ILLINOIS GENERAL ASSEMBLY

LEGISLATIVE RESEARCH UNIT

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TAX CREDITS FOR HEALTH SAVINGS ACCOUNTS

asked for information on the possibility of offering a tax credit to small businesses that set up health savings accounts for employees. The credit he described would be up to $500 per business and would apply to businesses with gross incomes up to $2 million per year. He asked (1) whether any state laws or regulations prevent offering such a credit, and (2) whether any states in our 18-state survey list offer such credits.

We describe our findings below, including an overview of Health Savings Accounts (HSAs) and Archer Medical Savings Accounts (MSAs). HSAs are an extension of MSAs, offering expanded eligibility and more funding options. No new Archer MSAs are authorized after the end of 2007.

Overview

Health Savings Accounts

A Health Savings Account is a federally tax-exempt account that a person may set up with a trustee, such as a bank or insurer. Employers may also offer HSAs. Contributions to an HSA, including contributions by an employer, are federally tax deductible. Employer contributions may be excluded from the account holder's gross income. Interest and other earnings on an account are not taxed; nor are distributions from the account if used to pay qualified medical expenses.

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To qualify for an HSA, a person must meet the following requirements:

(1) have a "high deductible health plan" (a plan with a higher annual deductible than typical health plans, and a limit on the sum of the annual deductible and out-of-pocket medical expenses);

(2) have no other health coverage except for some specified benefits;

(3) not be enrolled in Medicare; and

(4) not be eligible to be claimed as a dependent on another person's tax return.[1]

Illinois has no law specifically allowing a state tax deduction for contributions to an HSA. But a 2005 letter ruling by the Illinois Department of Revenue says that since contributions to and distributions from HSAs are excluded from federal adjusted gross income, they are automatically excluded from state income for tax purposes.[2]

Archer Medical Savings Accounts

An Archer Medical Savings Account (Archer MSA) is a tax-exempt account with a financial institution. Contributions to it, including contributions made by an employer, are federally tax deductible. Interest and other earnings on the account are not taxed, nor are distributions from it if used to pay qualified medical expenses. An employer and employee may not make contributions to the employee's Archer MSA in the same year.

Archer MSAs are available only to:

(1) an employee, or the spouse of an employee, of a small employer (in general meaning an employer with an average of no more than 50 employees during either of the 2 preceding years) that has a high-deductible health plan for employees or families; or

(2) a self-employed person, or the spouse of a self-employed person, who has a high-deductible health plan.

Such persons must not be eligible to be claimed as a dependent on another person's tax return, and may have no Medicare or other health coverage except some specified benefits.[3]

The last year for creating an Archer MSA was 2007.[4] Except in some specified circumstances, no new Archer MSAs may be set up. But in recent years very few people have chosen to open Archer MSAs. Only 45 new Archer MSAs were opened in 2005, and only 11 in 2006.[5]

Illinois' Medical Care Savings Account Act of 2000[6] says that employers offering high-deductible health plans to employees[7] may also offer "medical care savings accounts." Contributions to, distributions from, and earnings in such accounts are exempt from Illinois income tax.[8] To the extent (if any) that contributions are included in adjusted gross income, they may be subtracted from it in calculating state taxable income.[9] The employer must inform employees of the federal tax status of contributions before making any contributions to such an account.[10] (The Internal Revenue Code exempts Archer MSAs[11] and HSAs from federal income taxation.[12]) Only employers may make contributions to medical care savings accounts. Funds in an account may be used only to reimburse employees for their or their dependents' medical expenses.[13]

A 2006 bill would have allowed employees to contribute to these accounts, and offered tax credits to employers that offer the accounts. The credit would have equalled contributions made, up to $1,000 per employee.[14] The bill was never assigned to a substantive committee.

