COMMONWEALTH of VIRGINIA

Department of Taxation

January 3, 2013

TO:

The Honorable Lacey E. Putney
Chairman of House Appropriations
Post Office Box 127
Bedford, Virginia 24523

The Honorable Walter A. Stosch
Chairman of Senate Finance
4551 Cox Road, Suite 110
Glen Allen, Virginia 23060

The Honorable Harry R. Purkey
Chairman of House Finance
2352 Leeward Shore Drive
Virginia Beach, Virginia 23451

The Honorable Stephen H. Martin
Chairman of Senate Education and Health
Post Office Box 700
Chesterfield, Virginia 23832

The Honorable Robert D. Orrock, Sr.
Chairman of House Health, Welfare and Institutions
Post Office Box 458
Thornburg, Virginia 22565

The Honorable John C. Watkins
Chairman of Senate Commerce and Labor
Post Office Box 159
Midlothian, Virginia 23113

The Honorable Terry G. Kilgore
Chairman of House Commerce and Labor
Post Office Box 669
Gate City, Virginia 24251

The Department of Taxation is pleased to transmit its annual report regarding the study of Health Savings Accounts in Virginia. This report is required by *Va. Code* § 38.2-5601, as amended by the 2005 Acts of Assembly, Chapter 572. Please let me know if you have any further questions.

Sincerely,

Craig M. Burns
Tax Commissioner

Commonwealth of Virginia

Department of Taxation

Report on Tax Incentives for Health Savings Accounts in Virginia

Pursuant to *Va. Code* § 38.2-5601

January 3, 2013

Authority

The 2005 Acts of Assembly, Chapter 572, amended *Va. Code* §§ 38.2-5601 through 5602.1 to direct the Department of Taxation ("the Department") and the State Corporation Commission ("SCC") to present the Virginia Health Savings Account Plan to the chairs of the House Appropriations, Finance, Health, Welfare and Institutions, and Commerce and Labor Committees, by January 1, 2006, and to update the report annually thereafter.

The Department is required to update the report annually to cover the following:

- A system for providing income tax deductions or refundable tax credits for the working poor.
- A system for allowing voluntary employer contributions to the health savings accounts and tax deductions for such contributions.
- A system for allowing tax credits for health care practitioners providing services to holders of health savings accounts at reduced cost or without compensation.

This report on Tax Incentives for Health Savings Accounts ("HSAs") is a supplement to the report of the SCC on High-Deductible Health Plans.

Introduction

What is a Health Savings Account?

An HSA is a tax-exempt trust or custodial account established for the purpose of paying qualified medical expenses in conjunction with a high-deductible health plan. Tax-free contributions may be made to an HSA by either the employee or employer, or both, up to the amount of the deductible or a cap set by law. For 2012, these amounts were:

High-Deductible Health Plan	**Individual**	**Family**
Minimum Deductible	$1,200	$2,400
Maximum Out-of-Pocket Cost	$6,050	$12,100
Health Savings Account		
Maximum Contribution	$3,100	$6,250

An advantage of using an HSA is that certain medical expenses, such as those for vision and dental care, may be covered by funds from an HSA, whereas these expenses often are not covered under traditional health insurance. In addition, the use

of HSAs could promote competition among health professionals, which ultimately may lead to lower medical costs.

Tax and Other Incentives Currently Available to Virginians

Contributions by Individuals

Contributions by an eligible individual to an HSA (which are subject to the limits described above) are deductible in computing federal adjusted gross income. Accordingly, the contributions are deductible whether or not the eligible individual itemizes deductions. However, the statute denies a tax deduction to any individual who may be claimed as a dependent on another taxpayer's return. Contributions by individuals are not deductible to the extent that they exceed the limits previously described or if they are made by an individual who is not an eligible individual. Employees may also make pre-tax contributions, which may not be deducted.

In addition, contributions are excludable from certain creditor processes and garnishments. In 2010, the General Assembly passed legislation (2010 Acts of Assembly, Chapter 595) that exempts contributions to HSAs from any creditor, legal, equitable, or other process commenced in order to pay an existing debt or liability. This exemption may be viewed as another incentive afforded to individuals with HSAs, which further contributes to the attractiveness of such plans.

