LEGISLATIVE REVENUE OFFICE
State Capitol Building
900 Court Street NE, H-197
Salem, Oregon 97301
(503) 986-1266
http://www.leg.state.or.us/comm/lro/home.htm

Research Report

Number 5-03

October, 2003

# Changes in Oregon's Additional Medical Deduction for Seniors Incorporated in the 2003 Revenue Package

## Overview

One permanent tax law change approved in the revenue package (HB 2152) enacted by the 2003 Legislature, was a change to Oregon's additional medical deduction for seniors. First, the age requirement for the deduction was increased for 62 to 65 years old. Second, a phase-out of the deduction based on income was enacted. This policy change will result in raising personal income taxes for more than 100,000 Oregon seniors. Despite this change, this tax increase will not increase these seniors' tax burden to the level of all other taxpayers in Oregon. The overall income tax burden for seniors will remain significantly below other taxpayers at all income levels. Modifying the additional elderly medical deduction will increase the 2003-05 general fund revenue by an estimated $42 million.

The Oregon additional medical deduction was enacted in 1991 to assist seniors with their medical costs. The revenue impact from this additional deduction has been growing significantly since 1991, 155% growth in 11 years. Currently, Oregon and North Dakota, are the only two states in the U.S. with provisions to allow an additional deduction for medical expenses not qualifying under federal law. Oregon is the only state that allows an additional deduction for seniors only.

### *Background*

Federal Law
Congress first enacted a medical and dental expenses deduction for federal personal income taxes in 1942. The purpose of the deduction was to compensate individuals who have unexpected and involuntary medical expenses which could reduce an individual's ability to work and pay taxes.

States, like Oregon, that connect to the federal definition of taxable income also provide this deduction on state personal income taxes through the connection to federal tax law. This federal deduction allows medical and dental expenses in excess of 7.5% of a taxpayer's adjusted gross income be allowed as a deduction from personal taxable income for taxpayers who itemize deductions. This federal deduction does not have an age requirement but is allowed to all taxpayers who have a sizeable amount of medical expenses. This medical deduction helps reduce taxes for lower income individuals more than higher income taxpayers because meeting the medical expenses threshold of 7.5% of adjusted gross income is easier to meet the lower the income of the taxpayer. If a taxpayer's medical expenses do not exceed 7.5% of adjusted gross income, then no federal deduction is allowed.

There are a wide variety of expenses that can qualify for this medical and dental deduction. Here are some examples: laboratory fees, insurance premiums, hospital services, hearing aids, chiropractor services, contact lenses, crutches, eye surgery, dental treatment, disabled dependent care expenses, drug and alcohol addition, capital expenses, guide dog expense, lodging, long-term care premiums up to certain limits, medical conferences, medicines, nursing home, nursing services, psychiatric care, transplants, transportation, wheelchair and X-rays. You can deduct as medical expenses only those amounts paid during the tax year for which you received no insurance or other reimbursement, including Medicare.

Oregon Law

Prior to 1991, Oregon only allowed taxpayers with medical expenses in excess of 7.5% of their adjusted gross income to deduct those medical and dental expenses above 7.5% of adjusted gross income. At that time, Oregon's medical deduction tax policy was consistent with federal tax law. Then in 1991, the Oregon Legislature enacted HB 2352 which contained a provision to allow Oregonians aged 58 and over to deduct all their medical expenses on their state personal income taxes. This change in the medical deduction was only allowed for seniors and the age requirement was slowly raised from 58 years old in 1991-93 to 62 years old beginning in 1999. This additional elderly medical deduction can be used in conjunction with the federal provisions allowing a deduction of the medical expenses that are in excess of 7.5% of adjusted gross income. Seniors can use this additional Oregon medical deduction for the medical expenses up to 7.5% of the adjusted gross income of a taxpayer. Then, if the taxpayer still has additional medical expenses, he/she can claim a federal/state deduction for those medical expenses in excess of 7.5% of the adjusted gross income. The same medical and dental expenses allowed under federal law are also allowed under Oregon state law.

