent reported having no health insurance, public or private. In contrast, 85 percent of those with incomes above 400 percent of the federal poverty level had private coverage, and just 5 percent had no insurance.

The 2017 Tax Cuts and Jobs Act repealed the Affordable Care Act's excise tax on individuals without adequate health insurance starting in 2019. The Congressional Budget Office projects that repealing the individual mandate will increase the share of nonelderly adults without health insurance 4 percentage points by 2021. Medicaid and nongroup coverage will decline the most (figure 2).

FIGURE 2

Impact of Repealing Individual Mandate on Health Insurance Coverage of the Nonelderly 2021



Source: Congressional Budget Office (2017a, b).

Note: The Children's Health Insurance Program is included in Medicaid.

Data Sources

Congressional Budget Office. 2017a. "[Federal Subsidies for Health Insurance Coverage for People under Age 65: Tables from CBO's September 2017 Projections.](#)" Washington, DC: Congressional Budget Office.

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Key Elements of the U.S. Tax System

What tax provisions subsidize the cost of health care?

TAXES AND HEALTH CARE

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Q. What tax provisions subsidize the cost of health care?

A. A host of tax preferences for health care cost the federal government roughly \$225 billion in income tax revenue in 2018. The largest is the exclusion from taxable income of employer contributions for health insurance premiums.

In 2018, the federal government lost roughly \$225 billion in income tax revenue from at least eight tax preferences for health care. By far the most costly is the exclusion of employer contributions for health insurance premiums from taxable income.

EXCLUSION FOR EMPLOYER CONTRIBUTIONS TO HEALTH INSURANCE

Employer and most employee contributions to health insurance premiums are excluded from income taxes. The Joint Committee on Taxation estimates that the income tax expenditure on the exclusion for employer-sponsored health insurance was over \$146 billion in fiscal year 2018. Employer contributions for health insurance premiums are also excluded from employees' taxable wages when calculating payroll taxes. Including its impact on both income and payroll taxes, the exclusion reduced government revenue by \$280 billion in 2018.

OTHER MAJOR TAX EXPENDITURES FOR HEALTH CARE

Table 1 outlines the other major federal tax expenditures for health care:

- Individuals ineligible for employer-sponsored or public health insurance may receive subsidies to purchase insurance on Affordable Care Act Marketplaces (\$49 billion).
- Individuals may claim as an itemized deduction out-of-pocket medical expenses and health insurance premiums paid with after-tax dollars and exceeding 7.5 percent of their adjusted gross income in 2018 and 10 percent of their income in subsequent years (\$9 billion).
- Self-employed individuals may deduct health insurance premiums from their income (\$6 billion).
- Individuals younger than 65 covered by high-deductible health insurance plans may take an income tax deduction for contributions to health savings accounts (HSAs). Employers may make HSA contributions that are excluded from income and payroll taxes. Additionally, HSA balances grow tax-free, and withdrawals for medical expenses are not subject to income tax (\$5 billion).
- Medical benefits provided by workers' compensation insurance are excluded from taxable income (\$5 billion).
- Coverage for military retirees and dependents is excluded from taxable income (\$3 billion).
- Small employers who pay low average wages may take a credit when providing employees with health insurance. The credit phases out as firm size and average wages increase; it can only be taken for two years (\$1 billion).

Key Elements of the U.S. Tax System

What tax provisions subsidize the cost of health care?

TABLE 1

Estimated Tax Expenditures Fiscal Year 2018



Program	Cost (millions of dollars)
Exclusion of employer contributions for medical insurance premiums and medical care ^a	\$146,100
Premium tax credit for insurance purchased through ACA marketplaces	\$49,200
Deductibility of medical expenses by individuals	\$9,400
Deductibility of medical insurance premiums for self-employed	\$6,400
Health Savings Accounts ^b	\$5,300
Exclusion of workers' compensation medical benefits	\$4,600
Exclusion of medical care for military dependents and retirees	\$3,000
Tax credit for small businesses purchasing health insurance	\$600

Sources: Congressional Budget Office (2018a); Joint Committee on Taxation (2018); and Office of Management and Budget (2018).

Note: The Joint Committee on Taxation no longer classifies excluding Medicare benefits from taxable income as a tax expenditure.

(a) Only includes lost income tax revenues. Including income and payroll taxes, the exclusion reduced government revenue by \$280 billion.

Further Reading

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Key Elements of the U.S. Tax System

How does the tax exclusion for employer-sponsored health insurance work?

TAXES AND HEALTH CARE
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Q. How does the tax exclusion for employer-sponsored health insurance work?

A. The exclusion lowers the after-tax cost of health insurance for most Americans.

Employer-paid premiums for health insurance are exempt from federal income and payroll taxes. Additionally, the portion of premiums employees pay is typically excluded from taxable income. The exclusion of premiums lowers most workers' tax bills and thus reduces their after-tax cost of coverage. This tax subsidy partly explains why most American families have health insurance coverage through employers. Other factors play a role though, notably the economies of group coverage.

