

Fact Sheet

Defraying High Out-of-Pocket Health Care Costs: The Medical Expense Tax Deduction

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A Low-Cost/High-Impact Provision

The medical expense tax deduction helps millions of middle-income taxpayers of all ages confront high out-of-pocket health care costs. The provision, which partially offsets extraordinarily high medical payments, offers some relief to taxpayers with financially debilitating expenses.

A number of real-life factors can precipitate such situations. For example, people who receive emergency room services at hospitals that do not participate in their insurance plan often face medical bills in the tens of thousands of dollars.¹ The medical expense deduction can provide relief in such circumstances. It can also help reduce the burden of high health care costs for those with serious medical conditions and with rapidly rising prescription drug or other health care costs not covered by insurance.

In 2016, the last year reported on by the IRS, out-of-pocket medical expenses of the tax filers who claimed the deduction averaged \$15,467.² Unforeseen medical expenses of this magnitude represent a major financial burden for a middle-class family, amounting to more than a quarter of the estimated median household income in 2016 (\$59,039).³ Meanwhile, the deduction's limited benefit and stringent qualification requirements keep its budgetary cost down and discourage

abuse, making it one of the “low-cost/high-impact” provisions of the tax system.

Recent Changes to the Deduction

The medical expense deduction has a somewhat atypical structure. Taxpayers can deduct only qualified expenses in excess of a certain threshold that is calculated based on income. The Tax Cuts and Jobs Act of 2017 (TCJA) temporarily reduced the threshold from 10 percent to 7.5 percent of income for 2017 and 2018, resulting in greater deductions for those years. Here is an example that illustrates how the threshold works:

- In 2018, a taxpayer with income of \$60,000 incurs \$15,000 in qualified medical expenses.
- The income threshold was 7.5 percent for 2018. That means the deduction is arrived at by first calculating 7.5 percent of the taxpayer's income, $7.5\% \times \$60,000 = \$4,500$. This is the portion of the medical expenses *not* eligible to be deducted.
- Calculation of final deduction amount:

\$15,000	(total qualified medical expenses)
<u>-\$4,500</u>	
\$10,500	
- Amount taxpayer is eligible to deduct: \$10,500

Under a 10 percent income threshold, which is current law as of 2019, the taxpayer would have been able to deduct only \$9,000.

The monetary benefit of the deduction is proportional to a taxpayer's marginal tax rate. A \$10,500 deduction, for example, would reduce taxes by \$2,310 for a taxpayer in a 22 percent marginal income tax bracket. A \$9,000 deduction, meanwhile, would reduce taxes for that taxpayer by \$1,980, or \$330 less.

It is worth noting that TCJA affected the medical expense deduction not only directly by temporarily reducing the income threshold (thus increasing the deduction), but also indirectly by reducing the number of taxpayers who itemize deductions on their tax return. To benefit from the medical expense provision at all, taxpayers must itemize deductions. TCJA, however, changed several key tax parameters within the tax system. The changes are expected to make itemizing less common in general. According to the Joint Committee on Taxation, the number of itemizers is estimated to fall from 46.5 million in 2017 to 18.0 million in 2018.⁴ In addition, across-the-board reductions in marginal tax rates under TCJA reduced the value of all deductions for taxpayers. Nonetheless, the medical expense deduction remains important to millions of taxpayers with high medical expenses who itemize their deductions.

Today, policy makers face a choice of retroactively extending the 7.5 percent income threshold to the beginning of 2019 or allowing it to revert to 10 percent. Unless policy makers maintain continuity and retroactively restore the 7.5 percent threshold, taxpayers will not be able to deduct as much in 2019 as they did in 2018.

Estimated Effects of Lowering the Income Threshold

To understand the effects of the two choices facing policy makers, the AARP Public Policy Institute asked the Institute on Taxation and Economic Policy (ITEP) to analyze the potential effects of two medical expense deduction scenarios for 2019—current law (10 percent income threshold) and an alternative with a 7.5 percent income threshold. ITEP performed this analysis using its tax model.⁵

About 3.6 million taxpayers will benefit from the medical expense deduction this year under the 10 percent income threshold. Roughly 2.5 million of them, or nearly 70 percent, fall into the middle 60 percent of the income distribution (i.e., have incomes between \$23,100 and \$113,000). An estimated 1.4 million, or about 39 percent of taxpayers who will claim the medical expense deduction in 2019, are ages 65 and over.

According to ITEP's estimate, lowering the income deduction threshold to 7.5 percent will cost \$1.2 billion in 2019, not a large amount in the context of the year's \$4.4 trillion US budget.⁶ About 34 percent of this benefit will go to middle-income taxpayers. On average, taxpayers who claim the deduction will reduce their income taxes by \$380 in 2019 from the change in the income threshold. Taxpayers ages 65 and over will receive an average tax benefit of \$480.

Reducing the deduction's income threshold from 10 percent to 7.5 percent has two effects. First, taxpayers with eligible medical expenses between 7.5 percent and 10 percent of their income will become newly eligible for the deduction. Overall, ITEP estimates that over 792,000 taxpayers will become newly eligible as a result of this change. Second, the over 3.6 million taxpayers estimated to claim the deduction at the 10 percent income threshold can now deduct additional medical expenses. These taxpayers will receive a boost to their after-tax income, as they will be able to deduct additional medical expenses of up to 2.5 percent of their income.

State Impact

Geographical distribution of the deduction's benefit varies, affected by differences in medical costs, income levels, demographics, and many other factors. Table 1 shows several key pieces of information about state-level effects of reducing the income threshold: (1) the number of taxpayers claiming the deduction under the 10 and 7.5 percent income thresholds and difference between those two policy options, and (2) the total and average tax reduction in a state due to the policy change.

