MEDICAL SAVINGS ACCOUNT DEDUCTIONS

EVALUATION SUMMARY | APRIL 2022 | 2022-TE16

TAX TYPE	Income	REVENUE IMPACT (TAX YEAR 2017)	$16,000
YEAR ENACTED	1994	NUMBER OF TAXPAYERS	Less than 250
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: Because similar federal deductions were established after their creation, the Medical Savings Account Deductions no longer appear to be necessary to allow taxpayers to reduce medical savings costs and are used by few taxpayers.

WHAT DO THE TAX EXPENDITURES DO?

The Medical Savings Account Deductions [Sections 39-22-104.6, 39-22-304(3)(k), 39-22-504.7(2)(e), and 39-22-104(4)(h), C.R.S.] allow employers and employees to deduct up to $3,000 in annual contributions made to an employees' medical savings account from the taxpayer's Colorado taxable income, to the extent that the contributions are not already deducted from their federal taxable income. The deduction is available to both employees who make contributions to their own medical savings accounts and C-corporation employers who make contributions to their employees' accounts. Section 39-22-504.6(3), C.R.S., defines a medical savings account as "an account established to pay the eligible medical expenses of an account holder and his or her spouse and dependent children, if any."

WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not explicitly state a purpose for the deductions. Based on our review of statute, legislative history, and news articles, for the purposes of our evaluation we considered a potential purpose: to lower the cost of saving for medical expenses by providing a tax benefit.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to:

- Review whether the deductions are necessary and consider repealing them.
- Consider amending statute to establish a statutory purpose and performance measures for the deduction if they are not repealed.

MEDICAL SAVINGS ACCOUNT DEDUCTIONS

EVALUATION RESULTS

WHAT ARE THE TAX EXPENDITURES?

The Medical Savings Account Deductions [Sections 39-22-104.6, 39-22-304(3)(k), 39-22-504.7(2)(e), and 39-22-104(4)(h), C.R.S.] allow employers and employees to deduct up to a combined $3,000 in annual contributions made to an employees' medical savings account from their Colorado taxable income, to the extent that the contributions are not already deducted from their federal taxable income. The deduction is available to both employees who contribute to their own accounts and C-corporation employers who contribute to an employee's account, but contributions from all sources are limited to $3,000 per year. Section 39-22-504.6(3), C.R.S., defines a medical savings account as "an account established to pay the eligible medical expenses of an account holder and his or her spouse and dependent children, if any." Eligible medical expenses are those allowed in Section 213(d) of the Internal Revenue Code, such as medical exams and procedures, medicine, equipment, and insurance costs.

According to Department of Revenue (Department) guidance, employers who establish medical savings accounts for employees are directed to withhold the amounts contributed to the accounts from employees' taxable income. Employees may also establish their own medical savings account if their employer does not do so, in which case the employee makes deposits directly into the account and is responsible for claiming the deduction when they file their annual income tax return. Because Colorado uses federal taxable income as the basis for calculating a taxpayer's Colorado taxable income, if taxpayers deduct contributions to medical savings accounts from federal taxable income, the deductions will automatically be deducted from the employees' Colorado taxable income and they will not be eligible for the Medical Savings Account Deductions.

House Bill 94-1058, enacted in 1994, established Colorado medical savings accounts as a tax-advantaged account type and created the Medical Savings Account Deductions. In 1997, Senate Bill 97-054 clarified that the deductions could only be claimed by taxpayers who did not claim a deduction on their federal returns. When Medical Savings Accounts were created, there was not an equivalent account type at the federal level or a federal tax deduction for medical savings accounts that Colorado taxpayers could claim. Since that time, the federal government has created several other types of accounts for medical savings that also allow taxpayers to deduct contributions from their federal taxable income. Although these accounts do not necessarily qualify for the Medical Savings Account Deduction, the Department reported that because the statutory definition of Colorado medical savings accounts [Sections 39-22-504.6(3) and 39-22-504.7, C.R.S.] is fairly broad, other medical accounts established under federal law, could potentially qualify for the Medical Savings Account Deductions. However, because these accounts generally allow taxpayers to deduct or withhold contributions from their federal taxable income, which is the starting point for calculating state taxable income, contributions to these accounts would typically not qualify for the Medical Savings Account Deduction, since taxpayers are only able to claim it to the extent that the contributions have not been deducted from federal taxable income. Exhibit 1 provides information on federally established accounts that are similar to Colorado medical saving accounts.