ESI EXCLUSION IS WORTH MORE TO TAXPAYERS IN HIGHER TAX BRACKETS

Because the exclusion of premiums for employer-sponsored insurance (ESI) reduces taxable income, it is worth more to taxpayers in higher tax brackets than to those in lower brackets. Consider a worker in the 12 percent income-tax bracket who also faces a payroll tax of 15.3 percent (7.65 percent paid by the employer and 7.65 percent paid by the employee). If his employer-paid insurance premium is \$1,000, his taxes are \$254 less than they would be if the \$1,000 were paid as taxable compensation. His after-tax cost of health insurance is thus \$1,000 minus \$254, or \$746. In contrast, the after-tax cost of a \$1,000 premium for a worker in the 22 percent income-tax bracket is just \$653 (\$1,000 minus \$347). Savings on state and local income taxes typically lower the after-tax cost of health insurance even more.

These examples assume that workers bear the full burden of employer payroll taxes. Note that the effective marginal tax rates (25.4 percent for the worker in the 12 percent income-tax bracket and 34.6 percent for the worker in the 22 percent income-tax bracket) are less than the sum of the income-tax and payroll-tax rates (27.3 percent and 37.3 percent, respectively) because those rates are applied to compensation after the employer's share of payroll taxes has been deducted. Thus, for example, if the employer increases compensation by \$1,000, cash wages only increase by \$929 [calculated as $\$1,000 / (1 + \text{employer payroll tax rate})$], because the employer would have to pay additional employer payroll taxes of \$71. The lower-wage worker's resulting combined income and payroll tax would be 27.3 percent of \$929, or \$254. The higher-wage worker's resulting combined income and payroll tax would be 37.3 percent of \$929, or \$347. The example assumes the higher-wage worker has earnings below the maximum amount subject to Social Security taxes.

ESI EXCLUSION IS COSTLY

The ESI exclusion will cost the federal government an estimated \$280 billion in income and payroll taxes in 2018, making it the single largest tax expenditure. Note, too, that the open-ended nature of the tax subsidy has likely increased health care costs by encouraging the purchase of more comprehensive health insurance

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How does the tax exclusion for employer-sponsored health insurance work?

policies with lower cost sharing or with less tightly managed care.

Replacing the ESI exclusion with a tax credit would equalize tax benefits across taxpayers in different tax brackets, as well as between those who get their insurance through their employers and those who obtain coverage from other sources. Making the credit refundable would extend that benefit to those whose tax liability falls below the value of the credit. And designing the credit so that it does not subsidize insurance on the margin (i.e., to be a fixed dollar amount as opposed to a percentage of the premium) could lower health care costs.

Data Source

Urban-Brookings Tax Policy Center. "Microsimulation Model, version 0718-1."

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Key Elements of the U.S. Tax System

What are premium tax credits?

TAXES AND HEALTH CARE

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Q. What are premium tax credits?

A. The Affordable Care Act provides families with refundable, advanceable tax credits to purchase health insurance through exchanges. Premium credits cap contributions as a share of income for families with incomes between 100 and 400 percent of the federal poverty level.

ACA TAX CREDITS FOR HEALTH INSURANCE

The Affordable Care Act (ACA) provides families with refundable tax credits to purchase health insurance through both state and federal Marketplaces. Tax filers can claim premium credits if they (1) have incomes between 100 and 400 percent of the federal poverty level (FPL), (2) are ineligible for adequate and affordable health insurance from other sources, and (3) are legal residents of the United States. Tax filers with incomes between 100 and 138 percent of the FPL are generally ineligible for premium credits if they reside in states that take advantage of the ACA's Medicaid-eligibility expansion.

CALCULATION OF PREMIUM CREDITS

Premium credits effectively cap family contributions as a share of income for those purchasing midrange “benchmark” plans. In 2018, maximum family contributions ranged from 2.01 percent of income for families at the poverty threshold to 9.56 percent for families between 300 and 400 percent of FPL (table 1). Premium credits equal the difference between gross premiums and maximum family contributions.

For example, consider a family of four with income equal to 200 percent of FPL in 2018 who are purchasing an insurance plan costing \$15,000. Multiplying family income (here, \$49,200) by the applicable 6.34 percent maximum premium results in a family contribution of \$3,119 and thus a premium credit of \$11,881 (\$15,000–\$3,119).

The example above assumes the family purchases the second least expensive (Silver) plan from the menu of Bronze, Silver, Gold, and Platinum health insurance plans offered through Marketplaces. If the family purchased a more expensive plan, the credit would remain unchanged and the family would pay the full difference in premiums.

ADVANCE PREMIUM CREDITS AND RECONCILIATION

Premium credits are based on a household's income in the tax year premiums are paid. Yet the credits are calculated the following year, when households file their income tax returns. However, the Treasury usually sends advance payment of premium credits directly to the insurance company, and the household pays a

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What are premium tax credits?

reduced premium. The advance payment of credits is based on estimated income, generally from the last tax return filed before enrollment in health insurance. If actual income in the year of enrollment is less than estimated income, families qualify for additional credit amounts when filing their returns. If actual income is greater than estimated income, families must repay part or all of the advance credit.