TABLE 1
Estimated Effects of Lowering Income Threshold of the Medical Expense Tax Deduction by State, 2019.

State	Number of Beneficiaries			Tax Reduction from Lowering Income Threshold from 10% to 7.5%	
	Higher 10% Income Threshold (Current Law)	Lower 7.5% Income Threshold (Proposal)	Change	Total for the State, Thousand \$	Average Per Taxpayer, \$
Alabama	41,100	44,500	3,400	\$7,500	\$220
Alaska	1,300	1,300	-	\$100	\$100
Arizona	47,200	56,700	9,500	\$12,400	\$270
Arkansas	13,300	17,700	4,400	\$6,100	\$530
California	447,500	584,200	136,700	\$167,600	\$380
Colorado	102,600	128,900	26,300	\$38,300	\$340
Connecticut	62,800	74,400	11,500	\$14,900	\$320
Delaware	7,600	11,000	3,500	\$10,100	\$1,060
District of Columbia	3,600	4,200	600	\$700	\$200
Florida	254,500	290,600	36,100	\$92,900	\$500
Georgia	131,100	159,900	28,800	\$44,000	\$350
Hawaii	20,900	22,000	1,100	\$5,000	\$290
Idaho	5,300	9,000	3,700	\$3,200	\$390
Illinois	133,600	158,000	24,400	\$43,900	\$460
Indiana	56,600	59,900	3,300	\$16,500	\$320
Iowa	28,900	36,300	7,400	\$6,900	\$260
Kansas	24,800	26,400	1,600	\$6,400	\$440
Kentucky	31,500	36,700	5,200	\$4,400	\$360
Louisiana	54,300	57,400	3,200	\$18,500	\$360
Maine	18,200	19,400	1,200	\$6,000	\$460
Maryland	141,600	155,600	14,100	\$55,400	\$460
Massachusetts	72,000	98,900	27,000	\$23,200	\$380
Michigan	101,100	129,000	27,800	\$23,800	\$310
Minnesota	67,300	80,000	12,700	\$18,500	\$350
Mississippi	70,600	75,400	4,800	\$22,900	\$390
Missouri	60,200	66,600	6,400	\$19,000	\$410
Montana	7,200	12,000	4,700	\$1,400	\$130
Nebraska	15,500	18,300	2,800	\$5,300	\$360
Nevada	36,000	38,600	2,600	\$9,700	\$340
New Hampshire	16,400	20,600	4,100	\$6,300	\$570

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New Jersey	208,400	260,100	51,800	\$69,400	\$380
New Mexico	18,400	22,500	4,100	\$5,200	\$390
New York	135,900	200,300	64,400	\$58,600	\$370
North Carolina	77,200	86,000	8,800	\$35,000	\$500
North Dakota	5,800	5,900	100	\$1,700	\$1,220
Ohio	121,700	136,200	14,500	\$40,100	\$390
Oklahoma	38,600	40,900	2,300	\$6,700	\$300
Oregon	46,100	54,600	8,500	\$14,800	\$410
Pennsylvania	181,700	204,400	22,700	\$70,700	\$550
Rhode Island	15,600	17,100	1,400	\$4,800	\$380
South Carolina	25,100	30,500	5,400	\$8,800	\$330
South Dakota	4,600	5,700	1,100	\$1,500	\$420
Tennessee	53,400	62,400	9,000	\$23,700	\$430
Texas	347,600	462,800	115,200	\$108,000	\$300
Utah	36,500	46,300	9,800	\$11,500	\$330
Vermont	4,600	6,300	1,700	\$800	\$350
Virginia	137,200	151,400	14,200	\$50,200	\$390
Washington	29,900	49,600	19,700	\$9,900	\$270
West Virginia	8,900	9,300	400	\$2,300	\$340
Wisconsin	54,500	72,700	18,200	\$17,700	\$340
Wyoming	13,600	13,600	-	\$2,200	\$220
United States	3,639,500	4,431,500	792,100	\$1,234,500	\$380

Source: Institute on Taxation and Economic Policy.

Note: Estimates for smaller states may be less reliable because of the small sample size. Numbers may not add up because of rounding.

Endnotes

- 1 Sarah Kliff, “A \$20,243 Bike Crash: Zuckerberg Hospital’s Aggressive Tactics Leave Patients with Big Bills,” Vox, January 24, 2019, <https://www.vox.com/policy-and-politics/2019/1/7/18137967/er-bills-zuckerberg-san-francisco-general-hospital>.
- 2 IRS, “Statistics of Income, SOI Tax Stats (Complete Report),” Individual Income Tax Returns Publication 1304, IRS, Washington, DC, n.d., Table 2.1. Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2016 (Filing Year 2017), <https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-returns-publication-1304-complete-report>.
- 3 US Census Bureau, “Historical Income Tables: Households, Table H-8. Median Household Income by State, Table H-8. Median Household Income by State: 1984 to 2017,” Census.gov, accessed February 12, 2019, <https://www.census.gov/data/tables/time-series/demo/income-poverty/historical-income-households.html>.
- 4 The Joint Committee on Taxation, “Description: Tables Related to the Federal Tax System as in Effect 2017 through 2026, JCX-32-r-18, April 24, 2018,” Joint Committee on Taxation, accessed February 14, 2019, <https://www.jct.gov/publications.html?func=startdown&id=5093>.
- 5 For more information about the model, see “ITEP Microsimulation Tax Model Overview,” Institute on Taxation and Economic Policy, accessed February 14, 2019, <https://itep.org/itep-tax-model-simple/>.
- 6 “Budget Projections for FY 2019 (As of January 28, 2019),” Congressional Budget Office, accessed February 12, 2019, <https://www.cbo.gov/topics/budget>.

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