Legislative Fiscal Bureau

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TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Senate Bill 409 and Assembly Bill 815: Internal Revenue Code Update for Health Savings Accounts

Senate Bill 409 and Assembly Bill 815 are companion bills that would update state income tax references to federal law with respect to health savings accounts (HSAs), as provided under Public Law 108-173, the federal Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MPDIMA). SB 409 was introduced on January 27, 2004, and referred to the Joint Survey Committee on Tax Exemptions. AB 815 was introduced on February 5, 2004, and referred to the Assembly Committee on Insurance.

CURRENT LAW

State individual income tax provisions are generally referenced to definitions under federal law. Changes to federal law take effect for state purposes only after action by the Legislature. Generally, the Legislature reviews the previous year's federal law changes each year to update state references to the Internal Revenue Code (IRC). With exceptions, the current statutes refer to the federal IRC in effect on December 31, 2002.

Currently, Wisconsin conforms to federal provisions under Public Law 107-147, the Job Creation and Worker Assistance Act of 2002 (JCWAA), with respect to Archer Medical Savings Accounts (MSAs). Under the MSA program, self-employed individuals and employees of small firms (firms with 50 or fewer employees) can take advantage of medical savings accounts to pay for health care expenses. Simultaneous enrollment in a high-deductible health care plan is a requirement for participation in an MSA. Contributions by an employer to an MSA are excluded from the employee's gross income and contributions by the employee may be deducted from income. Earnings on MSAs accumulate on a tax-free basis. Distributions from an MSA are excluded from income if expended for qualified medical costs. Certain limits to contributions and to program participation apply, including a nationwide participation limit of 750,000 annually. [The nationwide limit has not provided a barrier to participation: in 2002, there were only 59,484 federal tax returns with deductions for MSA contributions.]

Under JCWAA, the MSA program, which had been scheduled to expire after December 31, 2002, was extended through December 31, 2003, after which no new MSAs may be set up, although existing accounts may be maintained. As stated above, Wisconsin law conforms to the MSA provisions under JCWAA.

SUMMARY OF BILLS

SB 409 and AB 815 would update state tax references to the IRC to include the provisions related to health savings accounts under Public Law 108-173. Under the federal provisions, an employee or another worker covered by a high-deductible health insurance plan may make pre-tax contributions to an HSA to cover heath care costs. HSAs are effective for federal purposes as of January 1, 2004.

A high-deductible health plan is defined as one that has at least a $1,000 annual deductible for self-only coverage and a $2,000 deductible for family coverage. These amounts are indexed annually for inflation. In addition, to be qualified as a high-deductible health plan, the plan must limit annual out-of-pocket expenses paid under the plan to $5,000 for individuals and $10,000 for families. Such expenses include deductibles, co-payments, and any other amounts paid for plan benefits.

Contributions to HSAs may be deducted from gross income in the determination of adjusted gross income, and are limited to the lesser of: (a) 100% of the annual deductible for the high-deductible health plan; and (b) the maximum deduction permitted under an MSA [The maximum deduction for MSAs applies to existing plans, as new MSA accounts are not permitted after December 31, 2003]. For 2004, the general limits are $2,600 for individuals and $5,150 for families. The limits are adjusted annually for inflation and are coordinated with those for MSAs; contributions to one type of health account reduce the annual contribution limit for the other type of health account. Individuals who reach age 55 by the end of the tax year may increase their contributions by $500 for 2004, $600 for 2005, $700 for 2006, $800 for 2007, $900 for 2008, and $1,000 for 2009 and thereafter. Contributions may not be made, however, after the participant retires. Excess contributions are subject to a federal excise tax, generally equal to 6% of the cumulative amount of excess contributions that are not distributed from the health account to the contributor.

An individual's employer may also make contributions to an HSA on behalf of an eligible individual. If an employer makes such contributions, the employer must make available comparable contributions on behalf of all employees with comparable health insurance coverage during the same period. If employer contributions do not satisfy the comparability rule, then the employer is subject to a federal excise tax equal to 35% of the aggregate amount contributed by the employer to health accounts for that period. If an employer makes contributions to an HSA, the contribution limits described above apply to the aggregate amounts contributed on behalf of the employee. In such a case, the amount contributed by the employer would be excluded from the employee's gross income (and associated unemployment and withholding taxes), and the amount contributed by the employee would be deducted from income on the individual income tax return.

Earnings on HSAs accumulate on a tax-free basis. Distributions from an HSA are not subject to tax to the extent that they are used to pay for qualified medical expenses of the account beneficiary. HSA distributions may not be used to purchase health insurance. Any distributions not used to pay the qualified medical expenses of the account beneficiary are included in federal gross income. Federal law also imposes a penalty of 10% on such distributions. However, the federal penalty does not apply if the distributions are made after the account beneficiary becomes disabled or dies.

Individual eligibility for an HSA is determined on a monthly basis. To be eligible, on the first of the month, the individual must be covered by a high-deductible health plan and must also not be covered by a plan that is not a high-deductible health plan.

MPDIMA allows taxpayers 60 days to roll over funds from an Archer MSA to an HSA.

Under SB 409 and AB 718, state tax law would conform to the MPDIMA provisions on HSAs. Specifically, the bills would provide that contributions to, and distributions from, HSAs that are excluded for federal individual income tax purposes would also be excluded for state tax purposes. The bills would also impose a penalty on excess contributions equal to 33% of the 6% federal excise tax on excess contributions. This treatment would be similar to other state penalties under current law that are based on 33% of the corresponding federal penalty.

As described above, federal law would impose an additional 10% tax on distributions not used for qualified medical purposes. While the bills would include such distributions in adjusted gross income, as drafted, there would be no state penalty corresponding to the federal penalty. Similarly, the bills would not provide a state penalty for employers that failed to maintain comparable health savings account contributions on behalf of employees with comparable health insurance coverage.

These provisions would apply for taxable years beginning after December 31, 2003.

FISCAL EFFECT

An estimate of the fiscal effect of SB 409 and AB 815 can be made based on information about the projected cost of the federal provisions through 2012-13.

Based on such projections, it is expected that the bills would reduce state tax revenues from the individual income tax by the following amounts:

2004-05	$3.5 million
2005-06	$3.5 million
2006-07	$4.0 million
2007-08	$4.3 million
2008-09	$4.7 million
2009-10	$5.1 million
2010-11	$5.4 million
2011-12	$5.7 million
2012-13	$6.0 million

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