Legality of a Health Savings Account Tax Credit

There do not appear to be any state provisions preventing a tax credit for employer contributions to HSAs. Article 9, section 2 of the Illinois Constitution on non-property taxes and fees says this in relevant part: "Exemptions, deductions, credits, refunds and other allowances shall be reasonable."[15] Court decisions indicate that the General Assembly has fairly broad discretion to allow such tax breaks, if there is no reason to think that lawmakers tried to favor one identifiable segment of the population and disfavor others.[16]

Other States

We did a computer search[17] of the laws of the states on our 18-state survey list (the 10 most populous states other than Illinois, neighboring states, and regional representatives[18]) and Kansas, which has a relevant credit, for tax credits for employers that set up or contribute to HSAs or MSAs. We also searched for such credits in Commerce Clearing House's *State Tax Guide* (updated weekly). Georgia and Kansas have such credits, which we describe below.

Georgia

A law effective May 7 of this year offers a state income tax credit for small employers (those with up to 50 employees) that provide employees with high-deductible health plans that include catastrophic health care coverage and are established and used with an HSA. The credit is $250 per employee if the employer paid at least that much in annual health insurance premiums for the employee. It may be taken for each such employee who is enrolled for 12 consecutive months in the employer's high-deductible health plan, if the plan is offered to all employees. The amount of credit taken may not exceed the employer's income tax liability for the tax year; but unused credits may be used against later years' tax liability.[19]

Kansas

A small employer (an employer with 2 to 50 full-time employees on at least half the working days in the preceding year, a majority of whom were employed in the state[20]) that offers a health benefit plan to its employees and their dependents, or an employer who contributes to an HSA of a full-time employee, can take an income tax credit equal to its monthly contributions. Limits per employee are $70 per month for the first year of participation, $50 for the second, and $35 for the third; no credit is offered for later years. Any state income tax deduction for expenses that are covered by the credit must be reduced by the amount of the credit.[21]

We hope this information is helpful. Please let us know if we can be of further assistance.

Sincerely,

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Notes

1. 26 U.S. Code sec. 223; Internal Revenue Service, "Health Savings Accounts and Other Tax-Favored Health Plans" (Pub. 969, 2007, downloaded from Internal Revenue Service Internet site).
2. Illinois Department of Revenue, "General information letter: Illinois follows federal income tax treatment of health savings accounts under IRC Section 125" (Apr. 1, 2005, downloaded from Illinois Department of Revenue Internet site).
3. 26 U.S. Code sec. 220; "Health Savings Accounts and Other Tax-Favored Health Plans."
4. 26 U.S. Code subsec. 220(i)(2)(A).

5. "Archer MSA Cutoff Year," *Tax Facts News* (National Underwriters Company publication), May 2007, p. 7 (downloaded from LexisNexis Internet site).
6. 820 ILCS 153/1 ff.
7. 820 ILCS 153/5, definition of "medical care savings account program."
8. 820 ILCS 153/10(c).
9. 35 ILCS 5/203(a)(2)(S).
10. 820 ILCS 153/10(b).
11. 26 U.S. Code subsec. 220(e)(1).
12. 26 U.S. Code subsec. 223(e)(1).
13. 820 ILCS 153/15.
14. 2006 S.B. 3014 (Righter-Radogno-Dillard-Roskam-Geo-Karis et al.).
15. Ill. Const., Art. 9, sec. 2.
16. See cases summarized in Legislative Research Unit, *1970 Illinois Constitution Annotated for Legislators* (4th ed., updated 2005), pp. 83-84.
17. We searched a database of those states' laws for ("health" or "medical" within 3 words of "savings"), with both in the same section as "credit."
18. Those states are Arizona, California, Florida, Georgia, Indiana, Iowa, Massachusetts, Michigan, Missouri, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Texas, Virginia, Washington, and Wisconsin.
19. Ga. Code, sec. 48-7-29.13, added by 2007 Ga. Act 463.
20. Kans. Stat., subsec. 40-2209d(u).
21. Kans. Stat., sec. 40-2246; Kansas Department of Revenue, "Kansas Small Employer Healthcare Credit" (Form K-57, rev. August 2007, downloaded from Kansas Department of Revenue Internet site).