Whether to Buy Health Coverage or Pay the Penalty

By Eddie Adkins and Lynn Ettinger

Deciding whether to pay for health insurance or forgo it and pay a penalty is easy for many people. They think, “Without insurance, if I get hurt or get some disease, I’ll have to pay all my health care costs. That could wipe me out financially, and I can’t take the chance.”
Others decide against insurance or are on the fence, typically because they’re young and healthy, or wealthy and healthy, or they think they just can’t afford it. If you fall into one of these three categories, it’s important to weigh the cost of the tax penalty against the cost of insurance premiums, copays and deductibles, even if you think you won’t need health care or you can afford to pay out of pocket.

The penalty, called the “individual shared responsibility payment,” went into effect in 2014 after being activated by the Affordable Care Act (ACA). This payment must be calculated on an individual’s Form 1040 federal income tax return for anyone in the household who didn’t have coverage, including the taxpayer, the spouse if a joint return is being filed and dependents claimed on the return.

The payment is the greater of either a percentage or a flat dollar amount, and is capped to prevent people from paying a higher penalty than coverage would have cost. In 2014, each uninsured person would pay the greater of 1% of the income shown on the tax return or a flat dollar amount of $95. For anyone under 18, the penalty is only $47.50. For a family, there’s a maximum flat dollar amount of $285. The cap is the national average premium a family would pay for a bronze plan offered through the exchanges.

The penalties rise over time, so the 1% of income penalty in 2014 increases to 2.5% of income in 2016, as the following table shows.

Tax Penalty Amount

	2014	2015	2016	Subsequent years
		Greater of		
Percent of income	1%	2%	2.5%	2.5%
		or		
Flat dollar amount	$95	$326	$695	Adjusted using Consumer Price Index for All Urban Consumers
Flat dollar amount — under 18	$47.50	$162.50	$347.50	
Maximum flat dollar amount for a family	$285	$975	$2,085	
		Cap		
National average premium for family size for bronze plan offered through the exchanges				

In calculating income, begin with household income — the income of the taxpayer, the spouse on a joint return and the dependents claimed on the return who are required to file a return. You will figure modified adjusted gross income by adding back to the adjusted gross income (AGI) any foreign income and tax-exempt interest that were excluded from your AGI.
Next, subtract the tax filing threshold from your modified adjusted gross income.

Income tax filing thresholds for 2014		
Filing status	**Under 65**	**65 or older**
Single	$10,150	$11,700
Head of household	$13,050	$14,600
Married filing jointly	$20,300	$21,500 (one) $22,700 (both)
Married filing separately	$3,950	$3,950
Qualifying widow(er) with dependent children	$16,350	$17,550

The penalty for individuals with household income at different levels is shown in the following table. For lower-income individuals, the applicable amount ends up being the dollar limit — the $95 in 2014, the $325 in 2015, and the $695 in 2016. In the middle range, what drives the penalty is the percent limit — the 1% in 2014, the 2% in 2015, and 2.5% in 2016 and beyond. Once you get to a fairly high level of income, the cap kicks in.

Single individual penalty amount, Greater of dollar amount or percent plus cap				
Household income	**2014**	**2015**	**2016**	
$15,000	$95	$325	$695	Dollar limit
$25,000	$149	$325	$695	
$50,000	$399	$797	$996	Percent limit
$75,000	$649	$1,297	$1,621	
$100,000	$899	$1,797	$2,246	
$250,000	$2,399	$2,700	$2,900	Premium cap*
$500,000	$2,448	$2,700	$2,900	

***Estimate, except for 2014; amounts for 2015 and 2016 will be announced by IRS during those years*

The requirement to either pay for coverage or the penalty doesn't apply to the people in these categories:

- Those whose premiums for self-only coverage in 2014 exceed 8% of household income (adjusted based on inflation to 8.05% for 2015, with further adjustments to be made in subsequent years)
- Those whose income is lower than the income tax return filing threshold
- Incarcerated individuals
- Indian tribe members
- Those who oppose accepting health care insurance due to religious beliefs
- Members of a health care sharing ministry who share ethical or religious beliefs, and medical expenses

How it works

To illustrate how the process works, let's look at Maggie. Her income is $15,000, and she's young and healthy. She would rather spend her money on jewelry and traveling than on insurance. Maggie's employer offers her coverage, though, and she's trying to figure out whether to pay for it or go uninsured and pay the tax.

We'll use numbers that are average premiums from the 2013 Kaiser Family Foundation and Health Research and Educational Trust Survey of Employer-Sponsored Health Benefits, assuming some inflation over time. Maggie would pay a premium of about $1,100 in 2014, but her tax penalty would be only $95. So she would save $1,005 by paying the tax penalty. On a monthly basis, that amounts to $84. So if she truly doesn't believe she needs insurance, she'll save $84 a month by paying the penalty.

However, the situation changes in 2016. The penalty increases so much that the monthly difference is only $50 (If Maggie's employer provides for the payment of premiums with pretax dollars, the difference is even smaller). So for 2016, Maggie might be more apt to say, "Basically it costs me only $50 more a month to have the health insurance versus paying the tax penalty, so maybe I'll go with insurance." But Maggie hasn't thought about whether she qualifies for the premium tax credit for lower-income individuals, and that could greatly affect her cost.