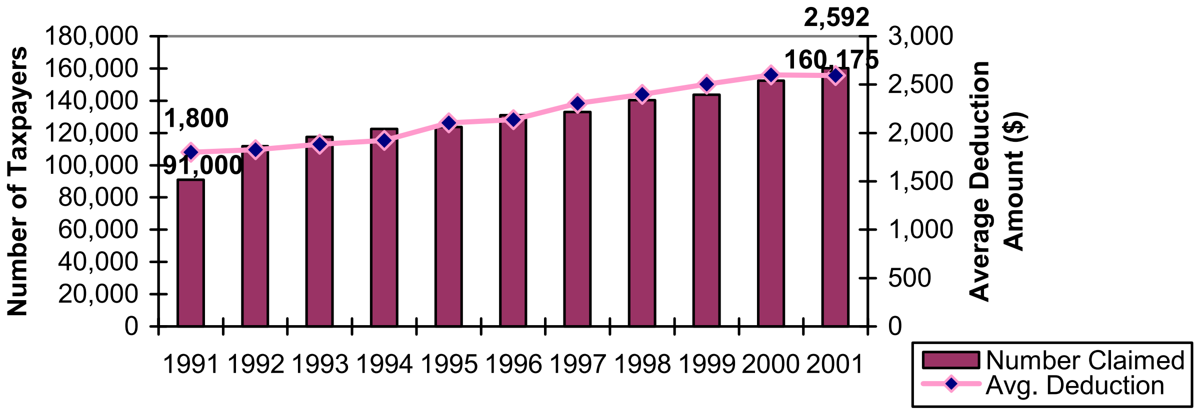
Other State Laws

According to a brief survey of reports summarizing US states' income tax deductions relating to health care, National Conference of State Legislatures (NCSL) indicated that in 2003 only two states, Oregon and North Dakota, have expanded the 7.5% of adjusted gross income threshold to qualify for the medical deduction from state personal income taxes. North Dakota does not restrict the medical deduction to taxpayers over the age of 62 years old like Oregon does under current law. Therefore, no other state has an additional medical deduction for the elderly comparable to Oregon.

### *Historical Utilization*

Oregon taxpayer's utilization of this additional elderly medical deduction has been stronger than predicted in the original 1991 revenue impact projections and has grown rapidly ever since. Originally, it was estimated that this new elderly medical deduction would reduce state personal income taxes by $11 million in the 1991-93 biennium. Instead, this new additional medical deduction reduced state personal income taxes by more than $13 million in the first year of implementation. By tax year 2001, the personal income tax lost from the Oregon additional elderly medical deduction had grown by 155% in 11 years to more than $33 million. The average deduction has increased 44% during this same time period from $1,800 to $2,592. In addition, the number of Oregon seniors utilizing the deduction has increased every year and over 11 years, it has increased 76% or by a total of 69,175 taxpayers. In 2001, the number of seniors claiming an additional medical deduction on their income taxes consisted of 47% of all seniors over the age of 62 years old. Figure 1 describes these trends in the utilization of this deduction.

