Is It Time for a Healthcare Catastrophe Tax Credit?

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Abstract:

Healthcare costs continue to rise in the United States and analysts and politicians debate steps to slow down the increases and to help those who find themselves in financial difficulties due to unexpected medical expenses. The Affordable Care Act provides premium subsidies for people purchasing insurance on state or federal exchanges, but even with insurance, high deductibles, co-pays and out-of-pocket maximums can create financial distress. The tax code offers limited relief with the federal medical expense deduction, but the value of the deduction is reduced by higher standard deductions and is of no benefit to lower income taxpayers who owe no federal tax. A Healthcare Catastrophe Tax Credit, scaled by income and refundable, could better target those confronted with high medical bills and provide a better safety net for lower- and middle-income taxpayers.

Introduction

Healthcare costs continue to rise in the United States as analysts and politicians debate steps to slow down the increases and to help those who find themselves in financial difficulties due to unexpected medical expenses. A recent study states that despite the Affordable Care Act (ACA) 66.5% of all bankruptcies were tied to medical issues (Himmerstein, et al, 2019). Thus, even as the Affordable Care Act resulted in fewer uninsureds, many people still can face catastrophic financial burdens.

There are multiple provisions in health care regulation designed to assist people with their medical expenses. People buying insurance on state or federal exchanges are eligible for premium subsidies that may allow them to purchase better coverage with lower out-of-pocket costs. The Affordable Care Act allows eligible applicants to purchase catastrophic plans, rather than full coverage, to keep premiums low and encourage relatively young and healthy people to still protect themselves against catastrophic medical bills. Even with insurance, however, it seems high deductibles and copayments can create financial distress.

The tax code comes at the problem from the other side, not dealing so much with preventing the financial burdens from occurring through the purchase of insurance, but rather giving a tax deduction to those who have paid significant medical expenses during the tax year. Beginning in 2019, however, the threshold to qualify for a medical expense deduction has been increased back to 10% of adjusted gross income, from 7.5% of adjusted gross income in 2017 and 2018. Combined with the increase in the standard deduction which makes it less likely that taxpayers will itemize deductions, the potential benefit of the medical expense deduction is lessened. The medical expense deduction is also not of use to people who pay little or no tax and are in lesser tax brackets.

Perhaps it is time to try a Healthcare Catastrophe Tax Credit similar in nature to the Earned Income Tax Credit. Such a credit could be scaled by income, similar to the Child Tax Credit, and also refundable, so it would be of assistance to low income taxpayers. A Healthcare Catastrophe Tax Credit is more targeted as it would go to those people who have actually suffered losses. Premium subsidies, on the other hand, go to everyone whether they end up with large medical bills or not.

This paper investigates the desirability of a Healthcare Catastrophe Tax Credit using health insurance exchange data for Allegheny County, PA and tax information from the Internal

Revenue Service. Specifically, a case study approach illustrates the potential effectiveness of a refundable Healthcare Catastrophe Tax Credit in assisting Americans confronted with high unreimbursed medical expenses.

Bankruptcies and Medical Debt

Personal bankruptcies often include medical debt either as a primary causal factor or as a contributing factor. The proportion of bankruptcies with medical causes did not change significantly after the ACA, with approximately 66% of debtors reporting a medical contributor prior to the ACA and approximately 68% reporting a medical contributor after the ACA, with no evidence suggesting that trends differed between states that did or did not accept the ACA's Medicaid expansion (Himmelstein et al, 2019). A smaller but still significant portion of personal bankruptcies are primarily caused by medical expenses. The Kaiser Family Foundation/LA Times Survey reported that 9% of personal bankruptcies are due to medical expenses (Amadeo, 2019), while another study concluded that medical debt is the predominant cause in 18% to 26% of all consumer bankruptcies (Austin, 2014).

Applying these percentages to the number of bankruptcies will illustrate the extent of the problem. Although bankruptcies have been declining since 2011, from 2016 through 2019 the number of non-business bankruptcies has been in a range from 750,000 to 800,000 per year, with 750,489 for the year ended March 31, 2019 (United States Courts, 2019). Medical debts may contribute to approximately two-thirds of these bankruptcies, or over 500,000 bankruptcies in 2019. Medical expenses may be the primary cause in 9% - 26% of these cases, or from approximately 67,500 to over 195,000 consumer bankruptcies in 2019.

