[JOINT COMMITTEE PRINT]

DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2003 BUDGET PROPOSAL

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of the revenue provisions and other provisions modifying the Internal Revenue Code (the "Code") that are contained in the President's fiscal year 2003 budget proposal, as submitted to the Congress on February 4, 2002.[2] The pamphlet generally follows the order of the proposals as included in the Department of the Treasury's explanation of the President's proposals.[3] For these provisions, there is a description of present law and the proposal (including effective date), an analysis of complexity and policy issues related to the proposal, and a reference to any prior budget proposal submission or recent legislative action.

Subsequent to the submission of the President's budget to Congress, provisions similar or identical to several of the budget proposals have been enacted into law (P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002," as passed by the House of Representatives on March 7, 2002, by the Senate on March 8, 2002, and signed into law on March 9, 2002).

The President's budget refers to a "bipartisan economic security plan"[4] in assessing the impact of the budget on the Federal fiscal surplus or deficit; a detailed description of the plan is not included in the budget documents. Similarly, this pamphlet does not provide a description.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2003 Budget Proposal* (JCS-3-02), March 18, 2002.

[2] See Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2003: Analytical Perspectives* (H. Doc. 107-159, Vol. III), pp. 55-83.

[3] See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2003 Revenue Proposals*, February 2002.

[4] See Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2003, Summary Tables: Table S-3, Impact of Budget Policy on the Surplus* (H. Doc. 107-159, Vol. I), p. 397.

I. SUMMARY OF COMPLEXITY ISSUES

It is generally acknowledged that complexity in the Federal tax system is a large and growing problem. The President's fiscal year 2003 budget acknowledges this and indicates that the Administration is developing simplification proposals.[5] The Administration indicates that this tax simplification project is focused on the following particular provisions: individual and corporate alternative minimum tax, family related provisions such as the earned income credit and the refundable child credit, differing rules regarding the definition of a child, income-based phaseouts, education incentives, Individual Retirement Accounts (IRAs), individual capital gains, excise taxes, tax-exempt bond arbitrage and private activity rules, asset depreciation classes and placed-in-service conventions, capitalization issues, international tax issues, and tax accounting issues such as accrual and inventory accounting, uniform capitalization rules, and percentage of completion method.

Complexity in the Federal tax system poses many problems. Among the more commonly recognized effects of complexity are (1) decreased levels of voluntary compliance; (2) increased costs for taxpayers; (3) reduced perceptions of fairness in the Federal tax system; and (4) increased difficulties in the administration of tax laws. Costs for taxpayers include the time to learn the tax laws, the time to fill out the necessary forms, and the costs of tax planning to secure certain tax benefits or favorable tax treatment and to avoid unfavorable tax treatment. Costs to society as a whole include these personal costs, as well as potential costs from beneficial activities, transactions, or investments that are forgone due to complex or uncertain tax treatment. Reduced perceptions of fairness in the Federal tax system may arise when complexity creates disparate treatment of similarly situated taxpayers. Disparate treatment arises (1) when taxpayers can't comprehend the law and don't have access to sophisticated tax advice; (2) when taxpayers have different interpretations of the law (which may be influenced by access to professional advice); and (3) when interactions among provisions create unintended consequences. Decreased levels of voluntary compliance are likely the direct result of the difficulties of complying with a complex system, even for those who wish to comply with the law. Additionally, the financial and other costs of compliance and the decreased perceptions of fairness that result from complexity are likely to contribute to taxpayers intentionally failing to comply with the tax law.

Though complexity is an undesirable feature of a tax system, many believe that complexity is an inherent feature of a tax system in a modern economy with individuals who have complex financial and economic situations as well as diverse family arrangements and responsibilities. A tax system that addresses these and other special circumstances, or that creates incentives for particular activities, will necessarily be complex. Nonetheless, most would agree that some complexity could be removed from the tax system without harm to the principal policy objectives of the tax system. Further, many would agree that complexity concerns should be balanced against other policy objectives, and that some desirable policies should not be pursued, or at least not pursued through the tax system, if the resulting tax provisions would be too complex.

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[5] See Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2003: Analytical Perspectives* (H. Doc. 107-159, Vol. III), p. 75.

Notwithstanding the Administration's acknowledgement of the problem of complexity, the budget proposal itself is dominated by proposals that would at least modestly increase the complexity of the Code, rather than reduce it. Compared to other budget submissions in past years, the complexity that would be added is not unusual. It has been common in recent years for the President's budget proposals to include numerous tax incentives or benefits for both individuals and corporations in the form of special rules and new credits, deductions, or exclusions for a favored activity or situation. While the President's proposals include some provisions that would decrease the complexity of the Code (such as reforming the excise tax based on investment income of private foundations and revising the tax treatment of charitable remainder trusts), and others that would have no significant impact on complexity (such as raising the cap on corporate charitable contributions), the bulk of the proposals add at least some complexity to the tax system.

Some of the proposals that increase complexity do so only very modestly. For example, the business credit for combined heat and power (CHP) property would likely be easy to determine eligibility for, relatively easy to administer, and would affect few taxpayers as there are not likely to be many investors in such property. However, the credit introduces complexity for taxpayers making the determination of the precise boundaries of the property that is eligible for the credit.

Other proposals have numerous sources of complexity and affect millions of taxpayers. In particular, the proposed tax credit for the purchase of health insurance would introduce numerous complexity issues; the most significant source of complexity would be the development of systems to administer the advanced payment features of the credit. Eligibility issues would prove complex as well, because eligible health insurance would need to be defined, as well as eligible taxpayers and children. Advancing the credit complicates these eligibility issues, because it will be difficult to determine concurrent eligibility for a variety of reasons, including the difficulty of knowing in advance one's annual income, which determines both eligibility for, and the size of, the credit. This credit is also a refundable credit, meaning that the Federal government will pay the credit in amounts in excess of tax liability. Refundable credits add particular complexities to a tax system. First, the refundable feature creates situations where individuals who would otherwise not have to file a tax return are brought into the tax system in order to collect the credit. This increases burdens on the IRS, as well as on the affected individuals, by requiring the filing of more tax returns in the aggregate. Additionally, experience with the earned income credit suggests that fraud is a problem and that the IRS has difficulty collecting credits paid out in error.

The charitable contribution deduction for non-itemizers would also add complexity for millions of taxpayers. Adding the deduction for non-itemizers would require that millions more taxpayers keep records of small contributions, and would lead to more disputes with the IRS on audits. This proposal and others like it that allow additional deductions for non-itemizers (such as the present-law student loan interest deduction) threaten to undermine one of the principal purposes of the standard deduction--that of simplifying returns for those with a low level of itemizable deductions by eliminating the need for record keeping and accounting for these deductions by allowing instead the standard deduction. As the exceptions multiply, all taxpayers in effect become itemizers, which leads to more complicated tax return preparation and administration.

