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Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives

Limitations on Tax-Advantaged Accounts

Mr. Chairman, Ranking Member Lewis, members of the subcommittee, I appreciate the invitation to appear before you today.

The Affordable Care Act (ACA) includes a number of spending reductions and tax increases designed to assure that expanding health coverage does not drive up the deficit. Some provisions limit the use of tax-advantaged accounts to pay for health-related expenses. These limitations make sense both as tax policy and as health policy, and repealing any of them would be unwise.

One section of the ACA raises an estimated $13 billion over the 2010-2019 period by limiting contributions to health flexible spending accounts (FSAs) to $2,500 a year. Another raises $5 billion by making the definition of medical expenses for FSAs, Health Savings Accounts (HSAs), and other tax-advantaged accounts conform to the definition used for the itemized income tax deduction for medical expenses. As a result, the cost of over-the-counter (OTC) medications and other OTC items may no longer be reimbursed from an account without a prescription or a letter of medical necessity from a physician. Reimbursements from tax-advantaged accounts are also counted in applying the ACA's excise tax on high-cost health plans.

Only a minority of workers benefits from these tax-advantaged accounts. In 2010, 39 percent of all workers and 56 percent of workers in large firms had access to flexible spending accounts. Only 37 percent of employees offered an FSA in 2010 chose to participate, and the average annual contribution to an FSA was $1,420, well below the new $2,500 limit.[1] Thus, only about one worker in seven has an FSA. A smaller fraction of workers is enrolled in other tax-favored accounts.[2]

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[1] Janemarie Mulvey, *Health Care Flexible Spending Accounts*, Congressional Research Service Report RL32656, January 11, 2012.

[2] Kaiser Family Foundation and Health Research and Education Trust, *Employer Health Benefits, 2011 Annual Survey*.

People with high incomes benefit disproportionately from tax-adantaged accounts because they are in higher tax brackets, tend to consume more health care, and can afford to deposit larger amounts in their accounts. Middle- and lower-income people benefit much less, if at all. For example, someone in the 15-percent income tax bracket who contributed the average of $1,420 to an FSA would save $322 in federal income and payroll taxes. The typical middle-income individual likely contributes much less than the average, however, and therefore receives even smaller tax savings. Low- and moderate-income households are unlikely to receive *any* income-tax savings because they pay little or no income tax. They do receive payroll tax savings, but low-income workers will lose more in future Social Security benefits than they gain in lower payroll taxes, because their Social Security benefits are based on their taxable earnings.[3]

These modest tax benefits entail relatively large administrative and compliance costs. Employers must manage the accounts themselves or hire a vendor to do so — typically at a cost of about $60 annually per participant. Accountholders must spend hours complying with onerous recordkeeping requirements to assure that they are using their accounts only for approved items.

FSAs and other tax-advantaged accounts also encourage the overconsumption of health care, which runs directly counter to bipartisan efforts to slow the growth of system-wide health-care costs in both public programs and the private sector. The accounts make people less price-sensitive and reduce the effectiveness of cost-sharing requirements in controlling health care utilization. Moreover, prior to the restriction on over-the-counter items, funds in tax-advantaged accounts could be used to purchase nearly any health care item or service, regardless of whether it was medically necessary, cost effective, or of meaningful health value.

The staff of the Joint Committee on Taxation (JCT) included changing the definition of medical expenses for tax-advantaged accounts in a 2005 report identifying options for improving tax compliance and reforming tax expenditures. JCT offered several reasons for using the same defintion of "medical care" for both tax-favored accounts and itemized deductions. First, having different definitions of "medical care" for different provisions caused similarly situated individuals to receive unequal tax treatment. Second, purchases of over-the-counter medicines and other items (such as pain relievers, cold remedies, and sunscreen) constitute routine personal expenses, which are generally not considered deserving of a tax subsidy. Third, "providing a subsidy for over-the-counter medicines may also result in less compliance, as it may be more difficult to distinguish products that are medical from those that are not, such as toiletries and products that promote general health."[4] These reasons still apply today.

Finally, the Affordable Care Act extends health coverage to 34 million more Americans and establishes minimum standards for health insurance policies, including an annual limitation on cost-sharing. These and other aspects of health reform further diminish the already weak policy rationale for FSAs and other tax-avantaged accounts for health spending.

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[3] Chuck Marr and Kris Cox, *Curbing Flexible Spending Accounts Could Help Pay for Health Care Reform,* Center on Budget and Policy Priorities, June 10, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=2829.

[4] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, January 27, 2005, pp. 105-8.