Contributions by Employers

Employer contributions to an eligible individual's HSA (which are limited as described above) are excludable from gross income, are not subject to withholding for income tax, and are not subject to other employment taxes (i.e., Social Security and Medicare taxes (FICA), federal unemployment tax (FUTA), or railroad retirement tax). Earnings on amounts in an HSA are not taxable prior to distribution from the account.

Contributions by employers are included in gross income to the extent that they exceed the limits previously described or if they are made on behalf of an individual who is not an eligible individual. If, however, the excess contributions for a taxable year and the net income attributable to these excess contributions are paid to the account holder before the last day prescribed by law, including extensions, for filing the account holder's federal income tax return for the taxable year, then (1) the distribution of the excess contributions is not taxed because it has already been included in the individual's taxable income; and (2) the net income attributable to the excess contributions is included in the account holder's gross income for the taxable year in which the distribution is made.

Distributions

Distributions from an HSA are excludable from gross income if used for qualified medical expenses of the HSA account holder and the account holder's family, with certain exceptions, and are includible in gross income if used for any other purpose. Under one such exception, in any year for which an HSA contribution is made, distributions from an HSA of that account holder to pay medical expenses are included in gross income if, for the month in which the expense was incurred, the individual for whom the expense was incurred was not covered under a high-deductible health plan or had coverage that makes a person ineligible for an HSA. If included in gross income, distributions generally are subject to an additional 10 percent tax at the federal level. However, if distributions that are included in gross income are made after the account holder turns age 65, becomes disabled, or dies, the additional 10 percent tax does not apply.

Qualified medical expenses do not include expenses for insurance other than long-term care insurance, premiums for "COBRA" type health care continuation coverage, or premiums for health care coverage while an individual receives unemployment compensation.

Virginia Conformity

Virginia conforms to the federal treatment of contributions, earnings, and distributions. Thus, there is no Virginia tax on contributions, earnings, or disbursements to the extent that they are exempt from federal tax.

What Tax Incentives Do Other States Offer?

The majority of states conform to the Internal Revenue Code for HSA purposes. The states that do not conform are: Alabama, California, and New Jersey. Because virtually all states with an income tax conform to the federal deduction for HSA contributions, very few, if any, other tax incentives are offered by states to encourage the use of HSAs.

Analysis of the Utilization of HSAs in Virginia

Va. Code §§ 38.2-5601 through 38.2-5602.1 require the Department and the SCC to annually update the Virginia Health Savings Account Plan. As part of this annual update, the SCC surveys health insurance providers that provide high-deductible health plans in Virginia. The SCC has provided the Department with this data to facilitate the Department in making recommendations on tax incentives to encourage the use of HSAs.

See the chart below for the data collected this year by the SCC. The term "policies sold" refers to the number of policies sold in that calendar year. The term "covered lives" refers to the number of lives covered by the policies sold in that calendar year. The term "in force policies" refers to the number of policies that were in force in that calendar year. The