Finally, the proposal to allow tax-free withdrawals from Individual Retirement Accounts (IRAs) for charitable contributions adds complexity to the tax system. The proposal's objectives could be achieved, also through the tax system, in a far less complicated manner. The proposal gives IRA owners a means to avoid the percentage of income limitations for charitable contributions imposed elsewhere in the Code.[6] There seems to be no particular policy reason that IRA owners should be permitted to avoid this limitation, but not other taxpayers. Therefore, if the limitation is perceived to be a problem that limits charitable giving, it would be simpler to eliminate, or at least raise, these limitations. Thus, rather than adding a complex provision that would work at cross purposes to another complex provision, taxpayers would be better served by making the present limitation less binding. This would provide some simplification to the Code for those taxpayers who would no longer need to make the calculations to determine nondeductible contributions and no longer be subject to carryforwards of the deduction.

Overall, the President's 2003 fiscal year budget proposal would add one new personal exemption for individuals, two new exclusions from income, three new deductions for individuals that are allowed regardless of whether the taxpayer itemizes deductions, one new deduction for businesses, and eight new credits (plus the expansion in scope of an existing credit), two of which are refundable and one of which has an income-based phaseout.

The staff of the Joint Committee on Taxation has included in this analysis of the President's Fiscal Year 2003 Budget Proposals a detailed discussion of the increased complexity, or improvements in simplification, that would arise from the adoption of each of the President's proposals.

[6] The proposal also effectively provides a means for taxpayers with IRA income who take the standard deduction to get an additional deduction for charitable contributions.

C. Health Care Provisions

1. Refundable tax credit for the purchase of health insurance

Present Law

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

An employer's contribution to a plan providing health coverage for an employee, and his or her spouse and dependents, is excludable from the employee's income for both income and payroll tax purposes. In addition, active employees participating in a cafeteria plan may pay their employee share of premiums on a pre-tax basis.

Self-employed individuals may deduct a portion of health insurance expenses for themselves and their spouse and dependents. The deductible percentage is 70 percent in 2002, and 100 percent in 2003 and all years thereafter. The deduction is not available for any month in which the self-employed individual is eligible to participate in an employer-subsidized health plan. The deduction may not exceed the individual's self-employment income.

Other individuals who pay for their own health insurance may claim an itemized deduction for their health insurance premiums only to the extent that premiums, when combined with other unreimbursed medical expenses, exceed 7.5 percent of adjusted gross income.

Self-employed individuals and individuals employed by small employers maintaining a high-deductible health plan can accumulate funds in an Archer medical savings account ("MSA") on a tax-preferred basis to pay for medical expenses.

Under the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), qualified beneficiaries are eligible to purchase continuation coverage under an employer-sponsored plan upon the occurrence of certain events that would otherwise result in loss of coverage, such as termination of employment. The employer may charge up to 102 percent of the average cost of the employer's health plan for continuation coverage. Depending on the circumstances, former employees and their dependents can elect to continue COBRA coverage for up to 18 to 36 months.

Description of Proposal

The proposal would provide a refundable tax credit for health insurance purchased by individuals who are under age 65 and do not participate in a public or employer-provided health plan. The maximum annual amount of the credit would be 90 percent of premiums, up to a maximum premium of $1,111 per adult and $556 per child (for up to two children). These dollar amounts would be indexed in accordance with the Consumer Price Index based on all-urban consumers. Thus, the maximum annual credit prior to any indexing of the premium limits,

would be $1,000 per adult and $500 per child (up to two children), for a total possible maximum credit of $3,000 per tax return.

The 90 percent credit rate would be phased-down for higher income taxpayers. Individual taxpayers filing a single return with no dependents and modified adjusted gross income of $15,000 or less would be eligible for the maximum credit rate of 90 percent. The credit percentage for individuals filing a single return with no dependents would be phased-down ratably from 90 percent to 50 percent for modified adjusted gross income between $15,000 and $20,000, and phased-out completely at modified adjusted gross income of $30,000.

Other taxpayers with modified adjusted gross income up to $25,000 would be eligible for the maximum credit rate of 90 percent. The credit percentage would be phased-out ratably for modified adjusted gross income between $25,000 and $40,000 if the policy covers only one adult, and for modified adjusted gross income between $25,000 and $60,000 if the policy (or policies) covers more than one adult.

Taxpayers claiming the credit would not be allowed to make contributions to an Archer MSA for the year the credit is claimed.

The credit would be claimed on the individual's tax return or on an advanced basis, as part of the premium payment process, by reducing the premium amount paid to the insurer. After implementation of the advanced payment option, the benefit of the credit would be available at the time that the individual purchases health insurance, rather than later when the individual files his or her tax return the following year. Health insurers would be reimbursed by the Department of the Treasury for the amount of the credit. Eligibility for the advanced credit option would be based on the individual's prior year return and there would be no reconciliation on the current year return.

Policies eligible for the credit would have to meet certain requirements, including coverage for high medical expenses.[62] Qualifying health insurance could be purchased through the non-group insurance market, private purchasing groups, State-sponsored insurance purchase pools, and State high-risk pools.

At the option of States, after December 31, 2003, the credit could be used by certain individuals not otherwise eligible for public health insurance programs to buy into privately contracted State-sponsored purchasing groups (such as Medicaid or SCHIP purchasing pools for private insurance or State government employee programs for States in which Medicaid or SCHIP does not contract with private plans). States could provide additional contributions to individuals who purchase insurance through such purchasing groups. The maximum State contribution would be $2,000 per adult (for up to two adults) for individuals with incomes up to 133 percent of the poverty level. The maximum State contribution would phase-down ratably, reaching $500 per adult at 200 percent of the poverty level. Individuals with income above 200 percent of the poverty level would not be eligible for a State contribution. States would not be allowed to offer any other explicit or implicit cross subsidies.

[62] The proposal does not include details regarding the requirements policies must satisfy.

Effective date.--The credit would be effective for taxable years beginning after December 31, 2002. The advanced payment option would be available beginning in July 2003.

Analysis of Complexity and Policy Issues

Policy issues

In general

The proposal is intended to provide an incentive to uninsured individuals to purchase health insurance by providing assistance in paying premiums. Proponents of the proposal argue that the proposal will enable low-income individuals to purchase health insurance, thereby reducing the number of uninsured individuals.