Bankruptcy statistics also indicate bankruptcy filers are relatively low income. One study reports the average filer is married, has a high school education, and makes less than $30,000 per year (Armstrong, 2019). Another study states the median income of individuals filing for bankruptcy is just under $35,000 per year (Fay, 2019). A third study reports the average median household income of medical bankruptcy filers is about $31,000 per year, while out-of-pocket medical costs averaged just under $18,000 per year (Himmelstein et al, 2009).

Existing Coping Mechanisms

Medical Expense Deduction: Unreimbursed medical expenses in excess of 10% of adjusted gross income (AGI) can be included in itemized deductions in 2019. (The 10% of AGI threshold was temporarily lowered to 7.5% of AGI in 2017 and 2018.) A taxpayer will only itemize deductions if they exceed the allowable standard deduction, which almost doubled beginning in 2018. The new standard deduction is $12,000 for a single filer in 2018, increased to $12,200 in 2019 and $12,400 in 2020. The new standard deduction is $24,000 for married filing jointly, increased to $24,400 in 2019 and $24,800 in 2020. Taxpayers are now much less likely to itemize deductions making the medical expense deduction less applicable. In addition, even if itemized deductions are increased, the tax benefit is limited to the marginal tax rate of the taxpayer.

For example, consider a taxpayer with $11,000 of unreimbursed medical expenses in 2019. Why $11,000? First, the initial motivation for this paper was a two-night hospital stay by a child of one of the authors in 2019 at a cost of over $11,000. Even for an upper middle-class income, $11,000 out-of-pocket may create a significant financial burden. Second, in researching statistics on medical debt, $11,000 seems to be a representative amount based on the following information:

- Over 90% of medical debtors had medical debt over $5,000, or 10% of pretax family income, and out-of-pocket medical costs averaged about $18,000 for medically bankrupt filers (Himmelstein et al, 2009)
- A review of expected total costs for people with "medium" health care needs compared to those with "high" health care needs shows a difference of approximately $3,000 to $15,000 per year in income ranges below $100,000 per year (using data from healthcare.gov in Allegheny County, PA). It is reasonable to assume that financial distress will be more likely for people with "high" health care needs.
- IRS data for 2017 (the last year available) shows the average medical expense deduction amount to be about $10,000 across many income levels except incomes over $200,000 per year.

The following tables show the tax savings resulting from use of the medical expense deduction for income levels ranging from $20,000 to $100,000. These examples assume that the taxpayer has enough other deductions so that itemized deductions exceed the standard deduction. (Otherwise, the unreimbursed medical expenses will not result in a reduction in tax liability.) Table One is for single filers and Table Two is for married filing jointly.

Table One: Tax Savings from Medical Expense Deduction, Single Filer, 2019					
Taxpayer Takes Standard Deduction:					
Adjusted Gross Income	$20,000	$40,000	$60,000	$80,000	$100,000
Standard Deduction	12,200	12,200	12,200	12,200	12,200
Taxable Income	$ 7,800	$27,800	$47,800	$67,800	$ 87,800
Tax Liability	$ 780	$ 3,142	$ 6,375	$10,775	$ 15,237
Taxpayer Itemizes Deductions with $11,000 of Unreimbursed Medical Expenses					
Medical Expense	$11,000	$11,000	$11,000	$11,000	$ 11,000
10% of Adjusted Gross Income	2,000	4,000	6,000	8,000	10,000
Maximum Deduction	$ 9,000	$ 7,000	$ 5,000	$ 3,000	$ 1,000
Taxable Income	$ 0	$20,800	$ 42,800	$ 64,800	$ 86,800
Tax Liability	$ 0	$ 2,302	$ 5,275	$ 10,115	$ 15,007
Tax Savings	$ 780	$ 840	$ 1,100	$ 660	$ 240

Table Two: Tax Savings from Medical Expense Deduction, Married Filing Jointly, 2019					
Taxpayer Takes Standard Deduction:					
Adjusted Gross Income	$20,000	$40,000	$60,000	$80,000	$100,000
Standard Deduction	24,400	24,400	24,400	24,400	24,400
Taxable Income	$ 0	$15,600	$35,600	$55,600	$ 75,600
Tax Liability	$ 0	$ 1,560	$ 3,844	$ 6,284	$ 8,684
Taxpayer Itemizes Deductions with $11,000 of Unreimbursed Medical Expenses					
Medical Expense	$11,000	$11,000	$11,000	$11,000	$ 11,000
10% of Adjusted Gross Income	2,000	4,000	6,000	8,000	10,000
Maximum Deduction	$ 9,000	$ 7,000	$ 5,000	$ 3,000	$ 1,000
Taxable Income	$ 0	$ 8,600	$ 30,800	$ 52,600	$ 74,600
Tax Liability	$ 0	$ 860	$ 3,294	$ 5,924	$ 8,564
Tax Savings	$ 0	$ 700	$ 600	$ 360	$ 120

The medical expense deduction provides tax savings of from 0% to 10% of the unreimbursed medical expenses. For the bottom two income levels, $20,000 and $40,000, the tax savings represent on average just over 5% of the medical expense burden. As noted earlier, consumer bankruptcies often involve filers with incomes around $30,000 to $35,000, so this is not much relief for those who really need help.