Fortunately for most households with large income increases, the maximum reconciliation payment is limited. In tax year 2017, the maximum payment ranged from \$600 for married couples with incomes below 200 percent of FPL to \$2,550 for couples with incomes of at least 300 but less than 400 percent of FPL (table 2). Families whose income equals 400 percent or more of FPL have no limit on reconciliation payments.

For tax year 2016, 56 percent of families receiving advanced credits had to make reconciliation payments. However, analysis of tax refund data suggests that for most lower-income filers, reconciliation payments will reduce tax refunds rather than require additional payments. Still, reconciliation will likely present hardships for some families receiving advanced premium credits, even if they do not have tax payments due, because many low-income households have grown to rely on tax refunds for pressing needs.

TABLE 1

Maximum Premium Contribution (after Credits) for Families of Four by Income Level, 2018



Income as Percentage of Federal Poverty Level	Premium as Percentage of Income	Income	Maximum Premium
100%	2.01%	\$24,600	\$494
133%	3.02%	\$32,718	\$988
150%	4.03%	\$36,900	\$1,487
200%	6.34%	\$49,200	\$3,119
250%	8.10%	\$61,500	\$4,982
300%	9.56%	\$73,800	\$7,055
399%	9.56%	\$98,154	\$9,384
400%	N/A	\$98,400	N/A

Source: Tax Policy Center computations based on ACF HHS 2018 Poverty Guidelines and IRS Rev. Proc. 2017-36.

Note: Maximum premium contribution based on purchase of second least expensive Silver plan offered through a health insurance exchange.

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What are premium tax credits?

TABLE 2

Maximum Reconciliation Payment by income level, 2017



Household Income as Percentage of Federal Poverty Level	Married Filing Jointly	All Other Filers
Under 200%	\$600	\$300
200–299%	\$1,500	\$750
300–399%	\$2,550	\$1,275
400% and above	Unlimited	Unlimited

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What is the Cadillac tax?

TAXES AND HEALTH CARE

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Q. What is the Cadillac tax?

A. Employer-sponsored health benefits whose value exceeds legally specified thresholds will be subject to a 40 percent excise tax, starting in 2022. The so-called Cadillac tax will be levied on insurance companies, but the burden will likely fall on workers. The tax will effectively limit the tax preference for employer-sponsored health insurance.

TAX ON HIGH-COST HEALTH PLANS STARTING IN 2022

Under the Affordable Care Act, employer-sponsored health benefits whose value exceeds specified thresholds will be subject to an excise tax starting in 2022. (The Cadillac tax was originally scheduled to take effect in 2018 but has been delayed twice by legislation, most recently by the Extension of Continuing Appropriations Act of January 2018.) This “Cadillac tax” will equal 40 percent of the value of health benefits exceeding thresholds projected to be \$11,200 for single coverage and \$30,150 for family coverage in 2022. The thresholds will be indexed to growth in the consumer price index in subsequent years. Thresholds will be higher for plans with more-expensive-than-average demographics, retirees ages 55 to 64, and workers in high-risk professions. The Cadillac tax will apply not only to employers’ and employees’ contributions to health insurance premiums, but also to contributions to health saving accounts, health reimbursement arrangements, and medical flexible spending accounts.

WORKERS BEAR THE BURDEN

The tax will be levied on insurance companies, but the burden will likely be passed on to workers in the form of lower wages. Some employers will avoid the tax by switching to less expensive health plans; this will translate into higher wages but also higher income and payroll taxes. In fact, the Joint Committee on Taxation and the Congressional Budget Office predict that 70 percent of the revenue raised by the Cadillac tax will be through the indirect channel of higher income and payroll taxes, rather than through excise taxes collected from insurers. Simulations suggest the excise tax will have the largest relative impact on after-tax income for families in the middle income quintile.

EFFECTIVELY LIMITS THE ESI EXCLUSION

Employer-provided health benefits are excluded from taxable income, reducing income and payroll tax revenue by an estimated \$280 billion in 2018. Even if one ignores the revenue losses, there are other undesirable aspects of the exclusion. The exclusion for employer-sponsored health insurance (ESI) is poorly targeted, as it is worth more to taxpayers in higher brackets who would be more likely to purchase insurance in the first place. Additionally, the ESI exclusions’ open-ended nature may contribute to faster health care

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cost growth. For these reasons, analysts have often suggested limiting the ESI exclusion by including the value of health benefits beyond a certain threshold in taxable income (Congressional Budget Office 2016).

While the Cadillac tax plan is not a direct limit, it effectively curtails the ESI exclusion. If employers avoid the excise tax by shifting compensation from health benefits to taxable wages, the ultimate impact will be identical to an exclusion limit. In both cases, health benefits that exceeded thresholds before introduction of the Cadillac tax would become subject to income and payroll taxes. If employers continue to offer high-cost health plans, the impact will be similar to an exclusion limit—though less progressive. Excess benefits would be taxed at 40 percent rather than at an individual worker’s marginal tax rate. (After accounting for income and payroll tax offsets, the effective excise tax rate is ultimately lower than 0.4 and, in fact, declines with income (Blumberg, Holahan, and Mermin 2015).)

Data Sources

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Key Elements of the U.S. Tax System

What tax changes did the Affordable Care Act make?

TAXES AND HEALTH CARE
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Q. What tax changes did the Affordable Care Act make?