**Figure 1: Utilization of the Oregon Special Elderly Medical Deduction: 1991 - 2001**

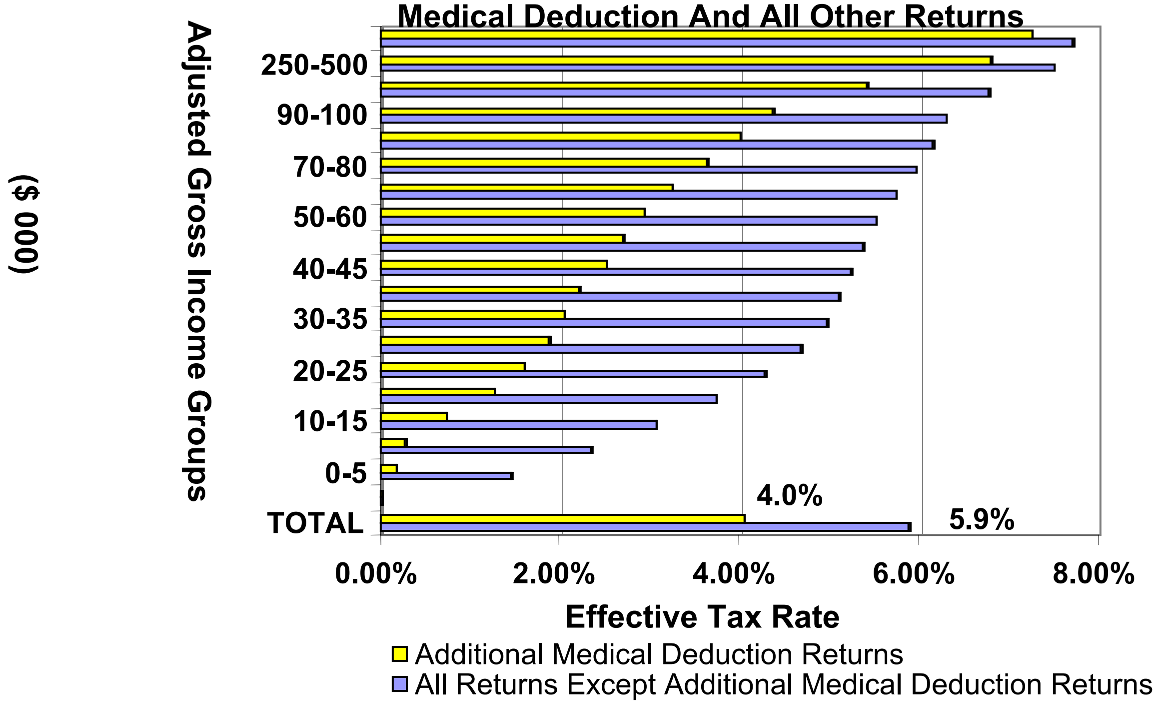



In tax year 2000, there were 47,500 more Oregon senior taxpayers claiming the Oregon additional medical deduction than there were total Oregon taxpayers claiming the federal medical deduction.

<u>2001 Tax Burden</u>

This Oregon additional medical deduction, as well as the additional standard deduction for senior taxpayers, lowers the personal income tax burden for these senior taxpayers compared to all other taxpayers. This fact is illustrated in Figure 2. In examining the effective tax rates for tax

**Figure 2: Comparison of the Effective Tax Rates By Income Groups for Tax Returns Claiming an Additional Elderly Medical Deduction And All Other Returns**



returns for 2001 and comparing those returns claiming the Oregon additional elderly medical deduction with all other tax returns, the effective tax rates are lower for every income group of seniors claiming an additional medical deduction compared to other returns. Overall, the effective tax rate for all returns not claiming the additional medical deduction is 6% of federal adjusted gross income (AGI) where the effective tax rate for seniors claiming the additional medical deduction is 4% of AGI. Currently, the average senior taxpayer claiming this medical deduction pays 33% less personal income taxes than the average taxpayer who does not claim this additional medical deduction. The disparity in the effective tax rates between taxpayers claiming the additional medical deduction and all other returns is largest for low-income taxpayers. The largest difference in the effective tax rates are in the $30,000 - $35,000 adjusted gross income group where the effective tax rate for seniors claiming the additional medical deduction is 2% of AGI and nearly 60% lower than the effective tax rate of 5% of AGI for all other tax returns in this income group. Please note that the individuals qualifying for an Oregon additional medical deduction also qualify for an additional elderly exemption and their Social Security income is exempt from personal income tax. All three of these factors lower these individuals' overall effective tax rate. Oregon's additional medical deduction is just one reason why these seniors have a lower tax burden than the rest of Oregon's taxpayers.

### *Changes in the 2003 Revenue Package*

The overall revenue package bill that the 2003 Legislature enacted was HB 2152. There were numerous changes to tax laws in order to provide sufficient revenue to balance the 2003-05 biennium state budget. HB 2152 had two permanent changes that affected Oregon's additional elderly medical deduction. First, the age requirement was raised to 65 years old over a 3 year period. Second, the deduction was phased-out for high income seniors.

<u>Age Increase</u>
Prior to the passage of HB 2152, the Oregon additional medical deduction was restricted to Oregon taxpayers aged 62 years and older. With the changes in 2003, the age requirement will rise by 1 year beginning 2003. The following table presents the new age requirement for qualifying for the Oregon additional elderly medical deduction.

| Tax Year | Age Requirement |
|---|---|
| 2003 | 63 years |
| 2004 | 64 years |
| 2005 and after | 65 years |

It is estimated that in 2003, 12,209 Oregon seniors would not qualify for the medical deduction because of the new age requirement and increase state personal income tax revenue by $2.5 million per year.