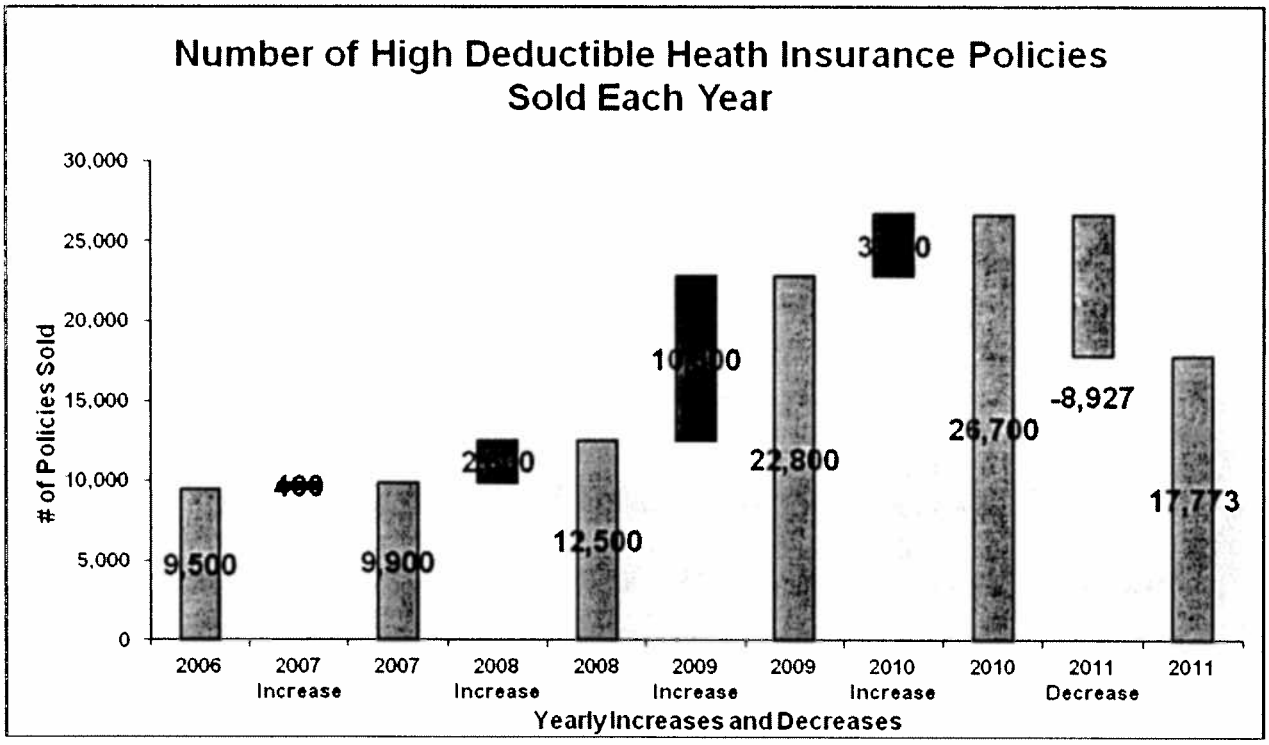
term "in force covered lives" refers to the number of lives covered that were in force in that calendar year.

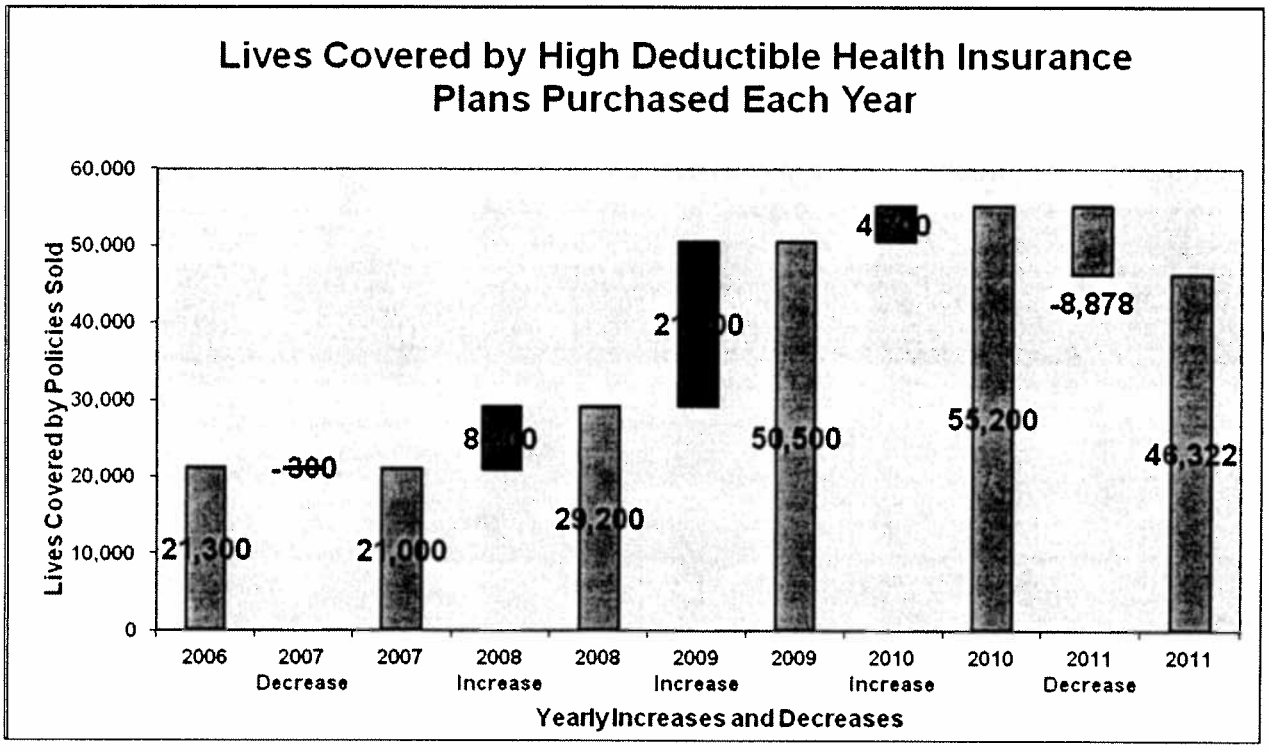
Policies Sold and Policies in Force in Virginia

