General Explanations of the Administration's Fiscal Year 2002 Tax Relief Proposals

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Invest in Health Care

REFUNDABLE TAX CREDIT FOR THE PURCHASE OF HEALTH INSURANCE

Current Law

Under present law, the tax treatment of health insurance premiums depends on whether an individual has medical expenses that exceed a certain threshold, whether the individual is covered under a health plan paid for by an employer, and whether an individual has self-employment income.

Individuals who purchase their own health insurance may claim an itemized deduction for the premiums only to the extent that the premiums, when combined with other unreimbursed medical care expenses, exceed 7.5 percent of AGI. Other medical care expenses include expenses of the taxpayer, a spouse, or a dependent for basic medical care, qualified long-term care services, and premiums for qualified long-term care insurance (subject to a dollar limit).

Employer-provided health coverage and reimbursements for medical care are generally excluded from gross income for income tax and from wages for employment tax purposes. Active employees participating in a cafeteria plan may pay their employee share of premiums and other medical care expenses on the same tax-preferred basis.

Premiums for health insurance (or an arrangement having the effect of health insurance) paid by self-employed individuals are deductible in computing their AGI. For self-employed individuals who are not eligible for subsidized employer coverage, premiums for health insurance are 60 percent deductible for 2001, 70 percent deductible for 2002, and 100 percent deductible for 2003 and thereafter.

Reimbursements made to an individual from accident or health insurance (or an arrangement having the effect of accident or health insurance) for injuries or sickness are excluded from gross income.

Reasons for Change

An additional incentive is needed to encourage individuals who do not have public or employer-provided health coverage to purchase health insurance. Any incentive should assist low-income individuals and families with little or no income tax liability to purchase health insurance, but should not discourage earning additional income. In addition, incentives need to be made available in advance so that uninsured individuals receive financial help at the time of purchase of health insurance.

Proposal

The proposal would create a refundable income tax credit for health insurance purchased for individuals under age 65. The credit would equal 90 percent of the health insurance premium. However, the maximum credit would be $1,000 per individual covered by a policy, up to a maximum of $2,000. Individuals participating in public or employer-provided health plans would not be eligible for the tax credit. Eligible health insurance plans would be required to meet minimum coverage standards, including coverage for high medical expenses.

Individuals without dependents filing a single return with AGI up to $15,000 would be eligible for the maximum credit. Above that income level, the maximum credit would be phased out ratably for individuals without dependents filing a single return who have AGI between $15,000 and $30,000. All other filers with AGI up to $30,000 would be eligible for the maximum credit and, above that income level, the maximum credit for these other filers would be phased out ratably between $30,000 and $45,000 of AGI in the case of a policy covering only one individual and would be phased out ratably between $30,000 and $60,000 of AGI in the case of a policy or policies covering more than one individual. These dollar amounts would be indexed by the Consumer Price Index for all-urban consumers.

Individuals could claim the tax credit for premiums paid as part of the normal tax-filing process. As an alternative to claiming the tax credit on the individual's tax return, the tax credit would be available at the time the individual purchases health insurance through a credit that could be applied to the purchase. A mechanism would be developed to allow the health insurance issuer to realize the value of the credits it receives in payment of premiums. Eligibility for a credit that could be applied to the purchase of insurance would be based on the individual's prior year tax return.

The health insurance tax credit would be effective for taxable years beginning after December 31, 2001. The credit would be phased in by limiting the credit to $750 per individual up to a maximum of $1,500 for 2002 and 2003. The full $1,000 credit for individuals and the $2,000 credit for families would be effective for taxable years beginning after December 31, 2003.

PROVIDE AN ABOVE-THE-LINE DEDUCTION FOR LONG-TERM CARE INSURANCE PREMIUMS

Current Law

Under present law, the tax treatment of long-term care insurance premiums depends on whether an individual has medical expenses that exceed a certain threshold, whether the individual is covered under a qualified long-term care insurance plan paid for by an employer, and whether an individual has self-employment income.

Individuals who purchase their own qualified long-term care insurance may claim an itemized deduction for the premiums, up to certain dollar limits that are based on age, but only to the extent that the premiums, when combined with other unreimbursed medical care expenses, exceed 7.5 percent of AGI.

For self-employed individuals who are not eligible for subsidized employer long-term care insurance coverage, premiums for qualified long-term care insurance (up to the applicable dollar limit) are 60 percent deductible for 2001, 70 percent deductible for 2002, and 100 percent deductible for 2003 and thereafter. Contributions by self-employed individuals are deductible in determining AGI and, thus, are not limited by the 7.5 percent of AGI applying to other individuals.