<u>Phase-out of the Deduction</u>

The second permanent change to the additional elderly medical deduction, that had the most significant impact on Oregon taxpayers utilizing the deduction, was a phase-out of the deduction based on income. The following table illustrates the reduction schedule for higher income taxpayers beginning in tax year 2003. The reduction in the deduction ranges from 0% - 100%. Joint income tax filers have federal adjusted gross income bracket amounts that are twice that of single income tax filers. This structure is consistent with Oregon's current law personal income tax brackets as well as the graduated tax assessment also enacted in HB 2152.

| Federal Adjusted Gross Income **(SINGLE)** | Reduction (%) | Federal Adjusted Gross Income **(JOINT)** |
|---|---|---|
| Below $15,000 | 0% | Below $30,000 |
| $15,000 - $30,000 | 60% | $30,000 - $60,000 |
| $30,000 - $40,000 | 80% | $60,000 - $80,000 |
| $40,000 - $50,000 | 90% | $80,000 - $100,000 |
| Above $50,000 | 100% | Above $100,000 |

If this Oregon additional elderly medical deduction policy change had been in place in 2001, the following pie charts, Figures 3 and 4, reveal how many Oregon taxpayers, single and joint, would have had an increase in their personal income taxes due to reductions in the additional medical deduction based on income.

Figure 3: Distribution of Single Taxpayers Claiming the Oregon Special Medical Deduction By Income Group - 2001

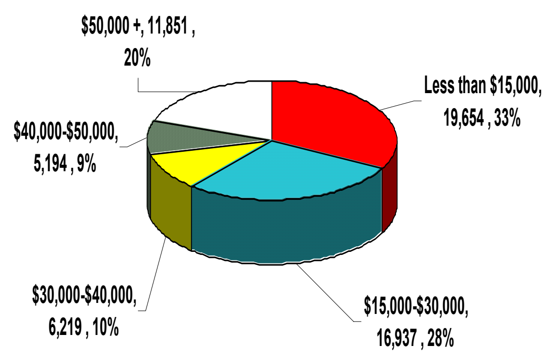
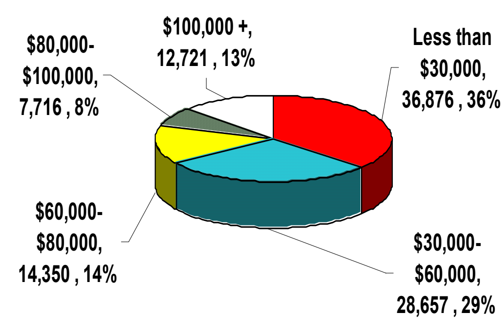



Figure 4: Distribution of Joint Taxpayers Claiming the Oregon Special Medical Deduction By Income Group- 2001




In 2001, 33% of all single and 36% of all joint income taxpayers, for a total of 56,530 taxpayers, would have been exempt from any changes in their Oregon additional medical deduction because of low income. There would have been 40,201 single and 63,444 joint taxpayers for a total of 103,645 taxpayers who would have paid higher taxes from the phase-out of the additional medical deduction for higher income seniors if the policy had been in place in 2001.

### *Overall and Distributional Impact*

The overall increase in state general fund revenue from the changes to the additional elderly medical deduction in HB 2152 is $42 million for the 2003-05 biennium. The distributional impact from these changes is important because not all taxpayers claiming the deduction will have a tax increase from the changes in HB 2152. See Table 1. In 2001, 160,175 single and joint income tax returns claimed an Oregon additional medical deduction. 35% of those income tax returns claiming a medical deduction would be exempt from the medical deduction changes in HB 2152. The overall decrease in the additional medical deduction in 2001, if the policy changes had been in place, would have been a reduction of -$289 million, 70% decline in the additional medical deduction. Joint income returns, with gross income of $100,000 or more, would pay 26% of the tax increase, the largest percentage of any income group. Overall, in 2001, single tax returns would pay 28% of the reduced medical deduction and joint returns would pay 72%.