A. The Affordable Care Act made several changes to the tax code intended to increase health insurance coverage, reduce health care costs, and finance health care reform.

The Affordable Care Act (ACA) made several changes to the tax code intended to increase health insurance coverage, reduce health care costs, and finance health care reform.

To increase health insurance coverage, the ACA provided individuals and small employers with a tax credit to purchase insurance and imposed taxes on individuals with inadequate coverage and on employers who do not offer adequate coverage. To reduce health care costs and raise revenue for insurance expansion, the ACA imposed an excise tax on high-cost health plans. To raise additional revenue for reform, the ACA imposed excise taxes on health insurers, pharmaceutical companies, and manufacturers of medical devices; raised taxes on high-income families; and increased limits on the income tax deduction for medical expenses.

ACA tax provisions in effect in 2018 (table 1) include the following:

- A refundable tax credit for families to purchase health insurance through state and federal marketplaces. Tax filers must have incomes between 100 and 400 percent of the federal poverty level, be ineligible for health coverage from other sources, and be legal residents of the United States. The Premium Tax Credit cost \$49 billion in fiscal year 2018 and primarily benefits low- and moderate-income families.
- A tax credit for small employers to purchase health insurance for their workers. Employers must have fewer than 25 workers whose average wages are less than \$50,000. Employers can only receive the credit for up to two years. The small-employer health insurance credit cost \$1 billion in 2018.
- A tax on individuals without adequate health insurance coverage (the “individual mandate”). Many individuals are exempt from the tax, including those with incomes low enough that they are not required to file a tax return, those whose premiums would exceed a specified percentage of income, and unauthorized immigrants. The 2017 Tax Cuts and Jobs Act eliminated the individual mandate starting in 2019. Individual mandate receipts were \$4 billion in 2018.
- A tax on employers offering inadequate health insurance coverage (the “employer mandate”). The tax applies to employers with 50 or more full-time equivalent employees. Employer mandate receipts were \$4 billion in fiscal year 2018 and projected to be \$10 billion by 2020. The taxes on individuals without adequate health insurance coverage and employers offering inadequate health insurance coverage disproportionately affect low- and moderate-income families, who are more likely to lack health insurance or to work for employers not offering coverage. (We assume the burden of the tax on employers not

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offering adequate coverage falls entirely on workers.)

- Excise taxes on health insurance providers, pharmaceutical manufacturers and importers, and medical device manufacturers and importers. Legislation passed in early 2018 suspended the medical device tax for 2018 and 2019 and suspended the health insurer tax for 2019. The health insurer and pharmaceutical taxes raised \$18 billion in 2018. These excise taxes have a similar percentage impact on after-tax incomes for families across the income distribution.
- An additional 0.9 percent Medicare tax on earnings and a 3.8 percent tax on net investment income (NII) for individuals with incomes exceeding \$200,000 and couples with incomes exceeding \$250,000. The additional Medicare tax raised \$10 billion and the NII tax raised \$27 billion in 2018. Nearly all families affected by the additional Medicare tax and NII tax are in the top 5 percent of income, with most of the burden borne by families in the top 1 percent of income.

TABLE 1

ACA Taxes and Credits Fiscal year 2018



Item	Amount (in \$ billions)
Credits	
Premium Tax Credit	\$49
Small Business Health Insurance Credit	\$1
Taxes	
Individual mandate	\$4
Employer mandate	\$4
Excise taxes on health insurance providers and pharmaceuticals	\$18
High-income taxes	\$37
Net revenues	\$13

Source: Congressional Budget Office (2018a, b) and Urban-Brookings Tax Policy Center Microsimulation Model (version 0718-1).

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What tax changes did the Affordable Care Act make?

Additionally, these ACA tax provisions are scheduled to take effect in the future:

- An excise tax on employer-sponsored health benefits whose value exceeds specified thresholds (the “Cadillac tax”) starting in 2022. Because the thresholds are only indexed to price inflation, more plans will be affected over time if, as likely, health care costs grow faster than prices for other goods and services. Some employers will likely avoid the tax by switching to less expensive health plans; this will translate into higher wages but also higher income and payroll taxes. Including the impact on income and payroll taxes, the tax on high-cost health plans is projected to raise \$8 billion in 2022 with the revenue gain growing rapidly over time, reaching \$39 billion by 2028. The Cadillac tax reduces after-tax incomes the most in percentage terms for middle-income families.
- An additional limit on the medical expense deduction. Pre-ACA, taxpayers could deduct medical expenses exceeding 7.5 percent of income when calculating taxable income. The ACA increased the threshold to 10 percent of income, and the Tax Cuts and Jobs Act temporarily lowered the limit back to 7.5 percent in 2017 and 2018. The threshold is scheduled to increase to 10 percent of income in 2019. The higher threshold is projected to raise \$2 billion in 2019 and has the largest relative impact on after-tax income for families in the fourth income quintile.

Tax changes were an important component of the package of reforms enacted by the ACA. Any major change to the ACA would require making tax policy decisions with implications for health insurance coverage, the budget deficit, and the distribution of after-tax income.

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How do health savings accounts work?