Employer-provided qualified long-term care insurance coverage and reimbursements for qualified long-term care services generally are excluded from gross income for income and employment tax purposes.

Reimbursements made to an individual from qualified long-term care insurance are generally excluded from gross income, regardless of whether the insurance is purchased by the individual or by the individual's employer.

Reasons for Change

Favorable tax treatment for the purchase of long-term care insurance generally provides an incentive for individuals to take greater financial responsibility for their long-term care needs. Allowing all individuals to deduct the cost of purchasing long-term care insurance will encourage the use of long-term care insurance. With the incorporation of tax deductibility for policies that meet eligibility standards, quality long-term care insurance will play a larger role in the financial security of older Americans.

Proposal

The proposal would allow individuals purchasing qualified long-term care insurance a deduction in determining AGI up to the annual dollar limitations that currently apply to the deductibility of long-term care insurance. The deduction would be available for the employee's share of the cost of employer-provided coverage if the employee pays at least 50 percent of the cost. In addition, qualified long-term care insurance policies would be required to meet new minimum standards for quality coverage.

The deduction would be effective for taxable years beginning on or after January 1, 2002, but would be phased in so that 25 percent of the premium would be deductible for 2002 through 2004, 35 percent for 2005, 65 percent for 2006, and 100 percent for 2007 and thereafter.

ALLOW UP TO $500 IN UNUSED BENEFITS IN A HEALTH FLEXIBLE SPENDING ARRANGEMENT TO BE CARRIED FORWARD TO THE NEXT YEAR

Current Law

A flexible spending arrangement ("FSA") is a reimbursement account or other arrangement under which an employee is reimbursed for qualified benefits. An FSA for medical care (or other qualified benefits) may be part of a salary reduction cafeteria plan. Under such a plan, an employee reduces current compensation and the employer agrees to provide the employee with qualified benefits. If the arrangement meets the cafeteria plan requirements of section 125, the compensation that was available is not included in the employee's gross income or wages for employment tax purposes. Section 125 prohibits cafeteria plans from providing deferred compensation. Proposed regulations under section 125 include rules that prevent FSAs from being used to provide deferred compensation, and require that FSAs have risk-shifting and risk-distribution characteristics similar to traditional health insurance. These rules include a "use it or lose it" provision that prevents the carry forward to future years of amounts in a cafeteria plan that are not used for medical expenses incurred by the end of a year.

Reasons for Change

Participation in FSAs can help employees to save for unexpected medical expenses. Requiring employees to forfeit the entire FSA account balance that has not been used at the end of the year discourages the use of FSAs. Further, without the ability to carry forward small amounts, employees may accelerate expenses or incur unnecessary costs (e.g., extra eyeglasses) as year end approaches in order to avoid forfeiting benefits. Modifying the "use it or lose it" rule to allow a limited carryforward will encourage saving for unexpected medical expenses and reduce the incentive to accelerate expenses or incur unnecessary costs, while preserving the character of a cafeteria plan health FSA as an arrangement that provides current health insurance coverage.

Proposal

An employer's cafeteria plan health FSA could permit up to $500 in amounts available for an employee's medical expenses but not used during the plan year to be carried forward to the employee's account for the next plan year of the health FSA. The proposal would be effective for plan years beginning after December 31, 2001.

PROVIDE ADDITIONAL CHOICE WITH REGARD TO UNUSED BENEFITS IN A HEALTH FLEXIBLE SPENDING ARRANGEMENT

Current Law

A flexible spending arrangement ("FSA") is a reimbursement account or other arrangement under which an employee is reimbursed for qualified benefits. An FSA for medical care (or other qualified benefits) may be part of a salary reduction cafeteria plan. Under such a plan, an employee reduces current compensation and the employer agrees to provide the employee with qualified benefits. If the arrangement meets the cafeteria plan requirements of section 125, the compensation that was available is not included in the employee's gross income or wages for employment tax purposes. Section 125 prohibits cafeteria plans from providing deferred compensation. Proposed regulations under section 125 include rules that prevent FSAs from being used to provide deferred compensation, and require that FSAs have risk-shifting and risk-distribution characteristics similar to traditional health insurance. These rules include a "use it or lose it" provision that prevents the carry forward to future years of amounts in a cafeteria plan that are not used for medical expenses incurred by the end of a year.

