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An analysis of the medical expense deduction under the U.S. income tax system

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ABSTRACT

This article analyzes the medical expense deduction based on several years of Internal Revenue Service public use file detailed individual tax return data. The medical expense deduction is allowed by the U.S. Internal Revenue Code for individual income taxpayers who itemize their deductions with certain limitations. Our analysis reveals several interesting findings. In particular, change in the limitation for adjusted gross income has had a dramatic effect on the income profile of taxpayers who claim medical expense deductions (while medical expense dollars have increased dramatically). In addition, we find the medical expense deduction has a small but a generally progressive effect across the income spectrum of U.S. taxpayers. Furthermore, elimination of the medical expense deduction would have a modestly adverse effect on income equality.

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1. Introduction

The medical expense deduction for individuals under the U.S. income tax system is part of the current discussion on a conglomeration of health care issues including rising costs, insurance coverage, tax fairness, and related policy considerations. Some commentators have suggested that total tax deductibility of medical expenses would be the “cure-all” for health care issues (accounting for one seventh of the U.S. GDP), leading to a net revenue gain of \$8 billion (Hubbard, Cogan, & Kessler, 2004).

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The Report of the President's Advisory Panel on Federal Tax Reform in 2005 (Report, Chapter 5) found that "taken together, tax preferences [including the medical expense deduction]. . . and tax benefits associated with health care will cost \$141 billion or 12% of all federal income tax revenue in 2006 [tripled since 1986]."¹ The Report states further that "tax benefits related to health care tend to benefit higher income households more than lower income households." In 2004, 72% of total tax benefits for health care spending were received by families earning more than \$50,000 (Report, Chapter 5). The Report recommended, in order to provide better equality, a plan to eliminate the standard deduction with a credit and place limitations on the amount of health care expenditures (e.g., employer provided health insurance) not includible in income.

According to the Joint Committee on Taxation (JCX-12-06), health care inequities do not typically apply to the medical expense deduction due to the policy rationale; non-discretionary medical expenses directly affect an individual's ability to pay taxes. For 2001, there were 14.6% (14.1% in 1991) or about 41 million people (35 million in 1991) of the U.S. population without health insurance; 62.6% of the 2001 insured were covered by employer based health insurance in 2001 (Mills and Bhandari, 2003).

In this paper, we analyze Internal Revenue Service (IRS) data for individual taxpayers to better understand the effects of the medical expense deduction and its relationship to income levels, tax rates and deduction limitations. The paper is organized as follows. Section 2 discusses the structure of the medical expense deduction and provides some historical background. Section 3 reviews the existing literature. Section 4 describes the IRS data used in our study. Section 5 examines the question of progressivity versus regressivity in the deduction and analyzes the effect of the deduction on after-tax income distribution. Section 6 concludes the paper with a summary of results.

2. Tax background

The deductibility of medical expenses for individuals is allowed under Internal Revenue Code (IRC) Section 213. An individual taxpayer (and their spouse and dependents) can claim allowable unreimbursed medical (and dental) expenses on their U.S. income tax return subject to certain limitations. One key limitation is the fact that IRC Section 213 is an itemized deduction which requires that the taxpayer itemize their deductions (on Schedule A – Itemized Deductions, Form 1040), versus claiming a standard deduction. Another key limitation is the adjusted gross income (AGI) floor of 7.5% currently (i.e., only medical expenses in excess of this percent constitute a medical expense deduction, sometimes referred to hereafter as MED). Note that there is also currently a different AGI limitation under the alternative minimum tax (AMT) rules (i.e., individuals who are subject to the AMT), which increases the floor for MED to 10% of AGI (IRC Section 56(b)(1)(B)).

The MED has been around a long time with some variations. The Revenue Act of 1942 instituted the MED with a 5% AGI floor which was lowered in 1954 to 3% to benefit lower income taxpayers (Bush & Watkins, 1985). TEFRA (1983) changed it to 5% and TRA of 1986 set it at 7.5% where it is currently (Gouveia & Strauss, 2004). Prior to 1983, IRC 213 had a three part formula: (1) deduction up to \$150 or one half of medical insurance premiums, (2) expenses for prescription drugs over 1% AGI were added to amount subject to the 3% floor, (3) the remainder of medical expenses (including remainder of medical insurance premium up to \$150) over 3% of AGI (Bush & Watkins, 1985; Gouveia & Strauss, 2004). The types of qualifying medical expenses, including medical insurance, have expanded over the years but the IRC Section 213 definition of qualifying medical care expenses has remained basically the same: "for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body." (Section 213 (d)(1).) The Internal Revenue Service has expanded the types of qualifying medical expenses, primarily through rulings.²

¹ Bracketed comments added by the authors.

² For example, Rev. Ruls. 2003-57 and 2003-58, both at 2003-22 IRB 959, and Ltr. Rul. 200318017. These rulings add the following to the list of qualifying costs: breast reconstruction surgery following a mastectomy to treat breast cancer; laser eye surgery to correct myopia; nonprescription medical supplies; the direct and indirect expenses of obtaining an egg donor to treat infertility. (Megaard, 2003.) Another recent example of the expansion of qualifying medical expenses was under IRS Private Letter Ruling 200704001, which allows for a disabled child's tuition at a special school.

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