Qualifying for the premium tax credit

If Maggie's employer offers her coverage that meets the ACA's requirements for minimum value and affordability, she won't be eligible for the premium tax credit. That means the plan must cover 60% or more of the total costs of health care, so that she pays no more than 40% of total health care costs in the form of deductibles and copays (but not counting the premiums she pays toward the 40%). Most employers meet this requirement. Maggie's coverage is considered affordable if her premiums for the lowest-cost self-only coverage that meets the 60% minimum value requirement don't exceed 9.5% of her compensation.

Let's say that Maggie's employer doesn't offer her affordable coverage. She can qualify for the premium tax credit only if she buys insurance on the federal or state exchange. If she gets insurance from her employer or an individual broker, she isn't eligible for the premium tax credit.

So, Maggie goes to the exchange, where a representative asks if she has affordable employer coverage (If she did, she wouldn't get the premium tax credit but she could still get coverage through the exchange). Next, the representative asks her household size and household income. If Maggie's income is low enough, she might qualify for Medicaid, in which case she wouldn't get coverage through the exchange or the premium tax credit. Because Maggie doesn't have affordable coverage from her employer and her household size and income disqualify her for Medicaid, she does qualify for the premium tax credit.

The exchange will base its calculations for Maggie's premium tax credit on her status as a single individual with income of $15,000. It will automatically use the premium for the second-lowest-cost, silver, plan (i.e., a plan that covers 70% of health care costs). Let's say that premium cost is $3,000. Next, to figure the premium tax credit, the exchange will subtract the maximum premium Maggie is required to pay as determined under the Internal Revenue Code, which is $300, from the $3,000. So the premium tax credit will be $2,700, and if Maggie chooses the silver plan in the exchange, she'll pay $300.

If Maggie chooses a more expensive plan, like a $4,000 plan, she will still get a premium tax credit of $2,700, so she'll pay more. If she chooses a less-expensive plan, her premium tax credit will still be $2,700, and her net premium will be even less than $300.

The Internal Revenue Code provides a table to show how to calculate the maximum premium an individual must pay in connection with the premium tax credit. So compare Maggie's income to the federal poverty line for her family size, which is $11,670 (In this context, household income is the modified adjusted gross income described earlier for the taxpayer, the spouse and dependents who have to file a return, plus adding back nontaxable Social Security benefits).

Let's look at the line "150% up to 200%." If Maggie's household income as a percent of the federal poverty line is exactly 150%, she would pay a maximum premium of 4% of her household income. If her household income as a percent of the federal poverty line is 200%, she would pay a maximum premium of 6.3% of her household income. If her income falls between 150% and 200%, she would pay a maximum premium between 4% and 6.3% on a prorated linear basis.

Maximum Premium Paid		
Household income as a percent of poverty line	**Initial premium (percent* of household income)**	**Final premium (percent* of household income)**
Up to 133%	2%	2%
133% up to 150%	3%	4%
150% up to 200%	4%	6.3%
200% up to 250%	6.3%	8.05%
250% up to 300%	8.05%	9.5%
300% up to 400%	9.5%	9.5%
More than 400%	No eligible for premium tax credit	

** Adjusted in subsequent years based on premium growth rate and income growth rate*

Maggie's income is 129% of the federal poverty line ($15,000 divided by $11,670). So, her premium is 2%, which amounts to $300 ($15,000 times 2%). Assuming that Maggie purchases the silver plan coverage and qualifies for the premium tax credit, she will pay a premium of $300 for 2014. Her tax penalty would be $95, and the difference is $205. So Maggie will spend $205 more than the tax penalty to get insurance. That's only $17 a month. In 2015 and 2016, when the individual mandate increases, she will actually save money by getting coverage instead of paying the tax penalty.

When Maggie goes to the exchange, the representative will calculate a tentative premium tax credit and apply it to the premium, resulting in a discounted premium. But when Maggie files her return, she'll have to use her actual income for the year, so there will be a true-up. If her income greatly increased from what she expected, she might have to give back some or all of her premium tax credit.

Financial assistance through cost subsidies is also available through the exchanges. If Maggie chooses a silver plan, depending on her income, she might also qualify for reduced copays, deductibles and total out-of-pocket spending limits. The federal government basically reimburses insurance companies for those cost subsidies.

If a person's household income is more than 250% of the federal poverty line, he or she won't qualify for a cost subsidy. Because Maggie's income is between 100% and 150% of the federal poverty line, she qualifies for the cost subsidies and ends up with a plan that's worth 94%, which is a very rich plan. Individuals with income between 150% and 250% of the federal poverty line also qualify for the cost subsidies, but the amounts aren't as large.

Most individuals will choose health insurance because they don't want the financial risk of being uninsured. If people don't qualify for the premium tax credit, it will be more expensive to get insurance than to pay the penalty, but especially as the gap between the cost of coverage and the cost of the penalty narrows over time, it's worth seriously considering coverage.