EXHIBIT 1. FEDERALLY ESTABLISHED ACCOUNTS THAT ARE SIMILAR TO A COLORADO MEDICAL SAVINGS ACCOUNT	
Medicare Medical Savings Account Plans, (Medicare Advantage)	A plan issued by Medicare and private insurance companies. Medicare Medical Savings Accounts are high-deductible health plans and savings accounts that allow taxpayers to pay Medicare-covered costs before they meet Medicare eligibility levels.
Health Savings Account	A savings account utilized with a high-deductible health insurance policy that allows individuals to save money tax-free on medical expenses.
Flexible Spending Account	An arrangement through an employer that allows individuals to pay for out-of-pocket medical expenses with tax-free dollars.
Archer Medical Savings Account	A tax-exempt trust or custodial account established with a bank or insurance company, used to pay for healthcare expenses. Although individuals can continue to use existing accounts, new accounts can no longer be established.

SOURCE: Office of the State Auditor summary of federal medical accounts that are similar to Colorado medical savings accounts.

Colorado statute requires Colorado medical savings accounts to be issued by a state chartered bank, a national banking association, an insurance company, or an employer maintaining a self-insured health plan [Section 39-22-504.6(1), C.R.S.]. Employees must sign a Department form, Employees Election Regarding Medical Savings Account [Form DR 0810], before the first contribution can be made. The Medical Savings Account Deductions are claimed on the "Other Subtractions" line on the Subtraction from Income Schedule [Form DR 0104 AD]. Then, taxpayers claim the deductions on Line 6, of the Colorado Individual Income Tax Return [Form DR 0104], or, in the case of an employer corporation making contributions, Line 12 of the Colorado C Corporation Income Tax Return [Form DR 0112]. Taxpayers who withdraw funds from the accounts for purposes other than for paying eligible medical expenses must add the amount withdrawn to their Colorado taxable income.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not explicitly identify the intended beneficiaries of the Medical Savings Account Deductions. We inferred, based on the operation of the deductions, Department guidance, news articles, and legislative history, that the intended beneficiaries of the deductions are taxpayers, including employees and employers who contribute to an employee's medical savings account.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not explicitly state a purpose for the deductions. Based on our review of statute, legislative history, and news articles, for the purposes of our evaluation we considered a potential purpose: to lower the cost of saving for medical expenses by providing a tax benefit. Colorado House Joint Resolution 94-1005, which was adopted in 1994 during the same session as the Medical Savings Account Deductions, states, "patients and consumers will reduce health care costs if they are allowed to benefit from prudent individual spending decisions and if they use pre-tax dollars to establish individual medical accounts or medical savings accounts." Although the resolution was passed independently from House Bill 94-1058, which established the deductions, it shows the General Assembly's intention at the time was to reduce health care costs. Further, at the time, no similar federal deductions were available, so the deductions established a new tax benefit for Coloradans saving for health care costs.

ARE THE TAX EXPENDITURES MEETING THEIR PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the deductions are meeting their purpose because no purpose is provided in statute or their enacting legislation. However, we found that the deductions do not appear to be meeting the potential purpose we considered for the evaluation because similar federal deductions generally make them unnecessary.