Opponents of the credit argue that it would not be sufficient to make insurance affordable for many individuals and thus would not be utilized by many uninsured. For example, the credit may not improve the opportunity for coverage in the individual market for the elderly and individuals with chronic health problems if coverage is too expensive, even with the credit. In addition, opponents of the credit question whether the amount of the credit will be sufficient to allow many low-income individuals, regardless of age or health status, to purchase adequate health insurance coverage. They argue that the credit is too low to allow individuals to purchase a policy other than a very minimal policy, and that those most likely benefiting from the credit will be insurers. Proponents counter that the credit level is sufficient, and that individuals who purchase insurance as a result of the credit will be better off than they would be without insurance.

Some opponents are also concerned about the focus of the credit on insurance purchased in the individual market. They believe the individual market does not presently offer sufficient protections to purchasers, and that any credit for the purchase of coverage in the individual market should only be adopted if accompanied by modest reforms.

The proposal addresses some of the present-law differences in tax treatment between employer-subsidized health insurance and insurance purchased by individuals. Critics of the proposal might argue that providing a credit for the purchase of health insurance would undermine the current employment-based health insurance system by encouraging healthier individuals who can obtain less expensive coverage in the individual market to leave the employee pool, thus increasing the cost of insurance for the employees remaining in the pool. Further, some argue that the existence of the tax credit could cause some employers to not offer health benefits for their employees. This could cause the insurance market to turn into a predominantly individual market, which could result in an increase in the cost of health coverage for some individuals.

Others argue that the design of the credit will not cause employees to leave employers' plans, as the credit is targeted to low-income individuals who are less likely to have employer-provided health insurance. Additionally, the subsidy rate is phased out as income increases and there is a cap on the premium eligible for the subsidy.

Because of the limit on the number of children per family eligible for the credit, families with more than two children will receive a smaller benefit under the proposal. For example, a married couple with two children could be eligible for a credit up to $3,000, while a single parent with three children could be eligible for a maximum credit of only $2,000.

Some argue that the objective of the proposal to increase health insurance would be better served under a direct spending program, especially because the credit is refundable and does not require that the individual pay tax. Those opponents to the credit argue that expanding public programs would be a better alternative because such expansion would not create an incentive to leave employer-provided coverage and would make health insurance coverage more affordable and accessible. On the other hand, a spending program may provide less individual choice of health insurance options.

Advanced payment mechanism

The advanced payment feature of the credit raises numerous issues. The main argument in favor of providing the credit on an advanced basis is that many of the intended recipients would not be able to purchase insurance without the advanced credit. Because advancing the credit merely changes the timing of payment and does not reduce the cost of insurance (except for the time value of money), this argument is best understood not as making the insurance affordable, as is often stated, but rather in making it available to those who would not otherwise be able to arrange the financing to pay for the insurance in advance of receiving the credit. Given the target population of the credit, it might reasonably be argued that for many, other financing mechanisms, such as credit cards, loans from relatives or friends, personal savings, etc., would not be available, or would not be used even if available, and the best way to encourage individuals to buy insurance would be to provide the credit in advance, at the time of purchase of the insurance.

Some argue that the mechanism for delivering the credit on an advanced basis would not be effective. For example, basing eligibility on the prior year's income raises issues. Using prior year information may make the advanced payment option easier to administer, however, using the prior year data and not requiring reconciliation means that the credit will in some cases not reach those intended to receive it. For example, individuals could have low income in the current year when they need assistance in purchasing health insurance, but prior year income that is too high to qualify for the advanced payment of the credit. Such individuals would not be eligible to receive the credit on the advanced basis and in many cases, because of their decreased income, would remain uninsured.

It may also be argued that the advanced payment mechanism of the proposal is flawed because an individual could receive the credit as an advanced payment based on the prior year's income, even though ineligible for the credit because of the current year's income. Because there is no reconciliation required on the current year return, such individual would not be required to repay the amount of the advanced payment of the credit to the government. For example, a recently graduated student could have current year income of over $100,000, but prior year income of less than $15,000 because the individual was in school on a full-time basis. Such individual could be entitled to the $1,000 advanced payment of the credit even though the

current year income exceeds the credit income limitation. Thus, using prior year income may result in inefficiency regarding delivery of the credit.

Using current year data or requiring reconciliation would reduce this problem. Using current year data could, however, create other issues, such as making the mechanics of the advanced payment system work and enforcement issues. For example, it may be difficult in some cases to collect the additional tax owed by people who erroneously claimed the advance credit. Experience with the earned income credit shows that this could be the case.

The fact that the tax credit is refundable could lead to fraud and abuse by taxpayers, as it may be difficult for the IRS to successfully enforce against taxpayers claiming the credit even though ineligible. Similar to the earned income credit, it would be difficult for the IRS to timely detect fraudulent refunds issued to taxpayers.

Complexity issues

Creating a new tax credit adds complexity to the Code. By providing additional options to individuals, the proposal may increase complexity because individuals will have to determine which option is best for them. A new tax credit will increase complexity in IRS forms and instructions, by requiring new lines on several tax forms and additional information in instructions regarding the tax credit. The new credit would also require IRS programming modifications.

The Code contains several provisions that provide benefits to taxpayers with children. These provisions have different criteria for determining whether the taxpayer qualifies for the applicable tax benefit with respect to a particular child. The use of different tests to determine eligibility for a provision with respect to a child causes complexity for taxpayers and the IRS. Under the proposal, the definition of child for purposes of the credit is unclear. Depending on the definition of child used for purposes of the credit, additionally complexity may arise. Additionally, the credit adds new phase-outs to the numerous existing phase-outs in the Code, which increases complexity in several ways.

The advanced payment aspect of the credit also adds additional complexity to the Code. Taxpayers would have to use different income amounts to calculate the credit depending whether the credit is claimed on an advanced basis or on the current year tax return. The proposal may also increase complexity for insurance companies by adding administrative burdens with respect to the advanced payment of the credit. Health insurers would be required to provide information statements to taxpayers receiving the credit on an advanced payment basis and to the IRS, including the policy number, the policy premium, and that the policy meets the requirements for a qualified policy.

Prior Action

A similar credit was contained in the President's fiscal year 2002 budget proposal.

2. Above-the-line deduction for long-term care insurance premiums

Present Law

Under present law, the Federal income tax treatment of qualified long-term care insurance expenses is similar to the treatment of health insurance expenses.[63] As is the case with health insurance expenses, the Federal income tax treatment of qualified long-term care insurance expenses depends on the individual's circumstances.