TAXES AND HEALTH CARE

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Q. How do health savings accounts work?

A. HSAs are tax-exempt savings accounts used in conjunction with a high-deductible health insurance plan to pay for qualifying medical expenses.

Individuals who participate in a qualifying high-deductible health insurance plan (HDHP) can establish a health savings account (HSA) to pay for qualifying medical expenses. Both employees and employers can make contributions to an HSA.

HSAs have many tax advantages. Contributions made by employers are exempt from federal income and payroll taxes, and account owners can deduct their contributions from income subject to federal income taxes. Further, any income earned on the funds in an HSA accrues tax-free, and withdrawals for qualifying medical expenses are not taxed. Withdrawals used for nonqualifying expenses are subject to income tax and an additional 20 percent penalty. But the penalty is waived for account holders who are disabled, who are ages 65 or older, or who have died. Unused balances can be carried over from year to year without limit.

Annual HSA contributions in 2018 are limited to \$3,450 for an individual and \$6,900 for a family. Account holders ages 55 or older can contribute an additional \$1,000 to either type of account. The contribution limits are indexed annually for inflation.

In 2014, employers contributed \$15.6 billion to HSAs, and individual tax filers contributed another \$4.4 billion. The US Department of the Treasury estimates the tax preference for HSAs reduced income and payroll taxes by \$7 billion in 2014.

Employers must offer an HSA-qualified insurance plan—usually an HDHP—for an employee to be eligible for an HSA. Individuals may also purchase an HSA-qualified insurance plan through the individual insurance market. A plan is HSA-qualified if it meets certain requirements; in 2018, these include a minimum deductible of \$1,350 for individual coverage and \$2,700 for family coverage.

HSAs are an expanded version of medical savings accounts (MSAs), established in 1996. Similar to HSAs, MSAs have many of the same tax advantages and also require account holders to have an HDHP. They are limited, however, to the self-employed or workers in small firms (50 or fewer employees). The Medicare Prescription Drug, Improvement, and Modernization Act authorized HSAs in 2003 to address the rising cost of medical care and the increasing number of uninsured individuals. No new contributions to MSAs could be made after 2007, except for individuals who previously made contributions to an MSA or who work for employers that had already established MSAs.

Key Elements of the U.S. Tax System

How do health savings accounts work?

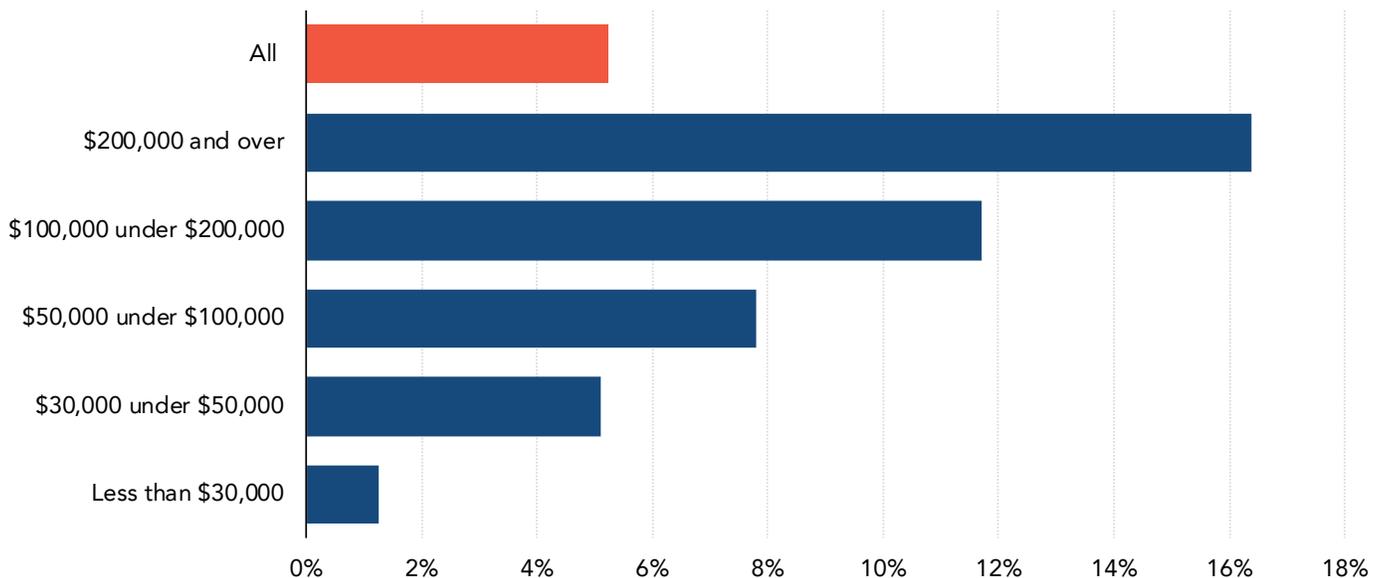
HSA and their associated HDHPs place more of the health care financing burden on out-of-pocket costs and are intended to encourage more cost-conscious health care spending. In practice, HSAs are most attractive to higher-income individuals because the tax exemptions associated with contributions, account earnings, and withdrawals are of greater value for higher income-tax brackets. Additionally, high-wage workers are more likely to be constrained by contribution limits for retirement accounts and use HSAs as an additional means of tax-preferred saving.

