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Tax on High-End Health Insurance Policies Takes the Low Road

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The Joint Tax Committee (JTC) recently shed important new light on the proposed "Cadillac excise tax" contained in the Senate Finance Committee's health care reform bill.[1] The excise tax is a new levy on high-cost health insurance plans designed to discourage consumers from purchasing overly costly health insurance policies.

As outlined by the JTC, the Cadillac excise tax demonstrates what happens when Congress takes a perfectly sound idea and distorts it almost beyond recognition to placate a host of political concerns and special interests. The main trouble with the excise tax as matter of tax and health care policy is not the intent of the tax but the bizarre, intentionally opaque implementation of the policy. The Finance Committee designed the new levy so it would appear to taxpayers as higher health care premiums rather than as a tax hike.

More broadly, the trouble with the new Finance Committee's Cadillac excise tax is that it is used to pay for yet another massive expansion of government rather than offsetting the cost of tax relief that could improve the incentives for more individuals to purchase their own health insurance.

Correcting the Taxation of Health Insurance Premiums. The federal tax code provides an unlimited exclusion from individual income tax and from taxes under the Federal Insurance Contributions Act for employer contributions toward health insurance and health care for employees and dependents. Similar, limited exclusions exist for employer contributions to health savings accounts and related programs, while self-employed individuals may take an above-the-line deduction for the full amount of their health insurance premiums.

Unlimited health insurance exclusions badly distort the composition of labor compensation, as employees receive more after-tax compensation if they take more compensation in the form of tax-exempt benefits and less in the form of cash wages. These exclusions also distort the tax system by artificially shrinking the tax base, thereby requiring higher tax rates to achieve the same level of revenues. And by distorting the purchase of health insurance toward more expensive plans, unlimited exclusions distort the pattern of health care consumption and contribute to making consumers insensitive to health care prices.

The America's Healthy Future Act of 2009, as reported out of the Finance Committee, contains a number of tax hikes to pay for the expansion of government, foremost of which is the high-cost premium excise tax. This tax is often called the "Cadillac" excise tax because the tax is intended to fall on the most expensive health insurance plans. The non-deductible tax would be 40 percent on the aggregate value of employer-sponsored health

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insurance and self-employed coverage over a basic threshold amount initially set at $8,000 for individuals and $21,000 for families.[2]

The Finance Committee wrote some special rules for the basic threshold, however, to appease various special interests. The threshold is increased by $1,850 for individuals and by $5,000 for families of taxpayers over 55 years of age and retired, so those with sufficient resources to retire early get a special retirement bonus.

Individuals in high-risk professions like law enforcement and firefighting get a similarly higher threshold. With all due appreciation to those in these high-risk professions, they are compensated in the marketplace with higher wages for the higher risks they face in their profession. An additional tax-based bonus is unwarranted. Further, this provision will create a new cottage industry in Washington as various professional associations seek to enjoy the category of high-risk profession. For example, economic forecasters may be categorized as high risk given their recent performance.

In addition, through their own misguided policies, certain states have significantly driven up health care costs and health insurance premiums for their citizens. Rather than encourage those states to correct their mistakes, the Finance Committee legislation gives them a pass by temporarily raising the Cadillac excise tax threshold by 20 percent for 17 states. This provision would force the other 33 states that have responsibly managed their health care systems to subsidize those that have not.

Who Pays the Tax? A cap on the employer-sponsored health insurance exclusion has the important characteristic of being perfectly transparent to the taxpayer. Individuals who continue to buy high-cost health plans would see they would owe more in income and payroll tax as a result. One reason politicians prefer the excise tax over capping the exclusion is a belief that the tax would come out of the profits of health insurance companies rather than health insurance purchasers. This is an economic fallacy. As the JTC notes, "the excise tax would be mainly passed along through increases in premiums, and many consumers [would] respond by reducing their demand for insurance above the excise tax cap."[3]

A related fallacy used in support of the excise tax is the hope that as the tax is passed forward to policyholders in higher premiums, the policyholder would blame the insurance company for the higher premiums rather than the federal government for levying a tax. Through its defiance of transparency, Congress seems to be forgetting that even complex legislation cannot fool all of the people all of the time. Insurance companies will be sure to see to that.

The JTC also provided very revealing tables regarding the incidence of the excise tax. For example, according to the JTC figures, nearly 12 million tax filers (singles, married filing jointly, and head of household) with incomes of $200,000 a year or less will pay some $10 billion in additional tax, a figure that more than triples in just six years. Despite being a tax on high-end insurance plans, taxpayers with incomes of $200,000 or less annually will pay over 85 percent of the additional tax burden under the excise tax. Thus the tax would clearly violate President Obama's pledge not to raise taxes on families with incomes below $250,000.

Additional Income Tax Liability

Income Level	2013	2015	2017	2019
Under $200,000	$10,001	$17,636	$25,940	$34,463
$200,000 and above	1,699	3,118	4,735	6,352
Total	**$11,700**	**$20,754**	**$30,675**	**$40,815**

Table 1 • WM 2667 heritage.org

1. See Joint Tax Committee, letter to Congressman Joe Courtney, October 16, 2009, at *http://courtney.house.gov/UploadedFiles/JCT_Excise_Tax_Review.pdf* (October 29, 2009).
2. See Curtis S. Dubay, "Baucus Health Insurance Excise Tax Misses the Mark," Heritage Foundation *WebMemo* No. 2654, October 19, 2009, at *http://www.heritage.org/Research/HealthCare/wm2654.cfm*.
3. See Joint Tax Committee, letter to Congressman Joe Courtney.

Spending-, Tax-, and Deficit-Neutral Health Care Reform. Capping the exclusion for employer-sponsored health insurance could raise as much or more revenue as the Cadillac excise tax. It would also fall in part on many of the same middle-income families as the excise tax. And it would be a transparent tax rather than a dark-of-night style tax, and it should be considered without the special bells and whistles for specified professions and wayward states.

Even a cap on the health exclusion is a tax increase, however, and so if it is adopted it should be joined with tax relief that encourages the uninsured to purchase moderately priced health insurance. Neither a cap on the exclusion nor the excise tax, if adopted, should be used to offset additional government spending. Health care reform should be tax neutral and spending neutral and thereby achieve the President's stated goal of being deficit neutral.

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