Statute does not provide performance measures for the deductions. Therefore, we created and applied the following performance measure to determine whether the deductions are meeting their purpose:

PERFORMANCE MEASURE: *To what extent do the deductions help Colorado taxpayers reduce healthcare saving costs?*

RESULT: We found that the Medical Savings Account Deductions reduce few taxpayers' healthcare saving costs because taxpayers can deduct contributions to medical savings accounts from their federal taxable income, which if they do, means that they cannot use the deductions at the state level. Although similar federal deductions were not available in 1994 when the State's deductions were established, in 1996 Congress passed legislation establishing them. The following year, the General Assembly passed Senate Bill 97-054, which clarified that the Medical Savings Account Deductions are only available to the extent that contributions were included in federal taxable income. As outlined above in EXHIBIT 1, contributions to a variety of accounts for medical savings are now eligible for federal income tax deductions and, because Colorado's taxable income is based on federal taxable income, taxpayers who deduct the contributions for federal tax purposes automatically receive the same reduction in Colorado taxable income. Further, because medical savings accounts that qualify for the federal deduction are widely available, and typically provide taxpayers with a more significant tax benefit than the state deductions alone, it appears uncommon for taxpayers to forego the available federal deductions and use only the State's Medical Savings Account Deductions.

Although the Department was unable to provide comprehensive data on taxpayers' use of the deductions, in 2019, the Department conducted a review of Tax Year 2017 filings to determine which expenditures were being claimed on the "Other Subtractions" line of the Subtractions from Income Schedule [Form DR 0104AD], as part of the Colorado Income Tax Return [Form DR 0104], which is where taxpayers claim the Medical Savings Account Deductions. Out of the nearly 9,000 returns the Department reviewed, less than 250 (about 3 percent) included claims for the Medical Savings Account Deductions. When the Department reviewed the claims, it found that about 150 (60 percent) of the claims did not provide any documentation to support their claim for the deductions. The remaining taxpayers, approximately 100, provided documentation that they made contributions to an account eligible for the medical savings account deductions. While these taxpayers could be using medical savings accounts that do not qualify for federal deductions, we were unable to determine why they would do so, since accounts that qualify for federal deductions typically provide a larger tax benefit and still effectively reduce taxpayers' Colorado taxable income by an amount equivalent to the Medical Savings Account Deductions. It is possible that some of these taxpayers claimed the deductions in error; for example, claiming them for contributions that were already deducted from their federal taxable income, although the Department lacked information to determine how often this may have occurred. However, regardless of the precise number of taxpayers that use the deductions, given that tax-advantaged medical savings accounts are widely used in the state, the Department's review indicates that few taxpayers who save for medical expenses use the deductions and the total savings provided by the deductions are not large enough to significantly reduce health care saving costs in the state.

WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURES?

The Department was unable to provide data necessary to comprehensively evaluate the Medical Savings Account Deductions' revenue impact to the State because the deductions are claimed on the same line as several other deductions and the amounts claimed cannot be disaggregated for analysis. However, based on the Department's review of 2017 tax returns, taxpayers claimed about $350,000 in Medical Savings Account Deductions in Tax Year 2017, which resulted in them saving approximately $16,000 in state income taxes. Although, as mentioned above, the Department found that about 60 percent of these taxpayers who claimed about $220,000 of the deductions (65 percent) did not provide documentation to support their claim. Due to their limited usage, the deductions do not appear to have a significant economic impact in the state or significantly reduce health care saving costs.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If the Medical Savings Account Deductions were eliminated, taxpayers who do not claim a federal deduction for contributions made to medical savings accounts would not be able to receive a deduction on their state income taxes. As discussed above, the Department identified less than 250 taxpayers who claimed the deductions in 2017 who each saved about $65 in income taxes, on average. If the Medical Savings Account Deductions were eliminated, these taxpayers would see a corresponding increase in their income taxes. However, because federally deductible medical savings accounts are available, even if the state deductions were eliminated, taxpayers could likely still benefit from one of several federally deductible account types. This would allow taxpayers to reduce both their federal and Colorado taxable income for eligible contributions.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 41 other states (excluding Colorado) and the District of Columbia that levy an income tax, all allow deductions for contributions to medical savings accounts. Most states with a deduction allow taxpayers to claim the same amount allowed by IRS rules, which generally exempt contributions to medical savings accounts. Other states still allow a deduction but restrict deductions to contributions to certain medical savings account types, modify the amount that can be deducted from state taxes, or have different requirements regarding when taxpayers can claim the deduction. For example, Ohio does not follow the federal tax treatment for Archer Medical Savings Accounts, Idaho modifies the amounts that taxpayers can deduct, and Indiana allows taxpayers to claim a deduction when money is withdrawn from a medical savings account instead of when it is deposited in the account.