In 2014, 11.7 percent of taxpayers with income between \$100,000 and \$200,000 contributed to an HSA, as did 16.4 percent of taxpayers with income over \$200,000 (figure 1). In comparison, only 5.1 percent of taxpayers with income between \$30,000 and \$50,000 made such contributions. The average contribution for taxpayers with income over \$200,000 was \$4,716, compared with an average contribution of \$1,500 for taxpayers with income between \$30,000 and \$50,000 (figure 2).

HSAs are also attractive to those who expect low health care expenses. These individuals enjoy the premium cost savings associated with HDHPs, as well as the HSA tax benefits, without fear of eventually paying a high deductible.

FIGURE 1

Percent of Tax Return Filers with HSA Contributions



Source: Internal Revenue Service, SOI Tax Stats, Table 1.4. "All Returns: Sources of Income, Adjustments, and Tax Items," 2017; US Department of the Treasury, Office of Tax Analysis, "Health Savings Accounts, 2014"; and author calculations.

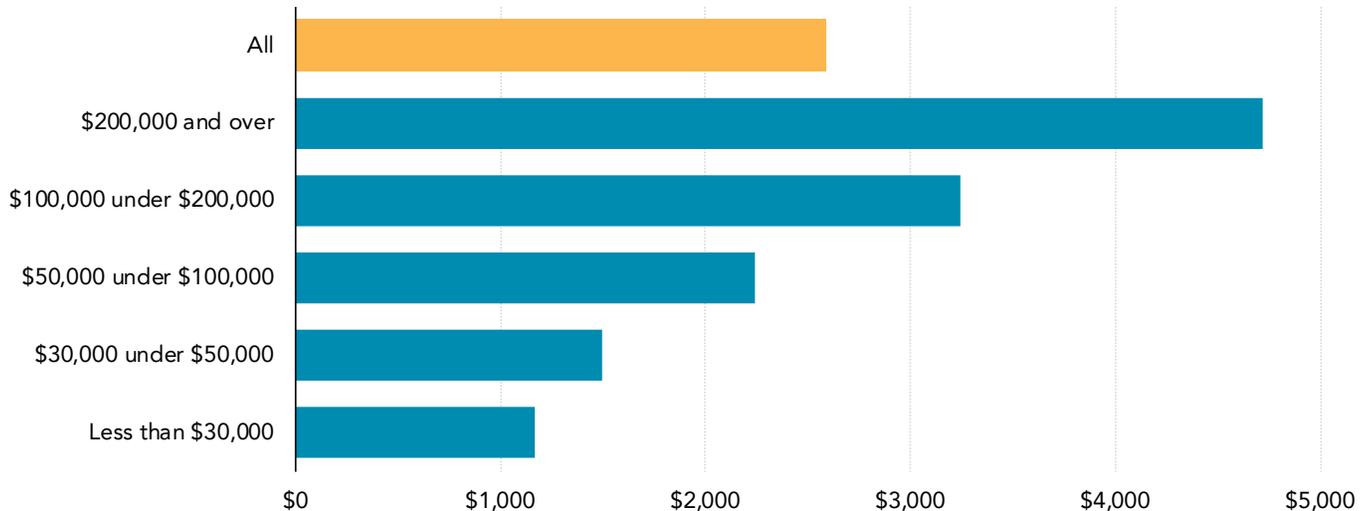
Note: Includes both individual and employer contributions.

Key Elements of the U.S. Tax System

How do health savings accounts work?

FIGURE 2

Average HSA Contribution by adjusted gross income, 2014



Source: Internal Revenue Service, SOI Tax Stats, Table 1.4. "All Returns: Sources of Income, Adjustments, and Tax Items," 2017; US Department of the Treasury, Office of Tax Analysis, "Health Savings Accounts, 2014"; and author calculations.

Note: Includes both individual and employer contributions.

Data Source

US Department of the Treasury, Office of Tax Analysis. "[Health Savings Accounts, 2014.](#)"

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Key Elements of the U.S. Tax System

How do flexible spending accounts for health expenses work?

TAXES AND HEALTH CARE
9/10

Q. How do flexible spending accounts for health expenses work?

A. A health care FSA is a tax-advantaged employer-sponsored account used to reimburse employees for qualifying health care expenses.

Health care FSAs are tax-advantaged benefit plans established by an employer to reimburse employees for qualified medical and dental expenses, such as copayments, deductibles, and prescription drug costs. FSAs are usually funded through salary-reduction agreements in which the employee agrees to receive lower monetary compensation in exchange for equivalent contributions to an FSA. For example, an employee who elects to reduce his or her monthly paycheck by \$200 would receive, in return, a \$2,400 annual contribution to his or her FSA.