**Table 1: Distributional Impact from Changes in Oregon's Additional Medical Deduction - Tax Year 2001**

| | Number of Returns | Additional Medical Deduction - Current Law ($ 000) | % Reduction from HB 2152 | New Additional Medical Deduction - HB 2152 ($000) | % of Total Reduction in Medical Deduction |
|---|---|---|---|---|---|
| **Single** | | | | | |
| Less than $15,000 | 19,654 | 14,134 | 0 | 14,134 | 0% |
| $15,000 - $30,000 | 16,937 | 25,365 | 60% | 10,146 | 5% |
| $30,000 - $40,000 | 6,219 | 13,842 | 80% | 2,768 | 4% |
| $40,000 - $50,000 | 5,194 | 13,826 | 90% | 1,383 | 4% |
| $50,000 + | 11,851 | 43,827 | 100% | 0 | 15% |
| **Joint** | | | | | |
| Less than $30,000 | 36,876 | 48,678 | 0 | 48,678 | 0% |
| $30,000 - $60,000 | 28,657 | 83,417 | 60% | 33,367 | 17% |
| $60,000 - $80,000 | 14,350 | 58,908 | 80% | 11,782 | 16% |
| $80,000 - $100,000 | 7,716 | 36,962 | 90% | 3,696 | 11% |
| $100,000 + | 12,721 | 76,285 | 100% | 0 | 26% |
| **TOTAL** | **160,175** | **415,245** | | **125,954** | **100%** |

For tax year 2003, the first year of implementation of HB 2152, the average impact from the changes in the Oregon additional elderly medical deduction for all income tax returns ranges from

**Table 2: Average Tax Impacts for HB 2152B from Changes in the Oregon Additional Medical Deduction - Tax Year 2003**

| TOTAL INCOME | AVERAGE OREGON TAX INCREASE | AVERAGE FEDERAL TAX REDUCTION | AVERAGE NET TAX INCREASE |
|---|---|---|---|
| **ALL RETURNS** | | | |
| LESS THAN $10,000 | $ 0 | $ 0 | $ 0 |
| $10,000 - $20,000 | $ 9 | -$ 2 | $ 7 |
| $20,000 - $30,000 | $ 21 | -$ 9 | $ 12 |
| $30,000 - $40,000 | $ 86 | -$ 18 | $ 68 |
| $40,000 - $50,000 | $135 | -$ 32 | $103 |
| $50,000 - $70,000 | $216 | -$ 27 | $188 |
| $70,000 - $100,000 | $333 | -$ 38 | $296 |
| $100,000 AND OVER | $611 | -$ 38 | $573 |
| **ALL RETURNS** | **$150** | **-$ 18** | **$132** |

$0 - $573 with an overall average impact of $132. See Table 2. As an individual's income grows so does the average Oregon additional elderly medical deduction because the threshold of claiming all medical expenses up to 7.5% of adjusted gross income grows. Taxpayers with total income above $100,000 will pay the highest average tax increase of $573.

Without some limitations on the growth of this deduction, in the future, Oregon additional elderly medical deduction will reduce state general fund tax revenue by an additional $14 million between tax years 2003-09. Under current law, the additional medical deduction is projected to reduce state revenue by $36 million in 2003 and grow to $50 million by tax year 2009. This is a growth rate of 37% over 6 years. The reasons for the growth in the Oregon additional elderly medical deduction is the rise in the senior population as well as personal health care costs. Over the next six years, by 2009, the elderly population, aged 65 years and older, is projected to increase from 444,223 to 494,960 seniors or by 50,737 seniors (11%). The personal health care deflator[1] is expected to grow annually by 3.5% for years 2003-09.

Under HB 2152, the Oregon additional elderly medical deduction is expected to grow by $4 million between tax years 2003-09. Overall, the additional medical deduction will reduce state general fund by $23 million in the 2003-05 biennium and grow to $28 million by the 2007-09 biennium. This is substantially lower than the projected reduction in state general fund from the medical deduction prior to the passage of HB 2152. It is estimated that the additional elderly medical deduction would have lowered state general fund revenue by $75 million in the 2003-05 biennium and up to $93 million in the 2007-09 biennium if the changes in the deduction had not been enacted in HB 2152. Even though recent changes in the additional elderly medical deduction will annually reduce the deduction by 70%, the tax revenue lost from this deduction will continue to be between $23 and $28 million in the next 3 bienniums.

[1] Personal health care (PHC) index is constructed from the producer price index for hospital care, nursing home input price index for nursing home care, and consumer price indices specific to each of the remaining PHC components (1996 = 100). Published in Health Spending Projections For 2002 – 2012, *Health Affairs*, February 7, 2003.