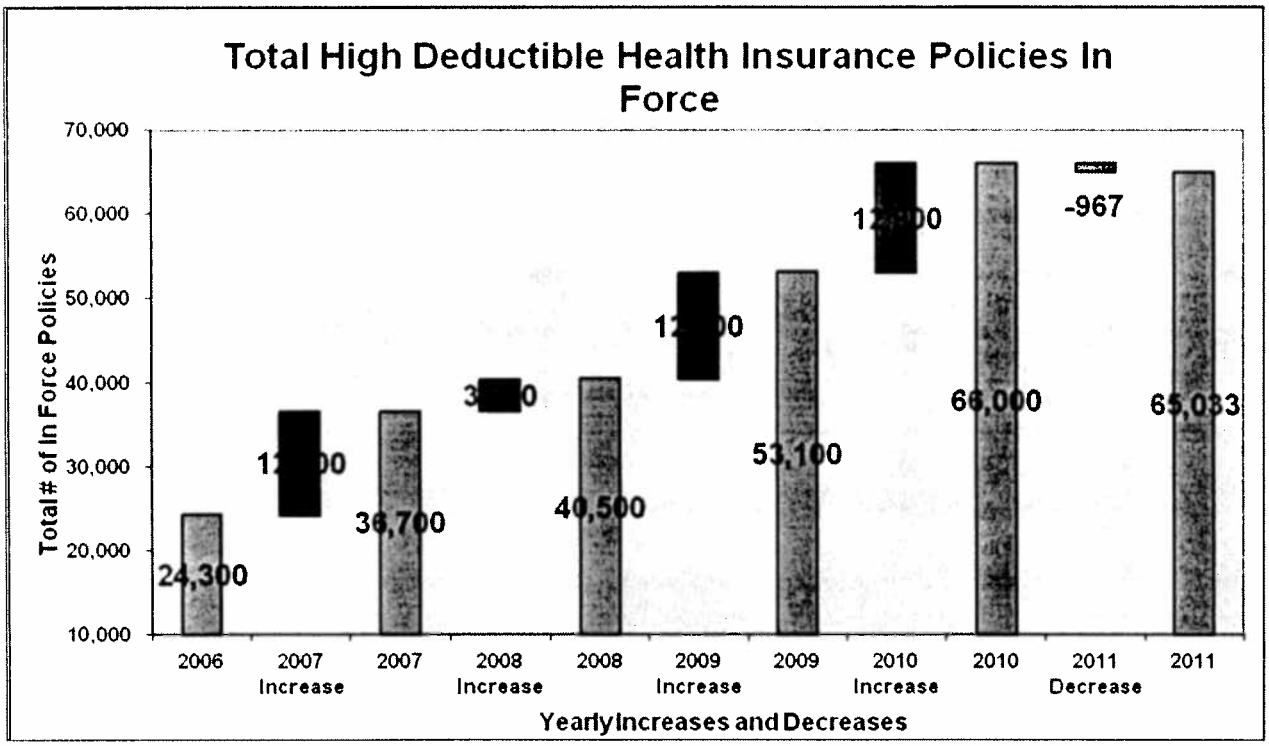
Taxable Year	Policies Sold	% Change	Covered Lives	% Change	In Force Policies	% Change	In Force Covered Lives	% Change
2006	9,500	-	21,300	-	24,300	-	50,100	-
2007	9,900	*4.2%*	21,000	*-1.4%*	36,700	*51.0%*	75,300	*50.3%*
2008	12,500	*26.3%*	29,200	*39.0%*	40,500	*10.4%*	91,700	*21.8%*
2009	22,800	*82.4%*	50,500	*72.9%*	53,100	*31.1%*	115,000	*25.4%*
2010	26,700	*17.1%*	55,200	*9.3%*	66,000	*24.3%*	154,000	*33.9%*
2011	17,773	*-33.4%*	46,322	*-16.1%*	65,033	*-1.5%*	165,921	*7.7%*