Individuals who purchase their own qualified long-term care insurance may claim an itemized deduction for the premiums, but only to the extent that eligible qualified long-term care insurance premiums, together with the individual's medical expenses exceed 7.5 percent of adjusted gross income.[64] The amount of qualified long-term care insurance premiums that may be taken into account in determining the amount allowed as an itemized deduction is limited as follows (for 2002): $240 in the case of an individual 40 years old or less; $450 in the case of an individual who is more than 40 but not more than 50; $900 in the case of an individual who is more than 50 but not more than 60; $2,390 in the case of an individual who is more than 60 but not more than 70; and $2,990 in the case of an individual who is more than 70. These dollar limits are indexed for inflation.

Self-employed individuals may deduct a portion of qualified long-term care insurance premiums for the individual and his or her spouse and dependents. The deductible percentage of such premiums is 70 percent in 2002 and 100 percent in 2003 and thereafter.[65] The deduction applies to qualified long-term care insurance premiums, subject to the same dollar limits that apply for purposes of the itemized deduction, described above.

Employees can exclude from income 100 percent of qualified long-term care insurance paid for by the employee's employer. There is no dollar limit on this exclusion. Unlike health insurance, long-term care insurance cannot be provided under a cafeteria plan.

Payments made under a qualified long-term care insurance contract are excludable from gross income, subject to a dollar limitation in the case of contracts that provide for payment on a per diem or similar basis.

In order for a long-term care insurance contract to be a qualified long-term care insurance contract: (1) the contract must be guaranteed renewable; (2) the contract generally cannot provide for a cash surrender value or other money that can be paid, assigned, or pledged as a loan

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[63] The main difference between the tax treatment of qualified long-term care insurance and medical insurance is that long-term care insurance cannot be offered under a cafeteria plan.

[64] Sec. 213(d).

[65] The deduction for long-term care insurance expenses of self-employed individuals is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse.

or borrowed; (3) all refunds of premiums, and all policyholder dividends or similar amounts, under the contract are to be applied as a reduction in future premiums or to increase future benefits; and (4) the contract must meet certain consumer protection standards.[66] Contracts that provide for per diem or similar payments are subject to additional requirements.

The consumer protection provisions applicable to qualified long-term care insurance contracts require that (1) such contracts meet certain provisions under the model long-term care insurance act and regulations promulgated by the National Association of Insurance Commissioners, (2) the issuer of the contract discloses that the contract is intended to be a qualified policy, and (3) the issuer offer the policyholder a nonforfeiture provision meeting certain requirements.

Description of Proposal

The proposal would provide an above-the-line deduction for a percentage of qualified long-term care insurance premiums up to the dollar limitations that apply under the itemized deduction. The deduction would not be available to an individual covered under an employer-sponsored health plan unless the employee pays at least 50 percent of the cost of the coverage. The proposal would also impose new standards on qualified long-term care policies.[67]

The deductible percentage of qualified long-term care insurance premiums would be 25 percent in 2004, 35 percent in 2005, 65 percent in 2006, and 100 percent in 2007 and thereafter.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2003.

Analysis of Complexity and Policy Issues

Policy issues

In general

The present-law favorable tax treatment of qualified long-term care insurance contracts was adopted to provide an incentive for individuals to take financial responsibility for their long-term care needs.[68] In addition, the present-law rules serve to provide certainty with respect to the tax treatment of qualified long-term care insurance contracts. Prior to the adoption of the present-law rules, which generally are effective beginning in 1997, the tax treatment of qualified long-term care insurance was unclear. There were no specific rules with respect to such insurance, rather, the tax treatment depended on the applicability of the rules relating to medical

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[66] Sec. 7702B.

[67] Details of the new standards are not specified.

[68] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-6), December 18, 1996, at 336.

expenses and accident or health insurance, which involved a case by case determination. Thus, the present-law rules contribute to simplification of the tax laws by reducing uncertainty.

The proposal would provide additional tax incentives for the purchase of qualified long-term care insurance. Like the present-law rules, such additional tax incentives are designed to encourage individuals to provide for their long-term care needs. The proposal raises both tax policy and health policy issues.

From a health policy perspective, one issue is whether it is appropriate to provide more favorable tax treatment for the purchase of long-term care insurance than for the purchase of health insurance. If this proposal were adopted, persons would be able to deduct long-term care insurance premiums above-the-line, whereas individuals who purchase their own health insurance (and who are not self employed) could only deduct health insurance premiums under the itemized deduction for medical expenses. Some argue that health insurance is a more fundamental need than, or at least an equal need to, long-term care insurance and that it is not appropriate to provide more favorable rules for long-term care insurance. Proponents of the proposal argue that the President's fiscal year 2003 budget proposal contains other provisions, in particular, a tax credit for the purchase of health insurance, that address the need for health insurance. In addition, some argue that an additional incentive to purchase long-term care insurance is appropriate to encourage individuals to purchase the insurance when they are younger. Premiums for long-term care insurance typically have a level payment feature; that is, part of the premium is allocated to the cost of current coverage and part to future coverage. Some argue that additional tax benefits will encourage individuals to purchase such coverage at a young enough age so that premiums are more affordable.

From a tax policy perspective, it could be questioned whether providing an additional incentive for the purchase of long-term care insurance serves the tax policy goal of accurate income measurement. Implementing the social policy of encouraging the financing of long-term care needs through subsidies provided in the tax system arguably is inefficient. Some might criticize the proposal as providing a targeted subsidy for one type of insurance product for which there has been a weak market, rather than directly addressing the social policy issue of growing long-term care needs. On the other hand, some might point out that Congress has already provided subsidies to long-term care insurance through the tax law to encourage people to provide for long-term care needs, and that this proposal is consistent with the policy already expressed by Congress.

Complexity issues

The proposal may contribute to complexity in the tax system by providing different sets of rules for long-term care insurance and health insurance. If the tax rules for long-term care insurance are more favorable than for health insurance, there may be pressure to provide health insurance under a long-term care policy. Thus, many of the definitional issues that arose prior to the enactment of the present-law rules may again arise. The proposal would also add complexity in that it would increase the number of savings incentives in the tax law, each with different requirements.

Prior Action

A similar proposal was included in the President's fiscal year 2002 budget proposal and in the Taxpayer Refund and Relief Act of 1999 as passed by the 106th Congress and vetoed by the President.

3. Allow up to $500 in unused benefits in a health flexible spending arrangement to be carried forward to the next year

Present Law

A flexible spending arrangement ("FSA") is a reimbursement account or other arrangement under which an employee is reimbursed for medical expenses or other nontaxable employer-provided benefits, such as dependent care. Typically, FSAs are part of a cafeteria plan and may be funded through salary reduction. FSAs may also be provided by an employer outside a cafeteria plan. FSAs are commonly used, for example, to reimburse employees for medical expenses not covered by insurance.