Premium Tax Credits: The ACA provides premium tax credits to people buying insurance on state or federal exchanges. The amount of the credit is equal to the total cost of the benchmark plan (the second lowest cost silver plan that is available to each member of the household) minus the individual or family's expected contribution to coverage. The credit is available to families earning up to 400% of the federal poverty line. Table Three gives the expected family contribution for different income levels for tax year 2019:

Table Three: Household income percentage of Federal poverty line:	**Initial Percentage**	**Final Percentage**
Less than 133%	2.08%	2.08%
At least 133% but less than 150%	3.11%	4.15%
At least 150% but less than 200%	4.15%	6.54%
At least 200% but less than 250%	6.54%	8.36%
At least 250% but less than 300%	8.36%	9.86%
At least 300% but less than 400%	9.86%	9.86%
Source: IRS Rev. Proc. 2018-34		

Table Four provides the Federal Poverty Level for the 2019 Coverage Year.

Table Four: Federal Poverty Level in 48 Contiguous States and Washington, DC	
Number of persons in household:	2019 Coverage Year
1	$12,140
2	$16,460
3	$20,780
4	$25,100
More	Add $4,320
Source: US Department of Health and Human Services	

Even with premium tax credits reducing the cost of health insurance, estimated yearly costs remain high due to deductibles, co-payments and coinsurance. Table Five summarizes the estimated total yearly costs for people obtaining insurance on an exchange in Allegheny County, PA in 2019. (Pittsburgh is the major city in Allegheny County.) Premiums, premium tax credits, deductibles, out-of-pocket maximums, and estimated yearly costs were obtained at Healthcare.gov for a variety of applicants based on marital status (single or married), number of children (0 or 2), age (25, 35, 45, or 55), annual income ($25,000, $40,000, or $70,000), gender (male or female), expected healthcare utilization (medium or high) and health plan (bronze, silver, or gold). Results are shown for applicants with high expected healthcare utilization as this group is more likely to experience financial distress.

Table Five: Estimated Total Yearly Costs = Premiums + Deductibles + Copays + Coinsurance									
	Annual Income = $25,000			Annual Income = $40,000			Annual Income = $70,000		
Age	Bronze	Silver	Gold	Bronze	Silver	Gold	Bronze	Silver	Gold
25	$8,899 - $16,310	$3,011 - $8,131	$5,813 - $9758	$10,419 - $17,669	$6,962 - $16,135	$7,334 - $11,883	$10,419 - $20,805	$10,184 - $20,559	$7,334 - $15,019
35	$8,707 - $16,312	$3,013 - $8,132	$7,014 - $11,778	$10,911 - $17,288	$6,965 - $16,138	$9,619 - $13,903	$10,911 - $21,822	$11,986 - $23,973	$9,219 - $18,437
45	$8,513 - $16,314	$3,016 - $8,133	$7,049 - $11,848	$10,801 - $16,901	$6,968 - $16,141	$9,337 - $13,973	$11,413 - $22,826	$12,603 - $25,366	$9,949 - $19,898
55	$8,161 - $16,321	$3,027 - $8,139	$7,172 - $12,093	$10,115 - $16,321	$6,979 - $16,152	$9,460 - $12,845	$7,735 - $15,870	$15,151 - $30,301	$12,534 - $25,067
Source: Healthcare.gov									

As noted earlier, bankruptcy filers tend to have lower incomes, so let's focus on the $25,000- and $40,000-income levels. Even with premium subsidies, estimated total yearly costs are a significant portion of annual income for those who experience high utilization rates for medical care. Based on the ranges in Table Five, it is reasonable to continue using $11,000 in unreimbursed medical expenses in our illustration of a healthcare catastrophe tax credit in the next section.