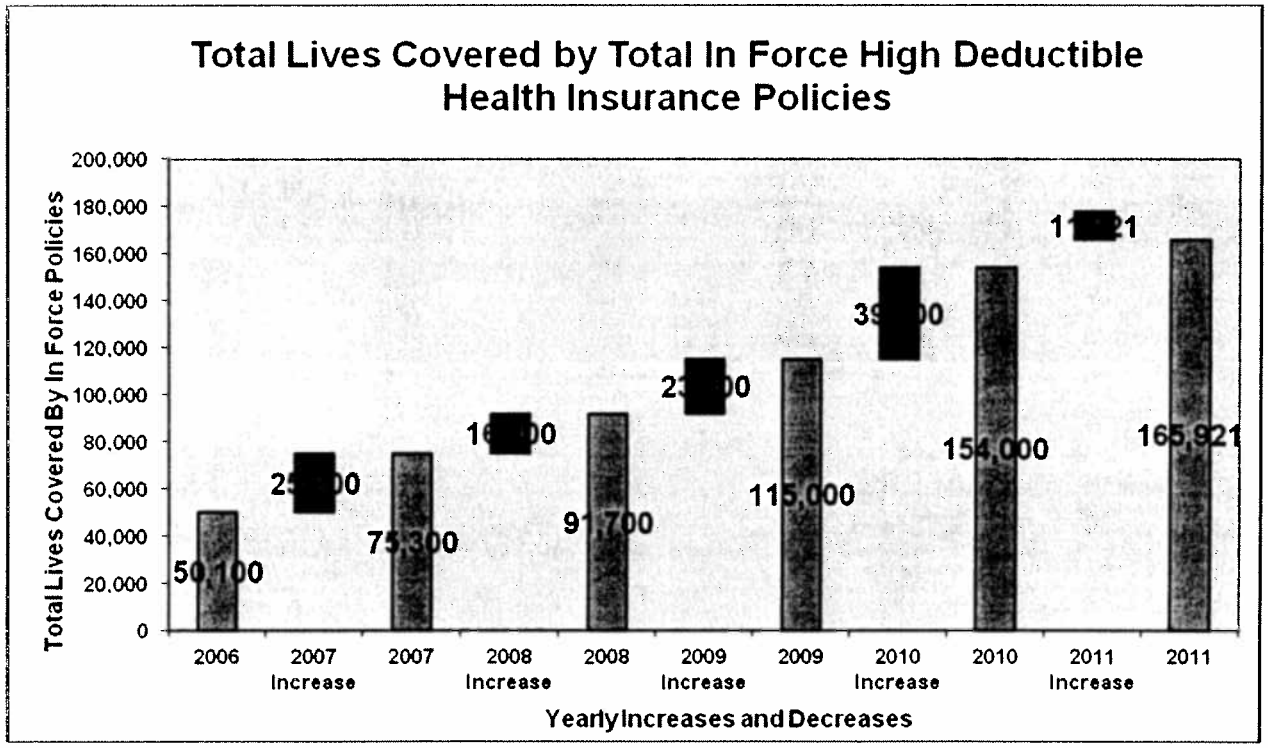
The difference between the total in force policies from one year to the next will not necessarily equal the number of policies sold in a year due to a variety of factors. First, the raw data collected from the surveys administered by the State Corporation Commission have been rounded for disclosure purposes. Additionally, the number of policies sold in the current year and the number of lives covered by those policies are obtained from different data sources than the total in force policies and the total lives covered by in force policies. Furthermore, many policyholders from previous years choose not to retain their policies in future years.

