Legislative Fiscal Bureau

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January 18, 2011

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Special Session Assembly Bill 2 and Special Session Senate Bill 2: Individual Income Tax Credit for Qualified Contributions To, and Earnings On, Health Savings Accounts

Special Session Assembly Bill 2 (SS AB 2) and Special Session Senate Bill 2 (SS SB 2) are identical 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 223 of the Internal Revenue Code (IRC). In addition, the 6.5% credit would apply to earnings on HSAs that are exempt from federal taxes under the same federal provisions.

The Assembly bill was introduced on January 4, 2011, and referred to the Assembly Committee on Health. The Senate bill was introduced on January 5, 2011, and referred to the Senate Committee on Health. The two committees held a joint hearing on the bills on January 11, 2011. On January 13, the each committee held an executive session on their respective bills. The Assembly Committee on Health recommended SS AB 2 for passage by a vote of seven to three (one absent), and the Senate Committee on Health recommended SS SB 2 for passage by a vote of three to two.

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. Each biennium, the Legislature typically reviews federal law changes from the prior two years to update state references to the IRC. The current state statutes refer to the federal IRC in effect on December 31, 2008, although there are a number of exceptions where federal law changes have not been adopted.

Since tax year 2004, federal law has exempted from taxation certain contributions to, and distributions from, a qualified HSA. Under the federal provisions, an individual covered by a high-deductible health insurance plan (as defined under federal law) may make pre-tax contributions to an HSA to cover health care costs, subject to certain contribution limits that are indexed annually for inflation. The general limits are increased for individuals who are age 55 or older by the end of the tax year. An individual's employer may also make contributions to an HSA on behalf of an eligible individual, and such contributions are excluded from the employee's income for federal tax purposes. HSA distributions are exempt from tax, as long as they are used to pay for qualified medical expenses of the account beneficiary. Earnings on amounts retained in HSAs are also exempt from tax.

Wisconsin does not currently conform to the federal HSA provisions. Therefore, contributions to, and earnings on, HSAs that are exempt for federal tax purposes must be added back to federal AGI for state tax purposes. However, because the initial contributions to HSAs, and the earnings on such contributions, are subject to the state income tax, subsequent distributions from HSAs are not subject to tax at the state level.

Federal law authorizes the establishment of Archer Medical Savings Accounts (MSAs), which were precursors to HSAs. Although federal law has not permitted the creation of new MSAs since 2007, accounts in existence at the time can be maintained. State law conformed to the federal provisions for establishing MSAs through calendar year 2005, but has not been modified to conform to the new federal expiration date. Federal law allows MSAs to be rolled over to HSAs on a tax-free basis. Because state law does not conform to the federal HSA provisions, the state does not allow tax-free rollovers of MSAs to HSAs.

FEDERAL HSA PROVISIONS

Under the federal HSA provisions, individuals may make pre-tax contributions to HSAs to cover certain heath care costs not covered by high-deductible health insurance plans. An HSA is a tax-exempt trust or custodial account maintained by a trustee to pay or provide reimbursement for those 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 $1,200 annual deductible for self-only coverage and a $2,400 deductible for family coverage for tax year 2011. 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 2011, the, out-of-pocket expenses must be limited to no more than $5,950 for individuals and $11,900 for families. Such expenses include deductibles, co-payments, and any other amounts paid for plan benefits, but not premiums.

In calculating adjusted gross income, contributions to HSAs are deductible expenses 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 2011, the general limits are $3,050 for individuals and $6,150 for families. The limits are adjusted annually for inflation and are coordinated with those for MSAs. For example, 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 $1,000. Contributions may not be made, however, after the participant becomes 65 years of age. 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. In such a case, the amount contributed by the employer would be excluded from the employee's gross income. If an employer makes contributions to an HSA, the contribution limits described above apply to the aggregate amounts contributed on behalf of the employee.

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 20% 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. The individual cannot be claimed as a dependent on another person's tax return or enrolled in Medicare.

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

SUMMARY OF BILLS

SS AB 2 and SS SB 2 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 under federal law, qualified distributions from HSAs would not be included in taxable income.

Under the bills, 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.

The proposed 6.5% credit would not apply to employer contributions to an HSA on behalf of an employee that are excludable from federal income under IRC provisions. As noted above, employer contributions are included in the employee's income for state tax purposes. However, the bills could be amended to also apply the credit to employer contributions to an HSA, provided the contributions are excluded from federal taxable income.

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.

State law prohibits enactment of any bill that would cause the estimated general fund balance to fall below $65 million in any fiscal year between 2007-08 and 2012-13. The bills contain nonstatutory provisions excluding their enactment from this prohibition.

FISCAL EFFECT

Based on information on the projected cost of the federal provisions through 2012-13, it is estimated that the HSA credit would reduce state tax revenues from the individual income tax by $20.7 million in 2011-12 and $27.3 million in 2012-13. This assumes the credit would first apply to tax year 2011 and that the 6.5% credit would apply to employer contributions to an HSA that are excluded from federal taxable income. (The bills would have to be amended to accomplish the latter treatment.)

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