PLYMOUTH INSTITUTE FOR FREE ENTERPRISE

CAP DEDUCTIBILITY OF UNTAXED BENEFITS

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TOPLINE: Congress should set a per-employee cap on the amount employers may deduct for untaxed non-monetary benefits. This would reduce an existing distortion in the tax code that discourages paying higher wages.

BACKGROUND: The three largest forms of employee compensation are wages and salaries, retirement contributions, and health insurance benefits. Of these, wages and salaries receive the least favorable tax treatment, as they're subject to income taxes (10% to 37% federal, plus state and local) *and* employer- and employee-side payroll taxes to fund Social Security and Medicare (typically 15.3% combined). Retirement plan contributions are subject to employer- and employee-side payroll taxes when earned, as well as income taxes that are deferred until distribution. Health insurance benefits receive the most favorable tax treatment, altogether avoiding federal income taxes and employer- and employee-side payroll taxes.

Over time, this favored treatment for health insurance benefits (which is estimated to be a $3.8 trillion tax expenditure over 10 years) has helped drive employers to offer more health benefits at the expense of higher wages and salaries. At the same time, the more favorable tax treatment for health insurance artificially inflates demand for health care by weakening incentives to control health care costs. This leads to reduced competition and higher prices in insurance markets.

Action Items (Congress):

- **Cap employers' deductions for tax-free non-monetary benefits (including but not limited to health benefits) provided to employees** at a fixed amount, perhaps $10,000, multiplied by the number of full-time-equivalent employees.
  - The cap should *not* include an annual inflation adjustment.
  - A higher per-employee cap should be allowed for an employer's first 100 employees to account for small employers facing higher costs in insurance markets.
- **Health Savings Account (HSA) contributions should not count toward the cap** (or only a portion of such contributions should count).
- **Changes to benefit deductibility should be paired with income tax reductions.**

How It Would Make Life More Affordable:

- It would effectively phase down the bias in the tax code that discourages companies from offering higher wages and salaries.
- More adoption of HSAs would encourage more cost consciousness, reduce reliance on public health care options, and help reduce overall health care costs.

BOTTOMLINE: Taxing wages while excluding benefits is a massive tax code distortion that drives up overall health care costs, limits health care choices, and reduces wages.