ARE THERE OTHER TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE AVAILABLE IN THE STATE?

As discussed, there are federal income tax deductions for contributions made to other types of accounts used for medical savings, like, Health Savings Accounts, Flexible Spending Accounts, and Archer Medical Savings Accounts. Because Colorado calculates taxable income based on federal taxable income, Colorado taxpayers also receive a deduction on their state income taxes for contributions to these federally recognized accounts for medical savings.

WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURES?

The Department was not able to provide comprehensive data necessary to determine how often the deductions are claimed and the revenue impact to the State. Specifically, taxpayers claim the deductions on the same reporting line as several other income tax deductions, which cannot be disaggregated for the purposes of analysis. The Department was able to provide some data for deductions based on a 2019 review that it conducted on Tax Year 2017 claims. However, since the purpose of the Department's review was to estimate the general frequency and cost of several deductions, the Department stated that the 2017 data for the deductions provide only a general estimate of how often the deductions are claimed.

In order to begin collecting comprehensive data on the deductions, the Department would need to require taxpayers to begin reporting the amount deducted on a separate reporting line. However, according to the Department, this type of change would require additional resources to modify the form and complete the necessary programming in GenTax, the State's primary information system for processing taxes collected by the State, to capture this information (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations). Further, it may not be cost effective to implement these changes, since it appears few taxpayer use the deductions.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO REVIEW WHETHER THE MEDICAL SAVINGS ACCOUNT DEDUCTIONS ARE STILL NECESSARY AND COULD CONSIDER REPEALING THEM. As discussed, we found that because most taxpayers are able to subtract contributions to medical savings from their federal taxable income by using one of several federally deductible account types, they do not appear to have a need to use the Medical Savings Account Deductions. For this reason, the deductions are used by few taxpayers, with the Department identifying less than 250 taxpayers who used them in Tax Year 2017, the most recent year with available data. In 1994, when the deductions were established, there was not a similar deduction available at the federal level, so at that time, the deductions would have provided a unique benefit to taxpayers who contributed to eligible accounts. However, beginning in 1996, the federal government began creating deductions for medical savings accounts through a pilot program to promote their usage. Federal tax benefits have since expanded over time. Because taxpayers can now deduct contributions to these accounts from both their federal and state income, without using the Medical Savings Account Deductions, the deductions may no longer be necessary. Therefore, the General Assembly could consider repealing them.

IF THE GENERAL ASSEMBLY DOES NOT REPEAL THE MEDICAL SAVINGS ACCOUNT DEDUCTIONS, IT MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES. Statute and the enacting legislation for the deductions do not state their purpose or provide performance measures for evaluating their effectiveness. Therefore, for the purposes of this evaluation we considered a potential purpose: to lower the cost of saving for medical expenses by providing a tax benefit. We identified this purpose based on statute, legislative history, and news articles. We also developed a performance measure to assess the extent to which the deductions are meeting this potential purpose. If the General Assembly does not repeal the deductions, it may want to clarify its intent for the deductions by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding their purpose and allow our office to more definitively assess the extent to which the deductions are accomplishing their intended goal(s).