The key benefit of FSAs is that these contributions are not subject to income or payroll taxes, which could mean significant tax savings for the account holder. An employee contributing \$200 a month to an FSA would save \$288 in federal income taxes if he or she were in the 12 percent tax bracket ($\$2,400 \times 0.12 = \288) and an additional \$184 dollars from reduced Social Security and Medicare payroll taxes ($\$2,400 \times 0.0765 = \183.60). Because the federal income tax savings depend upon the employee's income tax rate (which rises with income), the benefit of using an FSA is greater for higher-income workers. For example, the income tax savings for an employee in the 35 percent tax bracket with the same \$2,400 annual contribution would be \$840 ($\$2,400 \times 0.35 = \840).

An important attribute of health FSAs is that employers must make the entire value of an employee's FSA account available at the beginning of the year. For example, if either employee discussed above incurred a \$3,000 medical expense in March, he or she could use the full \$2,400 annual FSA contribution to help pay that cost, even though he or she would only have contributed \$600 into the account.

In 2013, the Internal Revenue Service (IRS) instituted a contribution limit for health care FSAs. The limit is adjusted yearly for inflation; in 2018, it is \$2,650 per year per employee. Generally, employees forfeit unused FSA funds at the end of the plan year, although employers may also offer one of two options:

- Provide a grace period of up to 2.5 months into a new plan year to use FSA money from the preceding plan year.
- Allow the employee to carry over up to \$500 per plan year to use in the new plan year.

The Bureau of Labor Statistics in 2017 estimated that about 44 percent of all civilian workers had access to an FSA that year. As a whole, high-income employees and employees in larger firms are more likely to have access. Only 1 in 5 low-income workers had access to an FSA in 2017 compared with around 2 in 3 workers at the top of the earning scale (figure 1).

Key Elements of the U.S. Tax System

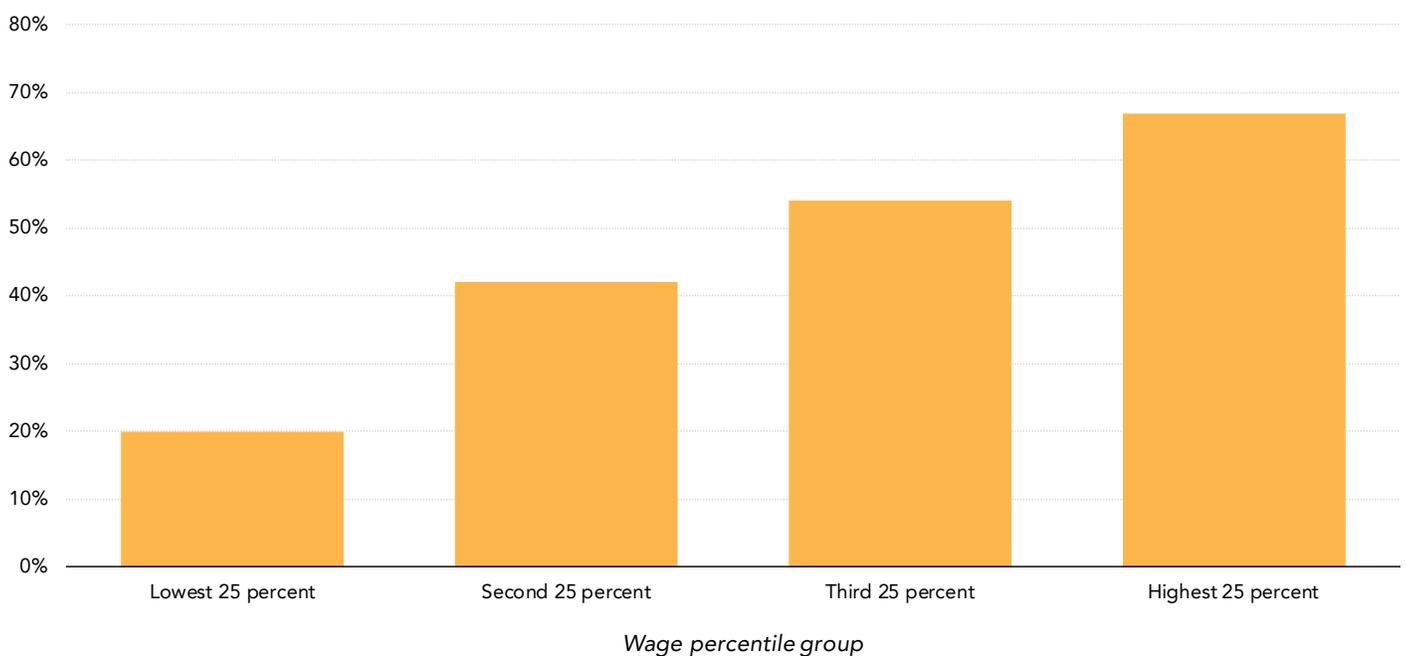
How do flexible spending accounts for health expenses work?

Employees in larger firms (500 or more workers) are more than three times as likely to have access than employees in smaller firms (99 or fewer workers), with 77 percent of the former reporting access versus 25 percent of the latter in 2017 (figure 2). Larger firms are typically better able to handle the complexity and administrative costs of offering FSAs.

More specific data on exactly who uses FSAs and how much federal tax revenue they cost are difficult to obtain because employees are not required to report FSA elections on federal income tax returns, and few surveys ask specifically about FSA participation.

