DESCRIPTION OF AN AMENDMENT IN THE NATURE OF A SUBSTITUTE TO THE CHAIRMAN'S MARK RELATING TO MEDICAL SAVINGS ACCOUNTS

Scheduled for Markup

by the

HOUSE COMMITTEE ON WAYS AND MEANS

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Prepared by the Staff

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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup on various revenue provisions beginning on September 18, 1995. This document, prepared by the staff of the Joint Committee on Taxation, provides a description of the medical savings account ("MSA") proposal scheduled for markup.[1]

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of an Amendment in the Nature of a Substitute to the Chairman's Mark Relating to Medical Savings Accounts* (JCX-34-95), September 18, 1995.

I. PRESENT LAW

Under present law, the tax treatment of health insurance expenses depends on whether the taxpayer is an employee or self-employed individual, and whether the taxpayer is covered under a health plan paid for by the employee's employer. An employer's contribution to a plan providing accident or health coverage for the employee and the employee's spouse and dependents is excludable from an employee's income. In addition, businesses generally can deduct, as an employee compensation expense, the full cost of any health insurance coverage provided for their employees. The exclusion and deduction are generally also available in the case of owners of subchapter C corporations who are also employees.

In the case of self-employed individuals (sole proprietors or partners in a partnership) no equivalent exclusion applies. However, present law provides a deduction for 30 percent of the amount paid for health insurance for a self-employed individual and the individual's spouse and dependents. The 30-percent deduction is also available to more than 2-percent shareholders of subchapter S corporations.

Individuals who itemize deductions may deduct amounts paid during the taxable year (if not reimbursed by insurance or otherwise) for medical care (including medical insurance) of the taxpayer and the taxpayer's spouse and dependents, to the extent that the total of such expenses exceeds 7.5 percent of the taxpayer's adjusted gross income (AGI).

There are no specific tax provisions for medical savings accounts.

II. DESCRIPTION OF MEDICAL SAVINGS ACCOUNT PROPOSAL

In general

In general, the proposal would permit individuals who are covered only by a catastrophic health plan to maintain a medical savings account ("MSA"). Within limits, contributions to an MSA would be deductible if made by the individual, or alternatively, would be excludable from an employee's income if made by the employer. An individual would not be eligible to make deductible contributions if the individual's employer makes contributions to an MSA for the individual. In general, the aggregate amount of individual or employer contributions that could be deducted or excluded for a taxable year would be the lesser of (1) the deductible under the catastrophic health plan, or (2) $2,500 if the catastrophic health plan only provides individual coverage or $5,000 if the catastrophic health plan also covers the individual's spouse and/or dependents. These dollar limits would be indexed annually based on the medical care component of the Consumer Price Index (rounded to the nearest multiple of $50). Income earned on amounts held in an MSA would be currently includible in income. Withdrawals from an MSA would be excludable from income if used for medical expenses for the individual and his or her spouse or dependents.

Deductible contributions to MSAs

Under the proposal, a deductible contribution could be made to an MSA for any month in which the individual is an eligible individual. In general, a person would be an eligible individual for a month if, as of the first day of the month, he or she is covered under a catastrophic health plan. However, an individual would not be eligible if the individual is also covered by another health plan (other than a plan that provides certain permitted coverage) which is not a catastrophic health plan and which provides coverage for benefits provided by the catastrophic health plan. An individual with other coverage in addition to a catastrophic plan would still be eligible to make deductible contributions to an MSA if such other coverage is certain permitted insurance[2] or is coverage (whether provided through insurance or otherwise) for accidents, dental care, vision care, or long-term care. Thus, for example, an individual whose only health plan coverage is a catastrophic health plan and a flexible spending arrangement under which the only health expenses that may be reimbursed are expenses for dental and vision care would be an eligible individual.

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[2] The following types of insurance would be permitted insurance and therefore would not preclude an individual from making a deductible contribution to an MSA: (1) Medicare supplemental insurance; (2) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under workers' compensation laws, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), (d) credit insurance, or (e) such other similar liabilities as the Secretary may prescribe by regulations; (3) insurance for a specified disease or illness; and (4) insurance that provides a fixed payment for hospitalization.

A catastrophic health plan would be defined as a health plan that has a deductible amount of at least $1,500 (or $3,000 if the plan provides coverage for more than one individual). These dollar amounts would be indexed annually for medical inflation provided to the nearest multiple of $50.

No deduction would be allowed for a taxable year if any employer contributions are made to an MSA on behalf of an individual during such year. (As discussed below, such employer contributions would be excludable from income, subject to the same limits as deductible contributions.)

The maximum annual deductible contribution to an MSA would be determined separately for each month based on the individual's status as of the first day for each month, including: (1) whether the individual is an eligible individual, (2) whether the catastrophic health plan covers only the individual or also a spouse and dependents, and (3) the amount of the deductible under the catastrophic health plan. In general, the maximum annual deductible contribution would be the sum of the following amounts determined separately for each month: (1) 1/12 of the lesser of $2,500 or the deductible under the catastrophic health plan for each month in which the individual is an eligible individual and the catastrophic health plan covers only the individual; and (2) 1/12 of the lesser of $5,000 or the deductible under the catastrophic health plan for each month in which the individual is an eligible individual and the catastrophic health plan also covers the individual's spouse and/or dependents.