There is no special exclusion for benefits provided under an FSA. Thus, benefits provided under an FSA are excludable from income only if there is a specific exclusion for the benefits in the Code (e.g., the exclusion for employer-provided health care (other than long-term care) or dependant care assistance coverage).

FSAs that are part of a cafeteria plan must comply with the rules applicable to cafeteria plans generally. One of these rules is that a cafeteria plan may not offer deferred compensation except through a qualified cash or deferred arrangement.[69] Under proposed Treasury regulations, a cafeteria plan is considered to permit the deferral of compensation if it includes a health FSA which reimburses participants for medical expenses incurred beyond the end of the plan year.[70] Thus, amounts in an employee's account that are not used for medical expenses incurred before the end of a plan year must be forfeited. This rule is often referred to as the "use it or lose it" rule.

In addition, proposed Treasury regulations contain additional requirements with which health FSAs must comply in order for the coverage and benefits provided under the FSA to be excludable from income.[71] These rules apply with respect to a health FSA without regard to whether the health FSA is provided through a cafeteria plan (i.e., without regard to whether an employee has an election to take cash or benefits).

The proposed regulations define a health FSA as a benefit program that provides employees with coverage under which specified, incurred expenses may be reimbursed (subject to reimbursement maximums and any other reasonable conditions) and under which the

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[69] Sec. 401(k).

[70] Prop. Treas. Reg. 1.125-2 Q&A-5(a).

[71] Prop. Treas. Reg. 1.125-2 Q&A-7(b).

maximum amount of reimbursement that is available to a participant for a period of coverage is not substantially in excess of the total premium (including both employee-paid and employer-paid portions of the premium) for such participant's coverage. A maximum amount of reimbursement is not substantially in excess of the total premium if the maximum amount is less than 500 percent of the premium.[72]

Under the proposed regulations, the employer-provided health coverage under the FSA and the reimbursements and other benefits received under the health FSA are excludable from an employee's income only if the health FSA satisfies certain additional requirements. According to the proposed regulations, health FSAs are required to (1) provide the maximum amount of reimbursement available under the FSA at all times during the period of coverage (properly reduced as of any particular time for prior reimbursements for the same period of coverage), (2) offer coverage for 12 months or, in the case of a short plan year, the entire short plan year, (3) only reimburse medical expenses which meet the definition of medical care under section 213(d), (4) reimburse medical expenses for which the participant provides a written statement from an independent third party stating the amount of the medical expense and that the medical expense has not been reimbursed or is not reimbursable under any other health plan, (5) reimburse medical expenses which are incurred during the participant's period of coverage, and (6) allocate experience gains with respect to a year of coverage among premium payers on a reasonable and uniform basis.[73]

Description of Proposal

The proposal would allow up to $500 of unused amounts in an employee's health FSA to be carried forward to the employee's account for the next plan year of the health FSA.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2003.

Analysis of Complexity and Policy Issues

In general

Under present law, the use-it-or-lose it rule generally causes employees to estimate the amount of health care expenses they are likely to incur during the year and to elect to contribute no more than that amount to a health FSA. Present law creates an incentive for employees to make a conservative estimate of anticipated health care expenses that are likely to be paid from an FSA in order to minimize the risk that amounts will be forfeited. The proposal would reduce this incentive by reducing the likelihood that amounts would be forfeited. The proposal is likely to increase the amount of contributions to health FSAs because some employees who currently do not make contributions to a health FSA because of the use-it-or-lose it rule will make contributions if the proposal is adopted and because some employees will increase contributions

[72] Prop. Treas. Reg. 1.125-2 Q&A-7(c).

[73] Prop. Treas. Reg. 1.125-2 Q&A-7(b).

if the proposal is adopted. Such an expansion of FSAs raises both tax and health policy issues. The proposal has elements that may both increase and reduce complexity.

Tax policy, efficiency and health policy issues

Some argue that cafeteria plans in general and FSAs in particular undermine sound income tax policy because they allow employees to choose whether certain income is taxable. Such plans and arrangements, like other income tax exclusions, contribute to unfairness in the Federal tax system because they result in unequal treatment of taxpayers with the same economic income. For example, medical expenses paid or reimbursed through a cafeteria plan are excludable from gross income, whereas if such expenses are paid directly by the employee, are deductible only if the employee itemizes deductions and only if the employee's total medical expenses exceed 7.5 percent of adjusted gross income. Thus, a taxpayer who is covered by a cafeteria plan may have lower tax liability that a similarly situated taxpayer who is not covered by such a plan.

Some argue that cafeteria plans, including FSAs, promote an efficient use of recourses by giving employers and employees more flexibility to address the concerns of a diverse and changing workforce. Such plans permit each employee to structure his or her own benefit program and reduce the need for employers to provide an array of benefits that some employees do not need or do not want.

There is a difference of opinion as to whether cafeteria plans, including health FSAs, promote or undermine sound health policy. Such plans reduce the cost to the employee of health care expenditures by the amount of the tax subsidy provided by the exclusion. Thus, such plans lower the cost of health care to the individual and may provide an incentive for greater health care utilization than would occur in the absence of the exclusion. This is true of all tax-favored health plans, whether provided through a cafeteria plan or otherwise, but may be exacerbated in the case of health FSAs because such arrangements provide a tax subsidy for the first dollar of health care coverage.

On the other hand, some argue that the availability of health FSAs may reduce health expenses. Some employees may be more likely to choose a less costly health insurance plan if they know they have money available in a health FSA that can be used to pay for expenses not covered by insurance. If such expenses are not in fact incurred, then health care spending will be reduced. However, some argue that cafeteria health FSAs operate more to shift health care expenses from the employer to the employee rather than to reduce overall spending on health care.

Proponents of the proposal argue that the use-it-or-lose it rule contributes to excess health care expenditures because some employees will incur unnecessary expenses merely to avoid losing amounts in a health FSA. They argue that if the use-it-or-lose it rule is modified, then employees will not incur such expenses. Others argue that the use-it-or-lose it rule serves mainly to affect the timing of expenses (e.g., an employee may choose to purchase new glasses this year rather than next year if they have amounts in an FSA) rather than reducing overall expenses.

Complexity issues

The proposal has elements that may both increase and decrease tax law complexity. By providing additional options to employees, the proposal may increase complexity because employees will have to determine which option is best for them. The proposal may also increase the complexity for employers by adding new administrative burdens with respect to cafeteria plans. On the other hand, easing of the use-it-or-lose it rule is likely to reduce the time it takes for individuals to determine whether and how much to contribute to a health FSA.