FIGURE 1

Share of Workers with Access to Health Care Flexible Spending Accounts by wage percentile, 2017



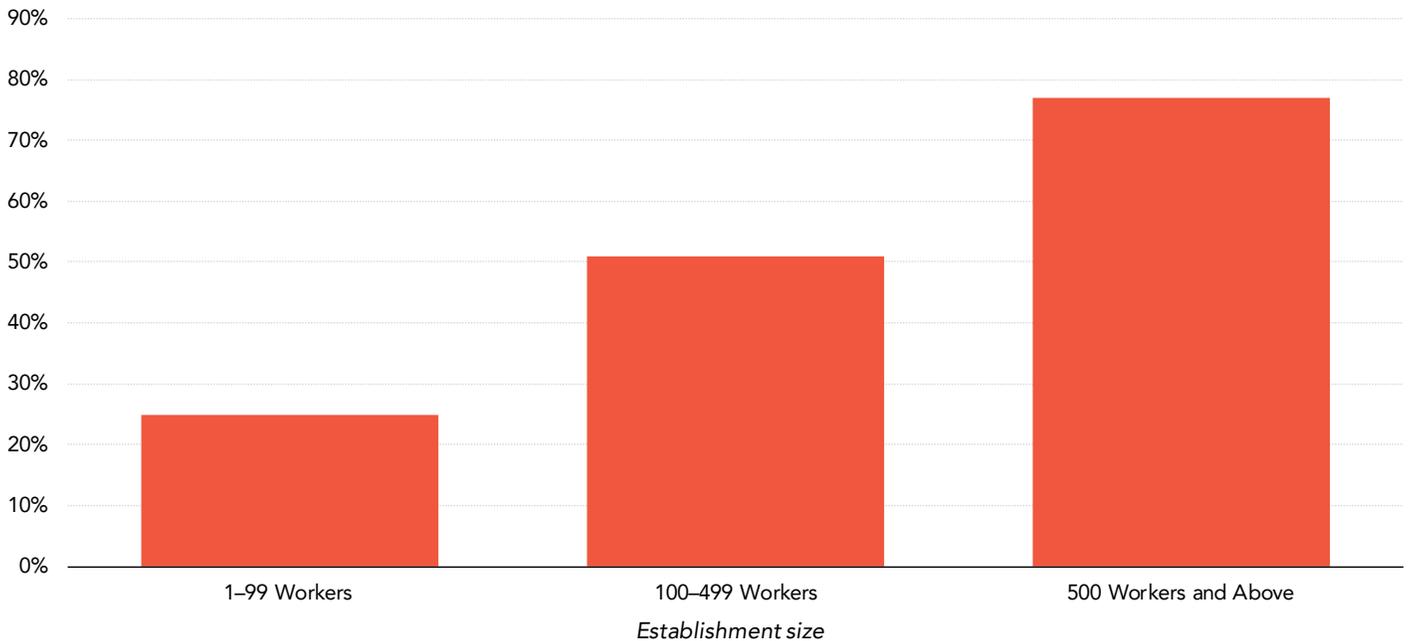
Source: Bureau of Labor Statistics. National Compensation Survey: Employee Benefits in the United States, March 2017—Civilian Tables. Table 41. “Financial Benefits: Access, Civilian Workers, March 2017.”

Key Elements of the U.S. Tax System

How do flexible spending accounts for health expenses work?

FIGURE 2

Share of Workers with Access to Health Care Flexible Spending Accounts by establishment size, 2017



Source: Bureau of Labor Statistics. National Compensation Survey: Employee Benefits in the United States, March 2017—Civilian Tables. Table 41. “Financial Benefits: Access, Civilian Workers, March 2017.”

Data Source

Bureau of Labor Statistics. *National Compensation Survey: Employee Benefits in the United States, March 2017—Civilian Tables*. Table 41. [“Financial Benefits: Access, Civilian Workers, March 2017.”](#)

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Key Elements of the U.S. Tax System

What are health reimbursement arrangements and how do they work?

TAXES AND HEALTH CARE
10/10

Q. What are health reimbursement arrangements and how do they work?

A. HRAs are tax-advantaged employer-sponsored accounts used to reimburse employees for qualified medical expenses. HRAs are usually offered in conjunction with high-deductible health plans.

HRAs are tax-advantaged employer-sponsored accounts used to reimburse employees for qualified medical and dental expenses, such as copayments, deductibles, and prescription drug costs. HRAs are usually offered in conjunction with high-deductible health plans.

Unlike health savings accounts and health flexible spending accounts, only an employer can contribute to the accounts. Employer contributions to the accounts and reimbursements for qualified medical expenses are exempt from federal income and payroll taxes. Any unused funds at the end of the plan year can carry over indefinitely, although employers may limit the aggregate carryover amount. Unlike health savings accounts, funds may never be used for nonqualified expenses and employees may lose their unused balances when they separate from their employers.

Employers need not fund HRAs until employees draw on the funds. Unlike flexible spending accounts, the entirety of the funds does not need to be available from the beginning of the period. HRAs are usually offered in conjunction with high-deductible health plans, although employers can “integrate” them with other qualified group health plans. With the implementation of the Affordable Care Act in 2010, most HRAs are no longer available as stand-alone accounts.

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