The exclusion for employer-provided health insurance is larger than the combined total for the mortgage interest deduction, the deduction for state and local taxes, and the charitable deduction.

Despite its enormous potential for raising revenue, the exclusion gets much less attention than other tax benefits, like the big-ticket itemized deductions. Why? The short answer: Out of sight, out of mind. Exclusions by their nature are invisible. There are tax benefits that do not have to be computed. No record keeping is required. No entries on a Form 1040. Nothing reported on payroll statements.

That bias of attention for itemized deductions over the exclusion is not just a shortcoming of the unsophisticated citizenry. Tax experts produce voluminous research on tax deductions while in-depth analyses of the healthcare exclusion are few and far between. That is in part because historically, it has not been quantitatively as important as it is now. (Between 1996 and 2012 the value of the exclusion for employer-provided health insurance increased by 165 percent, compared with a 65 percent increase in the mortgage deduction. See Figure 3.) It is also because of a lack of easy-to-use data on the tax status of insured employees. The IRS has decades of detailed information about mortgage interest, charitable contributions, and state and local taxes.

Just recently the Joint Committee on Taxation performed a simulation of tax reform that received a lot of attention in the press (Doc 2012-21210, 2012 TNT 199-37). The JCT found that eliminating all itemized deductions would, after accounting for revenue lost through repeal of the alternative minimum tax, allow for only a 4 percent reduction in tax rates in a revenue-neutral reform. The form a tax benefit takes — whether a deduction, credit, or exclusion — should not make a significant difference in our willingness to consider its future viability.

But citing complexity, the JCT omitted the exclusion from consideration. Public disclosure of JCT revenue estimates is always welcome, and the study provides unique insight into what is possible in future tax reforms. But as figures 1 and 2 make clear, the omission of the exclusion for employer-provided health insurance is not a minor detail. If it had been part of the exercise, it would have easily added 10 percent to the 4 percent reduction reported by the JCT.

There is near universal agreement among economists that the exclusion should be eliminated or curtailed. It creates an unwarranted bias in favor of employer-provided over self-financed health insurance. It creates a bias for compensation to be paid out in the form of health insurance instead of wages. It contributes to spiraling healthcare costs. And as an exclusion from taxable income, it favors the wealthy over the poor.

What will be the fate of the exclusion in the major tax reform that so many are predicting? Here are four possibilities in order from the smallest to the largest changes.

(1) Democratic Status Quo. In case you missed it, Congress had a major battle over the exclusion as part of the legislative process leading to passage of the Affordable Care Act. The Democrats controlled both houses of Congress back then, and they needed revenue to pay for exchange subsidies, the expansion of Medicaid, and tax credits for insurance purchases by small businesses and low-income households. The House wanted to raise taxes on the wealthy. In lieu of a cap on exclusions, which would directly raise taxes on employees, the Senate proposed an economically equivalent premium tax to be paid by insurance companies. Specifically, it was a 40 percent excise tax on each policy’s premiums in excess of an annual limitation.

The Senate approach prevailed in the final legislation. But there are many bells and whistles to address a variety of political concerns. To give unions time to renegotiate contracts, the tax would not take effect until 2018. At that time, the threshold will be $10,200 for single coverage and $27,500 for families (subject to adjustment if premium increases in the
interim are out of line with predictions). Set at that level, the limitation would apply to about 25 percent of employer-provided health insurance policies.

After 2018 the limitation would be adjusted for overall inflation (except in 2019, when it is adjusted by the inflation rate plus 1 percentage point).
Because healthcare inflation rates are widely believed to be higher than overall inflation rates, the annual limitation will quickly increase the number of policies subject to tax.

To provide relief to employees who are part of a plan with higher-than-average costs because of age and gender characteristics that are different from national averages, an upward adjustment of the cap is allowed. An upward adjustment is also allowed for premiums paid for qualified retirees (over 55 but not eligible for Medicare) and employees in high-risk professions (law enforcement, fire protection, emergency medical services, mining, agricultural, and fishing).

Taking all that into account, it is estimated that initially the tax will apply to 16 percent of all plans in 2018. But because the limitation is indexed to the Consumer Price Index, 75 percent of plans will be taxed after a decade (Bradley Herring and Lisa Korin Lentz, “What Can We Expect From the ‘Cadillac Tax’ in 2018 and Beyond?” Inquiry, Winter 2011).

Of course, between now and 2018 there will be plenty of opportunity for Congress to change or repeal the tax. But if Democrats can control the agenda, it is hard to imagine they will veer significantly from the policy that was so painstakingly drafted in the arduous negotiations of 2009 and 2010 — except to eliminate it.

(2) Romney-Style Benefit Caps. Republican presidential nominee Mitt Romney has suggested a cap on tax benefits that might include the exclusion. He has suggested at various times an annual limit of $17,000, $25,000, and $50,000 on deductions, and — we can only infer given the lack of detail — perhaps also the exclusion for employer-provided health insurance. Importantly, Romney has also promised to preserve health insurance tax benefits for middle-income earners. Harvard professor and Romney adviser Martin Feldstein has proposed a cap on all tax benefits, including those from the exclusion as well as those from itemized deductions and credits, equal to 2 percent of adjusted gross income (“Raise Taxes, but Not Tax Rates,” The New York Times, May 4, 2011).