Reasons for Change

Participation in FSAs can help employees to save appropriately for unexpected medical expenses. Requiring employees to forfeit the FSA account balance that has not been used at the end of the year discourages the use of FSAs. A related proposal would allow cafeteria plans to permit employees to carry forward up to $500 in unused amounts within the FSA. Also allowing employers to give participants the option of receiving a distribution of up to $500 in unused amounts or the option of contributing this amount to the employer's retirement plan or to an Archer Medical Savings Account (MSA) will further encourage participation. These options provide additional flexibility for employees participating in FSAs who would not benefit from the carryforward, such as participants terminating employment with the employer.

Proposal

An employer's cafeteria plan could permit up to $500 in amounts available but not used for medical expenses during the plan year to be distributed to the employee or contributed to a 401(k) plan, 403(b) plan, governmental 457(b) plan, or MSA. Amounts distributed would be subject to income tax withholding and employment taxes. Amounts the participant chooses to contribute to a 401(k) or other plan or MSA would be subject to the normal rules (e.g., contribution limits, discrimination tests, withdrawal restrictions, employment taxes) applicable to elective contributions to the receiving plan or MSA.

The proposal would be effective for plan years beginning after December 31, 2001.

PERMANENTLY EXTEND AND REFORM ARCHER MSA'S

Current Law

An MSA is a trust or custodial account used to accumulate funds on a tax-preferred basis to pay for medical expenses. An individual is eligible to establish an MSA only if the employee (or the employee's spouse) is covered by a high deductible health plan (and no other health plan) and is either self-employed or employed by a small employer maintaining the high deductible health plan. Generally, if more than 750,000 individuals establish an MSA before 2002, no additional MSAs may be established.

A high deductible health plan is defined as a health plan with an annual deductible in the range of $1,550 to $2,350 in the case of individual coverage and in the range of $3,100 to $4,650 in all other cases. A high deductible health plan must also have an out-of-pocket limit that is no higher than $3,100 in the case of individual coverage and $5,700 in all other cases.

Individual contributions to an MSA that do not exceed specified limits are deductible in determining AGI and employer contributions to an MSA are excludable up to those same limits. An individual who receives an employer contribution for a year is not allowed to make a deductible contribution for the same year. In addition, contributions to an MSA are not permitted under a cafeteria plan. The annual limit on MSA contributions is 65 percent of the annual deductible in the case of individual coverage and 75 percent of the annual deductible all other cases.

Earnings on an MSA are not includible in income. Distributions from an MSA that are used to pay medical expenses are generally excludable for income. If a distribution is not for purposes of paying medical expenses, the distribution is includible in income and subject to a 15-percent additional tax. Amounts distributed after an account holder reaches age 65, dies or becomes disabled are not subject to this 15-percent additional tax.

Reasons for Change

MSAs provide an additional option for individuals, including those currently without health insurance, to purchase coverage, and give them more control over spending on medical expenses. This control provides an incentive for individuals to become more cost conscious purchasers of medical services, potentially reducing the growth of health care costs. Eliminating restrictions on the availability of MSAs and easing some of the restrictions on MSA plan features will simplify the rules and make the use of these accounts attractive to more individuals.

Proposal

MSAs would be made permanent and liberalized. The 750,000 cap on the number of MSAs and the restriction related to employer size would be removed. All employees and individuals covered by a high deductible health plan, other than a health plan for which the individual is eligible to claim a refundable health care credit, would be eligible for MSAs. The definition of high deductible health plan would be modified to permit an annual deductible as low as $1,000 for individual coverage and $2,000 in all other cases.

MSA contributions would be allowed up to 100 percent of the maximum deductible and could be made by the employee, the individual or both up to the applicable limit for the individual for that particular year. Contributions to MSAs could be made through a cafeteria plan.

The proposal would be effective for taxable years beginning after December 31, 2001.

EXTEND EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

Current Law

Section 127 provides that an employee's gross income and wages do not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts are paid or incurred pursuant to a qualified educational assistance program. This exclusion is limited to $5,250 of educational assistance with respect to an individual during a calendar year. The exclusion applies whether or not the education is job-related. In the absence of this exclusion, educational assistance is excludable from income only if it is related to the employee's current job.

The exclusion applies with respect to undergraduate courses beginning before January 1, 2002.

Reasons for Change

Well-educated workers are essential to an economy experiencing technological change and facing global competition. Extension of section 127 will expand educational opportunity, increase productivity, and encourage retraining of current and former employees to reflect the changing needs of the workplace. In addition, extending section 127 will simplify the rules for employers and workers by eliminating the need to distinguish between job-related training and other employer-provided educational assistance.

Proposal

The current law exclusion would be extended through December 31, 2002.