Prior Action

A similar proposal was included in the President's fiscal year 2002 budget proposal.

4. Provide additional choice with regard to unused benefits in a health flexible spending arrangement

Present Law

A flexible spending arrangement ("FSA") is a reimbursement account or other arrangement under which an employee is reimbursed for medical expenses or other nontaxable employer-provided benefits, such as dependent care. Typically, FSAs are part of a cafeteria plan and may be funded through salary reduction. FSAs may also be provided by an employer outside a cafeteria plan. FSAs are commonly used, for example, to reimburse employees for medical expenses not covered by insurance.

There is no special exclusion for benefits provided under an FSA. Thus, benefits provided under an FSA are excludable from income only if there is a specific exclusion for the benefits in the Code (e.g., the exclusion for employer-provided health care (other than long-term care) or dependant care assistance coverage).

FSAs that are part of a cafeteria plan must comply with the rules applicable to cafeteria plans generally. One of these rules is that a cafeteria plan may not offer deferred compensation except through a qualified cash or deferred arrangement.[74] Under proposed Treasury regulations, a cafeteria plan is considered to permit the deferral of compensation if it includes a health FSA which reimburses participants for medical expenses incurred beyond the end of the plan year.[75] Thus, amounts in an employee's account that are not used for medical expenses incurred before the end of a plan year must be forfeited. This rule is often referred to as the "use it or lose it" rule.

In addition, proposed Treasury regulations contain additional requirements with which health FSAs must comply in order for the coverage and benefits provided under the FSA to be excludable from income.[76] These rules apply with respect to a health FSA without regard to

[74] Sec. 401(k).

[75] Prop. Treas. Reg. 1.125-2 Q&A-5(a).

[76] Prop. Treas. Reg. 1.125-2 Q&A-7(b).

whether the health FSA is provided through a cafeteria plan (i.e., without regard to whether an employee has an election to take cash or benefits).

The proposed regulations define a health FSA as a benefit program that provides employees with coverage under which specified, incurred expenses may be reimbursed (subject to reimbursement maximums and any other reasonable conditions) and under which the maximum amount of reimbursement that is available to a participant for a period of coverage is not substantially in excess of the total premium (including both employee-paid and employer-paid portions of the premium) for such participant's coverage. A maximum amount of reimbursement is not substantially in excess of the total premium if the maximum amount is less than 500 percent of the premium.[77]

Under the proposed regulations, the employer-provided health coverage under the FSA and the reimbursements and other benefits received under the health FSA are excludable from an employee's income only if the health FSA satisfies certain additional requirements. According to the proposed regulations, health FSAs are required to (1) provide the maximum amount of reimbursement available under the FSA at all times during the period of coverage (properly reduced as of any particular time for prior reimbursements for the same period of coverage), (2) offer coverage for 12 months or, in the case of a short plan year, the entire short plan year, (3) only reimburse medical expenses which meet the definition of medical care under section 213(d), (4) reimburse medical expenses for which the participant provides a written statement from an independent third party stating the amount of the medical expense and that the medical expense has not been reimbursed or is not reimbursable under any other health plan, (5) reimburse medical expenses which are incurred during the participant's period of coverage, and (6) allocate experience gains with respect to a year of coverage among premium payers on a reasonable and uniform basis.[78]

Description of Proposal

The proposal would allow up to $500 of unused amounts in an employee's health FSA to be distributed to the employee or contributed to a qualified cash or deferred arrangement ("401(k) plan"), tax-sheltered annuity ("403(b) plan"), governmental section 457 plan, or an Archer medical savings account ("MSA"). Amounts distributed to the employee would be includible in gross income and subject to employment taxes. Amounts contributed to a 401(k) plan or similar arrangement or an Archer MSA would be subject to the normal tax rules applicable to contributions to such arrangements. Thus, for example, amounts contributed to a section 401(k) plan would be subject to the limit on elective deferrals and subject to the nondiscrimination rules applicable to such plans.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2003.

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[77] Prop. Treas. Reg. 1.125-2 Q&A-7(c).

[78] Prop. Treas. Reg. 1.125-2 Q&A-7(b).

Analysis of Complexity and Policy Issues

In general

Under present law, the use-it-or-lose it rule generally causes employees to estimate the amount of health care expenses they are likely to incur during the year and to elect to contribute no more than that amount to a health FSA. Present law creates an incentive for employees to make a conservative estimate of anticipated health care expenses that are likely to be paid from an FSA in order to minimize the risk that amounts will be forfeited. The proposal would reduce this incentive by reducing the likelihood that amounts would be forfeited. The proposal is likely to increase the amount of contributions to health FSAs because some employees who currently do not make contributions to a health FSA because of the use-it-or-lose it rule will make contributions if the proposal is adopted and because some employees will increase contributions if the proposal is adopted. Such an expansion of FSAs raises both tax and health policy issues. The proposal has elements that may both increase and reduce complexity.

Tax policy, efficiency and health policy issues

Some argue that cafeteria plans in general and FSAs in particular undermine sound income tax policy because they allow employees to choose whether certain income is taxable. Such plans and arrangements, like other income tax exclusions, contribute to unfairness in the Federal tax system because they result in unequal treatment of taxpayers with the same economic income. For example, medical expenses paid or reimbursed through a cafeteria plan are excludable from gross income, whereas if such expenses are paid directly by the employee, are deductible only if the employee itemizes deductions and only if the employee's total medical expenses exceed 7.5 percent of adjusted gross income. Thus, a taxpayer who is covered by a cafeteria plan may have lower tax liability that a similarly situated taxpayer who is not covered by such a plan.

Some argue that cafeteria plans, including FSAs, promote an efficient use of recourses by giving employers and employees more flexibility to address the concerns of a diverse and changing workforce. Such plans permit each employee to structure his or her own benefit program and reduce the need for employers to provide an array of benefits that some employees do not need or do not want.

There is a difference of opinion as to whether cafeteria plans, including health FSAs, promote or undermine sound health policy. Such plans reduce the cost to the employee of health care expenditures by the amount of the tax subsidy provided by the exclusion. Thus, such plans lower the cost of health care to the individual and may provide an incentive for greater health care utilization than would occur in the absence of the exclusion. This is true of all tax-favored health plans, whether provided through a cafeteria plan or otherwise, but may be exacerbated in the case of health FSAs because such arrangements provide a tax subsidy for the first dollar of health care coverage.