Healthcare Catastrophe Tax Credit

A healthcare catastrophe tax credit can help alleviate the financial burden of unreimbursed medical bills for individuals and families. Let's consider the married filing jointly situation from Table Two. The medical expense deduction provided only a small benefit. For a family with an AGI of $40,000, the tax savings is only $700. If a healthcare catastrophe tax credit were available, the benefit would increase as a tax credit reduces tax liability dollar for dollar while a deduction only reduces tax liability based on the taxpayer's marginal tax rate. In this case, a nonrefundable tax credit would save the $40,000 AGI taxpayer $1,560. A nonrefundable credit is of limited value to lower-income families. The maximum possible credit in this example is $11,000, the amount of the unreimbursed medical expenses. However, a nonrefundable tax credit can only offset an existing tax liability. The family earning $20,000 would get no benefit as no tax is owed. Also, the nonrefundable tax credit would provide much greater benefits to higher income taxpayers, in this case providing a benefit of $8,684 to the $100,000 AGI family.

In order to make the healthcare catastrophe tax credit beneficial to lower income families it should be refundable. In order to target the benefits to those who really need relief it should be scaled by income so lower-income families get greater amounts and higher-income families get lesser amounts. One possible scaling mechanism could be to use the expected premium contribution percentages already utilized to determine the size of premium tax credits. Table Six provides an example for a family of five facing $11,000 of unreimbursed medical expenses. The expected premium contribution percentages are found in Table Three and the federal poverty level income for a family of five is calculated by multiplying the federal poverty level percentages in the second column of Table Six by the federal poverty income levels in Table Four. The expected contribution to high medical costs is found by multiplying the expected premium contribution percentage by the federal poverty level income for a family of five. The Healthcare Catastrophe Tax Credit amount available to the family is found by subtracting the expected contribution from the amount of the unreimbursed medical expenses ($11,000 in this example).

Table Six: Refundable Healthcare Catastrophe Tax Credit for $11,000 Unreimbursed Expense

Expected Premium Contribution	Federal Poverty Level (%)	Federal Poverty Level Income for a Family of 5	Expected Contribution to High Medical Cost	Tax Credit (Medical Costs – Expected Contribution
4.15%	150%	$44,130	$1,831	$9,169
6.54%	200%	$58,840	$3,848	$7,152
8.36%	250%	$73,550	$6,149	$4,851
9.86%	300%	$88,260	$8,702	$2,298
9.86%	400%	$117,680	$11,603	$ 0

This approach results in a significant benefit to lower-income taxpayers with unreimbursed medical expenses and tax credits are reduced as income increases. Tax credits will also vary by family size due to the changing poverty level income. For example, a single person with an income of $37,000 and $11,000 in medical expenses could receive a credit of $7,409 while a family of four with an income of $37,000 and $11,000 in medical expenses could receive a credit of $9,438.

As presented, the amount of the tax credit is determined by the amount of the unreimbursed medical expenses without limit. If unreimbursed medical expenses were assumed to be $21,000, then all tax credit amounts would be $10,000 higher. Budget constraints necessitate a limit on the amount of the credit. A reasonable amount may be between $10,000 and $15,000. This is consistent with the amount of estimated total yearly costs for medical expenses shown in Table Five, particularly for the $40,000 income level, which is about the average income for non-business bankruptcy filers. The credit could possibly be funded by eliminating the medical expense deduction for high income taxpayers and/or reducing the household income percentage of federal poverty line eligible for premium tax subsidies from 400% to 300%. IRS statistics for tax year 2017 show medical expense deductions of $6.3 billion for taxpayers earning over $200,000 per year. At marginal tax rates of about 30%, these deductions cost the federal government about $1.9 billion. It is noted in the Bankruptcies and Medical Debt above that medical debt may be the primary causal factor in approximately 67,500 to 195,000 consumer bankruptcies in 2019. Assuming the higher number, a credit of $10,000 for each of the 195,000 filers would cost $1.95 billion.

The amount available for healthcare catastrophe tax credits may be roughly doubled by reducing the income percentage eligible for premium tax credits from 400% to 300% of federal poverty income. Average household size in the United States is approximately three. From Table Four, the federal poverty level for a family of three is $20,780. Three hundred percent of this is $62,340 per year. IRS statistics show premium tax credits for incomes of $50,000 up to $100,00 in 2017 of approximately $2.8 billion. If credit amounts are roughly equally distributed by income, cutting off the premium tax credits at $63,000 would save about $2 billion that could be applied to healthcare catastrophe tax credits.

Conclusion

The implementation of the Affordable Care Act and tax provisions allowing for premium tax credits and medical expense deductions have not meaningfully reduced the financial distress caused by high unreimbursed medical expenses. A healthcare catastrophe tax credit aimed more directly at families facing high medical debts may help lower the incidence of medically related bankruptcies and provide a medical financing safety net for lower-income Americans.

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