(3) Republican Healthcare Reform. The GOP’s main idea is to eliminate the favorable tax treatment of employer-provided health insurance under current law and replace it with a tax incentive that would apply equally to health insurance provided by employers and purchased by individuals. This leveling of the playing field makes a lot of economic sense. It makes even more political sense because the most vehement supporters of retaining the exclusion are labor unions closely tied to the Democratic Party.

In 2007 President George W. Bush proposed replacing the exclusion with a standard deduction of $7,500 for individuals and $15,000 for families for all health insurance whether employer-provided or purchased individually. In 2008 Republican presidential candidate John McCain proposed a more egalitarian version of this idea: a refundable tax credit for all health insurance of $2,500 for individuals and of $5,000 for joint filers. In 2010 House Budget Committee Chair Paul Ryan of Wisconsin,
now the Republican candidate for vice president, proposed a refundable tax credit of $2,300 per adult and $5,700 per family with credit amounts indexed to the average of overall and medical inflation. (See notes to the table for citations.)

If Republicans take power, this could be a very attractive option. It could serve as the foundation of a Republican alternative to Obamacare. It could also provide significant tax benefits to lower-income families that would help inculcate the party against charges of unfairness to the poor that would result from its cuts in non-defense spending. The drawback from a budget perspective is that these proposals use all or most of the revenue from repealing the exclusion for a replacement incentive that extends tax benefits to individual health insurance. (See, for example, estimates by the Tax Policy Center, “Repeal Employer-Sponsored Health Insurance Income and Payroll Tax Exclusion, With Refundable Credit,” Table T09-0268, May 22, 2009, Doc 2009-11867, 2009 TNT 99-29.) But there is no operational reason why these proposals could not be converted into significant revenue raisers by reducing the value of the new tax benefits substituted for the exclusion.

(4) Pedal-to-the-Metal Tax Reform. Under this approach, Congress takes a significant bite out of the exclusion and then gradually phases it out entirely. President Bush’s 2005 tax reform panel proposed limiting the exclusion to the national average premium and then indexing that limit with the CPI. In 2010 the Rivlin-Domenici deficit reduction plan included a cap on the exclusion equal to the 75th percentile of health insurance premiums and then from that point phasing out the exclusion over 10 years. The Bowles-Simpson plan has a similar cap implemented earlier but phased out over a longer period.

In these tax reforms, the primary objective behind limiting the exclusion is raising revenue. From the perspective of healthcare reform, that is a crude approach. Beyond the simple phase-in, there are no concessions to address politically sensitive issues. There is no new incentive to replace the lost exclusion. And there is no coordination with other healthcare policies.

Conclusion

Even the proposals that most aggressively attack the exclusion for employer-provided healthcare phase out the exclusion over a minimum of 15 years. To date Congress has shown little interest in using limits on the exclusion to raise revenue beyond that raised from the excise tax on high-cost plans scheduled to take effect in 2018. However, because of the huge tax benefits generated, even
small percentage reductions in those tax benefits could provide significant revenue to pay for rate cuts or contribute to deficit reduction.

Select Washington Officials to Choose Next IRS Commissioner

By William Hoffman — whoffman@tax.org

The next IRS commissioner — the public face of the federal agency more U.S. citizens encounter than any other — will be chosen by a group of people who could fit comfortably in a hearing room on Capitol Hill.

The IRS announced October 10 that Douglas Shulman’s last day will be November 8 and that Steven Miller, deputy commissioner for services and enforcement, will take over as acting commissioner. Regardless of whom the Senate confirms for a full five-year term, the choice of Shulman’s successor is likely to be a quiet affair conducted in the upper reaches of the White House, Treasury, and Congress. (For prior coverage of the IRS announcement, see Tax Notes, Oct. 15, 2012, p. 237, Doc 2012-21034, or 2012 TNT 197-2.)

The choice of Shulman’s successor is likely to be a quiet affair conducted in the upper reaches of the White House, Treasury, and Congress.

The White House considers presidential appointments within its purview, said Mark W. Everson, IRS commissioner from 2003 to 2007. Above all, presidents and their senior advisers want a competent IRS administrator who won’t cause problems for taxpayers or the administration, he said. “They want the IRS to do its job, but they don’t want it to be noticed,” Everson said. “It’s sort of like the old adage about being seen and not heard.”

Yet while the IRS serves more than 150 million individual taxpayers and millions more businesses each year, the vast majority will have no input on the choice of the person who ultimately will answer for processing their returns and issuing prompt and accurate tax bills (or refunds). And that’s not to mention responsibility for the growing number of tasks the IRS is increasingly called on to manage by Congress, more of which seem unrelated to the Service’s primary mission of tax administration and enforcement.

“There is a certain urgency to this,” Everson said. “While I have very high regard for Steve Miller, I think it’s important that whoever is president work expeditiously on this, because it’s an important organization of the United States government, and [the IRS is] going through unique pressures — with the extenders, tax reform, healthcare reform, [and] identity theft, there’s a convergence of very difficult