On the other hand, some argue that the availability of health FSAs may reduce health expenses. Some employees may be more likely to choose a less costly health insurance plan if they know they have money available in a health FSA that can be used to pay for expenses not

covered by insurance. If such expenses are not in fact incurred, then health care spending will be reduced. However, some argue that cafeteria health FSAs operate more to shift health care expenses from the employer to the employee rather than to reduce overall spending on health care.

Proponents of the proposal argue that the use-it-or-lose it rule contributes to excess health care expenditures because some employees will incur unnecessary expenses merely to avoid losing amounts in a health FSA. They argue that if the use-it-or-lose it rule is modified, then employees will not incur such expenses. Others argue that the use-it-or-lose it rule serves mainly to affect the timing of expenses (e.g., an employee may choose to purchase new glasses this year rather than next year if they have amounts in an FSA) rather than reducing overall expenses.

Complexity issues

The proposal has elements that may both increase and decrease tax law complexity. By providing additional options to employees, the proposal may increase complexity because employees will have to determine which option is best for them. The proposal may also increase the complexity for employers by adding new administrative burdens with respect to cafeteria plans and the plans and arrangements to which left over amounts in a cafeteria plan could be contributed. On the other hand, easing of the use-it-or-lose it rule is likely to reduce the time it takes for individuals to determine whether and how much to contribute to a health FSA.

Prior Action

A similar proposal was included in the President's fiscal year 2002 budget proposal.

5. Permanently extend and reform Archer Medical Savings Accounts ("MSAs")

Prior and Present Law

In general

Within limits, contributions to an Archer MSA are deductible in determining adjusted gross income if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an Archer MSA are not currently taxable. Distributions from an Archer MSA for medical expenses are not taxable. Distributions not used for medical expenses are taxable. In addition, distributions not used for medical expenses are subject to an additional 15-percent tax unless the distribution is made after age 65, death, or disability.

Eligible individuals

Archer MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high

deductible health plan.[79] An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year. An individual is not eligible for an Archer MSA if they are covered under any other health plan in addition to the high deductible plan.

Tax treatment of and limits on contributions

Individual contributions to an Archer MSA are deductible (within limits) in determining adjusted gross income (i.e., "above the line"). In addition, employer contributions are excludable from gross income and wages for employment tax purposes (within the same limits), except that this exclusion does not apply to contributions made through a cafeteria plan. In the case of an employee, contributions can be made to an Archer MSA either by the individual or by the individual's employer.

The maximum annual contribution that can be made to an Archer MSA for a year is 65 percent of the deductible under the high deductible plan in the case of individual coverage and 75 percent of the deductible in the case of family coverage.

Definition of high deductible plan

A high deductible plan is a health plan with an annual deductible of at least $1,650 and no more than $2,500 in the case of individual coverage and at least $3,300 and no more than $4,950 in the case of family coverage. In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must be no more than $3,300 in the case of individual coverage and no more than $6,050 in the case of family coverage.[80] A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage (as described above). In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

Taxation of distributions

Distributions from an Archer MSA for the medical expenses of the individual and his or her spouse or dependents generally are excludable from income.[81] However, in any year for which a contribution is made to an Archer MSA, withdrawals from an Archer MSA maintained by that individual generally are excludable from income only if the individual for whom the

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[79] Self-employed individuals include more than two-percent shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to section 1372.

[80] These dollar amounts are for 2002. These amounts are indexed for inflation in $50 increments.

[81] This exclusion does not apply to expenses that are reimbursed by insurance or otherwise.

expenses were incurred was covered under a high deductible plan for the month in which the expenses were incurred.[82] For this purpose, medical expenses are defined as under the itemized deduction for medical expenses, except that medical expenses do not include expenses for insurance other than long-term care insurance, premiums for health care continuation coverage, and premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law.

Distributions that are not used for medical expenses are includible in income. Such distributions are also subject to an additional 15-percent tax unless made after age 65, death, or disability.

Cap on taxpayers utilizing Archer MSAs

The number of taxpayers benefiting annually from an Archer MSA contribution is limited to a threshold level (generally 750,000 taxpayers). If it is determined in a year that the threshold level has been exceeded (called a "cut-off" year) then, in general, for succeeding years during the pilot period 1997-2002, only those individuals who (1) made an Archer MSA contribution or had an employer Archer MSA contribution for the year or a preceding year (i.e., are active Archer MSA participants) or (2) are employed by a participating employer are eligible for an Archer MSA contribution. In determining whether the threshold for any year has been exceeded, Archer MSAs of individuals who were not covered under a health insurance plan for the six month period ending on the date on which coverage under a high deductible plan commences would not be taken into account.[83] However, if the threshold level is exceeded in a year, previously uninsured individuals would be subject to the same restriction on contributions in succeeding years as other individuals. That is, they would not be eligible for an Archer MSA contribution for a year following a cut-off year unless they are an active Archer MSA participant (i.e., had an Archer MSA contribution for the year or a preceding year) or are employed by a participating employer.

The number of Archer MSAs established has not exceeded the threshold level.

Duration of Archer MSA pilot program

Without extension, after 2002, no new contributions could be made to Archer MSAs except by or on behalf of individuals who previously had Archer MSA contributions and employees who are employed by a participating employer. An employer is a participating employer if (1) the employer made any Archer MSA contributions for any year to an Archer MSA on behalf of employees or (2) at least 20 percent of the employees covered under a high deductible plan made Archer MSA contributions of at least $100 in the year 2001. Self-

[82] The exclusion still applies to expenses for continuation coverage or coverage while the individual is receiving unemployment compensation, even for an individual who is not an eligible individual.

[83] Permitted coverage, as described above, does not constitute coverage under a health insurance plan for this purpose.

employed individuals who made contributions to an Archer MSA during the period 1997-2002 also would have been able to continue to make contributions after 2002.

Subsequent to the submission of the President's budget to Congress, the Archer MSA program was extended through 2002 by P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002."

Description of Proposal

Under the proposal, Archer MSAs would be made permanent. In addition, (1) the cap on the number of Archer MSAs and the employer size restriction would be removed, and (2) all 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 tax credit, would be eligible for Archer MSAs.

The Administration's proposal would modify the definition of high deductible health plan to include an annual deductible as low as $1,000 for individual coverage and $2,000 in other cases. Plans would also be permitted to provide up to $100 of coverage for allowable preventive services per covered individual each year (without counting the amount against the deductible).

The proposal also would allow contributions to an Archer MSA by the individual, the employer, or both, up to 100 percent of the maximum deductible under the plan, up to the applicable limit for the individual for the year. Under the proposal, contributions to Archer MSAs could be made through a cafeteria plan.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2002.

