Legislative Fiscal Bureau
One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

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TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Assembly Bill 4 and Senate Bill 7: Individual Income Tax Credit for Qualified Contributions To, and Earnings On, Health Savings Accounts

Assembly Bill 4 and Senate Bill 7 are similar bills that would provide a nonrefundable credit against the state's individual income tax for certain contributions to, and earnings on, health savings accounts (HSAs). The HSA tax credit would be 6.5% of the allowable federal deduction for contributions to HSAs, as provided under section 1201 of Public Law 108-173, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MPDIMA). In addition, the 6.5% credit would apply to earnings on HSAs that are exempt from federal taxes under the same federal provisions.

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. As stated above, Wisconsin law conforms to the MSA provisions under JCWAA. The federal government has since extended the MSA program through December 31, 2005, after which no new MSAs may be set up, although existing accounts may be maintained. Based on current state law, the federal tax deductions for MSAs do not apply for state tax purposes for MSAs established after December 31, 2003.

FEDERAL HSA PROVISIONS

Under the federal HSA 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. The federal HSA provisions took effect on 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 amounts that are also indexed for inflation. For 2005, the, out-of-pocket expenses must be limited to no more than $5,100 for individuals and $10,200 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; or (b) the maximum deduction permitted under an MSA. For 2005, 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 $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.

SUMMARY OF BILLS

AB 4 and SB 7 would provide a nonrefundable credit against the state's individual income tax for 6.5% of the allowable federal deduction related to HSAs, described above, that an individual claims on the federal income tax form for the same taxable year. In addition, the 6.5% credit would apply to federally tax-exempt earnings on HSAs, as provided under MPDIMA. As under federal law, qualified distributions from HSAs would not be included in taxable income.

The only difference between the two bills is the initial applicability date. Under AB 4, the state credit would first apply for taxable years beginning on January 1 of the year in which the bill takes effect, except that if the bill takes effect after July 31, the provisions would first apply to taxable years beginning on January 1 of the year following the year in which the bill takes effect. Under SB 7, the credit would first apply to taxable years beginning on January 1, 2005.

It should be noted that the proposed 6.5% credit was also intended to apply to employer contributions to an HSA on behalf on an employee that are excludable from federal income under the provisions of MPDIMA. However, as drafted, such amounts would not be eligible for the proposed credit (even though the employer contributions would be included in the employee's income for state tax purposes). The bills could be amended to also apply the credit to employer contributions to an HSA that are excluded from federal taxable income under MPDIMA.

Under the bills, no credit would be allowed unless it is claimed within four years of the unextended due date of the tax return relating to the year for which the credit is claimed. The credit would be prorated for nonresidents and part-year residents based on the ratio of the taxpayer's Wisconsin adjusted gross income (AGI) to federal AGI.

The Department of Revenue would be authorized to enforce the HSA tax credit and could take any action, conduct any proceeding, and proceed as it is authorized in respect to income taxes. The income tax provisions relating to assessments, refunds, appeals, collection, interest, and penalties would also apply to the HSA credit.

FISCAL EFFECT

Based on information on the projected cost of the federal provisions through 2012-13, it is expected that the HSA credit would reduce state tax revenues from the individual income tax by the following amounts:

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

The estimated fiscal effects shown above assume that AB 4 and SB 7 would first apply to tax year 2005 and that the bills would be amended to apply the 6.5% credit to employer contributions to an HSA that are excluded from federal taxable income under MPDIMA.

Prepared by: Faith Russell