The data demonstrates that the utilization of high-deductible health plans in Virginia decreased in 2011. Although the number of lives covered by in force policies increased in 2011, the number of policies sold, the number of lives covered by new policies, and the number of in force policies decreased in 2011. However, there has been an overall increase in both the number of policies sold and the number of covered individuals since 2006. For example, the annual number of individuals covered by policies in force during the calendar year has more than tripled between 2006 and 2011. See the graphs below.


Number of High Deductible Heath Insurance Policies Sold Each Year
# of Policies Sold
30,000
25,000
20,000
15,000
10,000
5,000
0
9,500
400
9,900
12,500
22,800
26,700
-8,927
17,773
2006
2007 Increase
2007
2008 Increase
2008
2009 Increase
2009
2010 Increase
2010
2011 Decrease
2011
Yearly Increases and Decreases


Lives Covered by High Deductible Health Insurance Plans Purchased Each Year
Lives Covered by Policies Sold
60,000
50,000
40,000
30,000
20,000
10,000
0
21,300
-300
21,000
29,200
50,500
55,200
-8,878
46,322
2006
2007 Decrease
2007
2008 Increase
2008
2009 Increase
2009
2010 Increase
2010
2011 Decrease
2011
Yearly Increases and Decreases


Total High Deductible Health Insurance Policies In Force
Total # of In Force Policies
70,000
60,000
50,000
40,000
30,000
20,000
10,000
24,300
36,700
40,500
53,100
66,000
-967
65,033
2006
2007 Increase
2007
2008 Increase
2008
2009 Increase
2009
2010 Increase
2010
2011 Decrease
2011
Yearly Increases and Decreases


Total Lives Covered by Total In Force High Deductible Health Insurance Policies
Total Lives Covered By In Force Policies
200,000
180,000
160,000
140,000
120,000
100,000
80,000
60,000
40,000
20,000
0
50,100
75,300
91,700
115,000
154,000
165,921
2006
2007 Increase
2007
2008 Increase
2008
2009 Increase
2009
2010 Increase
2010
2011 Increase
2011
Yearly Increases and Decreases

Proposed Virginia Tax Incentives

Incentives for Individuals

After considering possible tax incentives that could be offered to the working poor, the Department does not recommend offering any tax incentives at this time. HSAs were developed at the federal level in 2004 and, since that time, the market for HSAs has expanded considerably. Given this growth, it may not be necessary to offer greater incentives than those that already make HSAs attractive to taxpayers.

As mentioned above, contributions by an eligible individual to an HSA (which are subject to the limits described above) are deductible in computing federal adjusted gross income. Because Virginia conforms to the federal treatment of contributions and distributions, there currently is no Virginia tax imposed on HSA contributions, earnings, or disbursements to the extent that they are exempt from federal taxation.

Another issue is whether an incentive, if one were to be offered, would be aimed at the right entities. Current data does not indicate whether the contributions to existing HSAs are being made by the individuals themselves or by their employers. Without additional information, a tax incentive may be offered to those who may not be significantly influenced by its availability. Therefore, the Department does not recommend offering tax incentives to the working poor.

Incentives for Employers

After consideration of the possible tax incentives that could be offered to employers who contribute to their employees' HSA funds, the Department does not believe that offering such a tax incentive would encourage HSA usage. This decision is based on the current tax incentives already available to businesses and the undesirable effects that may occur if Virginia were to adopt an additional incentive.

Under current federal law, the amount a business contributes to an employee's HSA fund is fully deductible as a business expense. Because of the flow through effect of federal conformity, these business expenses are also fully deducted from the calculation of Virginia income taxes for which the business is liable.

If Virginia were to encourage additional employer contributions, undesirable effects could occur as a result of certain federal provisions. First, an underlying premise of the HSA program is to promote individual responsibility in "shopping" for the necessary medical services. The theory behind this premise was that if people contribute their own money to medical expenses, instead of the current practice of letting the insurance company handle everything, then individuals will exercise more responsibility in "shopping" for the best available price for their medical needs, thus promoting more competition in the medical

industry. If Virginia were to provide an incentive for employer contributions, employees could be discouraged from contributing, thereby undermining the above premise.