Analysis of Complexity and Policy Issues

In general

The proposal is intended to make the MSA market a more viable option for purchasing health insurance coverage and to give individuals more control over spending for medical expenses. Proponents argue that individual control over health insurance will result in individuals becoming more cost conscious in purchasing medical services, potentially reducing the growth of health care costs. Eliminating the restrictions on MSAs will make the use of the accounts attractive to more individuals.

Opponents argue that because high deductible insurance may be more attractive to individuals who are young and healthy, such individuals may leave employer-based health insurance pools, causing the cost of insurance held by less healthy individuals to increase. Opponents argue that this will lead employers to not offer health insurance coverage or to raise the percentage of premiums that employees must pay. Others argue that the cost difference will be minimal and that MSAs can be attractive to individuals with health problems who want individual choice of health care providers.

Because MSAs can be rolled-over indefinitely and withdrawn for non-medical purposes at retirement, opponents argue that MSAs would be used as tax-shelters, particularly by healthy, affluent individuals. Proponents argue that the rollover feature allows individuals to set aside money for future medical expenses.

Complexity issues

The proposal has elements that may both increase and decrease tax law complexity. By providing additional options to individuals, the proposals may increase complexity because individuals will have to determine which option is best for them. The proposal would decrease complexity by making the temporary MSA program permanent.

Prior Action

A similar proposal was contained in the President's fiscal year 2002 budget proposal.[84]

6. Provide an additional personal exemption to home caregivers of family members

Present Law

In order to determine taxable income, an individual reduces adjusted gross income by a dollar amount ($3,000 for 2002) for the personal exemption with respect to each of the individual's dependents that meet certain requirements. To qualify as a dependent under present law, an individual must: (1) be a specified relative or member of the taxpayer's household; (2) be a citizen or resident of the U.S. or resident of Canada or Mexico; (3) not be required to file a joint tax return with his or her spouse; (4) have gross income below the dependent exemption amount ($3,000 in 2002) if not the taxpayer's child; and (5) receive over half of his or her support from the taxpayer. If no one person contributes over half the support of an individual, the taxpayer is treated as meeting the support requirement if: (a) over half the support is received from persons each of whom, but for the fact that he or she did not provide over half such support, could claim the individual as a dependent; (b) the taxpayer contributes over 10 percent of such support; and (c) the other caregivers who provide over 10 percent of the support file written declarations stating that they will not claim the individual as a dependent.

Description of Proposal

The proposal would allow an additional personal exemption for each qualified family member with long-term care needs who resides with the taxpayer in the household the taxpayer maintains. A taxpayer would be treated as maintaining the household for the year only if the taxpayer furnishes more than one-half the cost of maintaining the household for the entire year. The proposal would deem the present-law support test to be satisfied if the taxpayer and the qualified family member with long-term care needs reside together for a specified period. The length of the specified period would depend on the relationship between the taxpayer and the qualified family member with long-term care needs. The specified period would be over half the

[84] P.L. 107-147, the "Job Creation and Worker Assistance Act of 2002," extended the Archer MSA program through 2002.

year if the individual is: (1) the spouse of the taxpayer, or (2) the ancestor of the taxpayer (including stepparents and in-laws). The specified period would be the full year for all other relatives and members of the taxpayer's household.

An individual would be considered to have long-term care needs if he or she were certified by a licensed physician (prior to the filing of a return claiming the credit) as being unable for at least 180 consecutive days to perform at least two activities of daily living ("ADLs") without substantial assistance from another individual, due to a loss of functional capacity (including individuals born with a condition that is comparable to a loss of functional capacity). As under the present-law rules relating to long-term care, ADLs would be eating, toileting, transferring, bathing, dressing, and continence. Substantial assistance would include both hands-on assistance (that is, the physical assistance of another person without which the individual would be unable to perform the ADL) and stand-by assistance (that is, the presence of another person within arm's reach of the individual that is necessary to prevent, by physical intervention, injury to the individual when performing the ADL).

As an alternative to the 2-ADL test described above, an individual would be considered to have long-term care needs if he or she were certified by a licensed physician as, for at least 180 consecutive days: (a) requiring substantial supervision to be protected from threats to health and safety due to severe cognitive impairment and (b) being unable to perform at least one ADL or to engage in age appropriate activities as determined under regulations prescribed by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services.

The taxpayer would be required to provide a correct taxpayer identification number for the individual with long-term care needs, as well as a correct physician identification number (e.g., the Unique Physician Identification Number that is currently required for Medicare billing) for the certifying physician. Failure to provide correct taxpayer and physician identification numbers would be subject to the mathematical error rule. Under that rule, the IRS may summarily assess additonal tax due without sending the individual a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Further, the taxpayer could be required to provide other proof of the existence of long-term care needs in such form and manner, and at such times, as the Secretary requires.

Effective date.--The proposal would be effective for taxable years beginning after December 31, 2003.

Analysis of Complexity and Policy Issues

Complexity issues

The addition of a new personal exemption with special criteria, while beneficial to taxpayers, adds complexity to the tax law.

The proposal would add new criteria for the additional personal exemption, relating to whether an individual has long-term care needs. The tests, related to activities of daily living and requiring physician certification, resemble present-law tests of whether long-term care insurance premiums may be deductible or excludible. However, the extension of these tests to the rules

relating to the personal exemption adds more factual determinations and certification requirements, resulting in increased complexity.

Although some taxpayers would no longer be required to keep records for purposes of the present-law support test, many of the same records would be necessary to substantiate the maintenance of the household test under the proposal. In addition, new records would be required with respect to physician certification under the 2-ADL test and the alternative test.

Policy issues

The proposal is intended to subsidize individuals who maintain a household that includes certain family members with long-term care needs. The practical effect of the proposal is to allow an additional personal exemption to individuals whose household includes such family members. It can be argued that the proposal has the positive social policy benefit of encouraging individuals to provide in-home care for family members with long-term care needs.

Proponents could argue that allowing an additional personal exemption in this case better reflects the individual's ability to pay taxes, because of the likelihood that family members with long-term care needs may have increased expenses associated with those needs. Thus, it could be argued, the proposal is unlikely to cause inaccurate measurement of income, even though its principal purpose may be to further a non-tax related social policy. Others may argue that the level of the subsidy is too small to induce the intended behavior. In some cases, the tax benefit will represent a windfall benefit to individuals who would have engaged in the behavior regardless of the additional tax benefit. In any case, opponents may argue that the tax law is not an efficient medium for the delivery of subsidies to individuals in order to further a social policy goal.

Prior Action

An identical proposal was included in the President's fiscal year 2002 budget proposal.