The deduction limit generally would be determined separately for each spouse of a married couple. If both spouses are covered under the same catastrophic health plan, then the $5,000 deduction limit would be divided equally between the spouses unless they agree on a different division (in the time and manner prescribed by the Secretary). In such a case, no deduction would be allowed with respect to either spouse if an employer contribution is made to an MSA on behalf of either of the spouses. If either spouse or any dependent is covered under another catastrophic health plan, the maximum deductible contribution for each spouse would be no more than $2,500.

Permitted deductions for contributions to an MSA would be taken in arriving at adjusted gross income (i.e., "above the line"). No deduction would be allowed to an individual if any other person is entitled to a personal exemption on account of such individual, whether or not such personal exemption is actually taken.

Contributions to an MSA for a taxable year could be made until the due date for filing the individual's tax return for the year (determined without regard to extensions).

Employer contributions to an MSA

Employer contributions to an MSA on behalf of an eligible individual would be excludable from gross income and would not be considered wages for employment tax purposes. The amount excludable could not exceed the deduction limit applicable to the individual. The

exclusion would apply whether or not the employee may choose to have the amounts contributed to an MSA or another health plan. For example, there would be no income inclusion merely because the employee may choose between a catastrophic health plan with an employer contribution to an MSA and coverage under another (noncatastrophic) health plan. Employer contributions to an MSA would not be excludable from income if made at the election of the employee (i.e., pursuant to a salary reduction arrangement under a cafeteria plan). Any employer contribution to an MSA (if otherwise allowable as a deduction) would be allowed only for the taxable year in which paid.

The proposal does not specify the timing of employer contributions. Thus, for example, an employer could make monthly contributions or a single annual contribution to an MSA.

Definition and tax treatment of MSAs

In general, an MSA would be a trust (or a custodial account) created exclusively for the purpose of paying the qualified medical expenses of the account holder (or his or her spouse or dependents) that meets requirements similar to those applicable to individual retirement arrangements ("IRAs").[3] The trustee of an MSA could be a bank, insurance company, or other person that demonstrates to the satisfaction of the Secretary that the manner in which such person will administer the trust will be consistent with applicable requirements.

The holder of an MSA would have to currently include earnings on MSA assets in gross income. Any capital losses on MSA assets could be used only to offset capital gains on MSA assets. Unused capital losses could be carried forward to succeeding taxable years to offset future gains on MSA assets.

An MSA trustee would be required to make such reports as may be required by the Secretary. A $50 penalty would be imposed for each failure to file without reasonable cause.

Distributions from an MSA

Distributions from an MSA that are used to pay the qualified medical expenses (not reimbursed by insurance or otherwise) of the individual or the individual's spouse or dependents would be excludable from gross income whether or not the individual is an eligible individual at

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[3] For example, MSA contributions (other than amounts rolled over from another MSA) would have to be in cash, no MSA assets could be invested in life insurance contracts, MSA assets could not be commingled with other property except in a common trust fund or common investment fund, and an account holder's interest in an MSA would be required to be nonforfeitable. In addition, if an account holder engages in a prohibited transaction with respect to an MSA or pledges assets in an MSA, rules similar to those for IRAs would apply, and any amounts treated as distributed to the account holder under these rules would be treated as not used for qualified medical expenses.

the time of the distribution. Distributions for qualified medical expenses of the individual's spouse and dependents would be permitted even if the catastrophic health plan only covers the individual. Qualified medical expenses would generally be defined as under the rules relating to the itemized deduction for medical expenses (sec. 213). However, for this purpose qualified medical expenses would not include any insurance premiums (including premiums for the catastrophic health plan), except for premiums for long-term care insurance. Distributions from an MSA that are excludable from gross income under the proposal could not be taken into account for purposes of the itemized deduction for medical expenses.

Distributions for purposes other than qualified medical expenses would be subject to an ordering rule so that such distributions would be includible in income until the amount of previously deducted or excluded contributions have been exhausted. Under the proposal, amounts not used for qualified medical expenses would be included in gross income to the extent such distributions do not exceed the excess of (1) the aggregate contributions to such account which were deductible or excludable from gross income, over (2) the aggregate prior payments from such account which were includible in gross income. For this purpose, all MSAs of the account holder would be aggregated and all distributions during a taxable year would be treated as a single distribution. An additional tax of 10 percent of the amount includible in income also would apply unless the distribution is made after the individual attains the age of 59-1/2 , dies or becomes disabled.

Distributions upon the death of the account holder would be subject to rules similar to the rules applicable to IRAs.

Rollovers from one MSA to another MSA would be permitted without income inclusion if made within 60 days of distribution.

The proposal would include a correction mechanism so that if contributions for a year (whether made by the individual or the employer) exceed the deduction limit for the year, the excess contribution can be withdrawn tax free. In order for tax-free treatment to apply, the excess contributions would have to be withdrawn before the due date (including extensions) for filing the individual's tax return for the year and be accompanied by the amount of income attributable to such contribution.

Effective Date

The proposal would be effective with respect to taxable years beginning after December 31, 1995.

Legislative Background

The proposal is similar to H.R. 1818, the "Family Medical Savings and Investment Act of 1995", introduced by Chairman Archer and others on June 13, 1995. The Committee on Ways and Means held hearings on H.R. 1818 on June 27, 1995.