Also, if an employer contributes more than the federal limit to an employee's HSA, the excess contributions will be included in the employee's gross income for the year. Once the federal limit is exceeded, any contributions made by the employee would not be deducted from the employee's income either. For these reasons, the Department believes the most prudent and responsible action would be to forego offering a tax incentive for employer contributions.

Incentives for Health Care Professionals

Providing an income tax credit for health care practitioners who provide services to HSA holders at reduced cost or without compensation is a difficult task. The current methods for acquiring medical services with HSA funds are not conducive to an income tax credit. In addition, Virginia already employs tax incentives to encourage health professionals to render their services to the less fortunate at a reduced cost or without compensation. As a result, a new tax incentive may unnecessarily add complexity to the health care system.

The current procedure under which HSA holders pay for medical services and receive the appropriate federal tax treatment is a streamlined one. If an HSA holder has not made a contribution to his HSA during the year and incurs a medical expense, he has two options. He may pay the medical expense with his own funds without taking a distribution from the HSA and treat the expense as a contribution, which is deductible on his income tax return. Alternatively, if the account holder did not wish to make a contribution during the year, then he could take a distribution instead to pay for the medical expense. In a typical scenario, the distribution would be deposited in the HSA holder's bank account and then he could simply write the health professional a personal check.

In either scenario above, the HSA holder would not be required to make a unique transaction or notation with the provider of services as a result of use of the HSA. The health care provider would not be able to differentiate this transaction from a transaction with a patient who has a high deductible insurance plan and no HSA. Therefore, health professionals would not automatically know which of their patients utilize HSAs to pay for their medical services. This makes it very difficult for health professionals to know if they are giving a discount to a patient who has an HSA. The effort that would be necessary to allow health professionals to identify which patients utilize HSAs would unnecessarily complicate the process.

Furthermore, Virginia has an existing program, the Neighborhood Assistance Program, which allows for significant income tax credits to health professionals who provide services to low-income patients pursuant to the Neighborhood Assistance Act. Tax credits are available to businesses and individuals who contribute to approved neighborhood assistance organizations designed to benefit impoverished individuals. Credits are also available to

physicians, chiropractors, dentists, nurses, nurse practitioners, physician assistants, optometrists, dental hygienists, professional counselors, clinical social workers, clinical psychologists, marriage and family therapists, physical therapists, and pharmacists who donate health care services within the scope of their licensure at a qualified health clinic. The credit can be applied against the income tax imposed on individuals, trusts, estates, and corporations; the Bank Franchise Tax; the Insurance Premiums License Tax; and the Gross Receipts Tax imposed on public service companies.

An additional income tax credit for health care professionals who provide services would duplicate the efforts being made through the Virginia Neighborhood Assistance Program. This duplication could hurt the effectiveness of any proposal offered here as well as the Virginia Neighborhood Assistance Program. Because of this potential duplication of efforts within the tax code and the already streamlined process in place for using HSAs to pay for health expenses, any proposal offered to entice health care professionals to offer services to HSA holders at a reduced cost or without compensation would not be effective and potentially would be counter-productive.

Conclusion

Although the utilization of high-deductible health plans in Virginia decreased in 2011, there has been an overall increase in both the number of high-deductible health plan policies sold and the number of covered individuals since 2006. In fact, the annual number of individuals covered by policies in force during the calendar year has more than tripled between 2006 and 2011. After examining the utilization of high-deductible health plans in Virginia and considering the constraints detailed above, the Department does not recommend offering additional tax incentives. The most important aspect of the HSA program is the federal tax incentives, to which Virginia already conforms. Virginia conforms to the federal treatment of contributions, earnings and distributions. Thus, there is no Virginia tax on either contributions, earnings or disbursements to the extent that they are exempt from federal tax.

Congressional action may impact the popularity of HSAs in Virginia. In March of 2010, the President signed the Patient Protection and Affordable Care Act, legislation that reforms health care in the United States. The primary features of the legislation include mandating that most citizens obtain health insurance by 2014, establishing a state-run pool of insurance exchanges to assist small businesses, allowing parents to keep children on their policies until age 26, cutting Medicare costs, limiting insurance companies' ability to deny coverage, and expanding Medicaid. It is unclear at this time what impact this legislation will have on HSAs.