CATASTROPHIC HEALTH INSURANCE DEDUCTION

EVALUATION SUMMARY | APRIL 2022 | 2022-TE15

TAX TYPE	Income	REVENUE IMPACT (TAX YEAR 2017)	Minimal
YEAR ENACTED	1994	NUMBER OF TAXPAYERS (TAX YEAR 2017)	Minimal
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: Because insurance that would qualify for the deduction is currently not being sold in the state, the deduction is not reducing the cost of catastrophic health insurance.

WHAT DOES THE TAX EXPENDITURE DO?

The Catastrophic Health Insurance Deduction [Section 39-22-104.5, C.R.S.] provides employees with a state income tax deduction on wages withheld by their employer to pay for catastrophic health insurance if the wages have not already been deducted on their federal income tax returns.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the expenditure. Based on our review of statute, legislative history, and news articles from the period when the expenditure was created, we considered a potential purpose: to reduce taxpayers' costs for catastrophic health insurance by reducing their Colorado tax liability.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Repealing the deduction, since eligible policies are not currently sold in the state.
- Amending statute to establish a statutory purpose and performance measures for the deduction if the deduction is not repealed.

FOR FURTHER INFORMATION ABOUT THIS REPORT, PLEASE CONTACT
THE OFFICE OF THE STATE AUDITOR | 303.869.2800 | WWW.COLORADO.GOV/AUDITOR

CATASTROPHIC HEALTH INSURANCE DEDUCTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Catastrophic Health Insurance Deduction [Section 39-22-104.5, C.R.S.] provides employees with a state income tax deduction on wages withheld by their employer to pay for catastrophic health insurance if the wages have not already been deducted on their federal income tax returns. Catastrophic health insurance provides coverage for unexpected high-cost health care, such as may be incurred due to an accident or a serious illness. Policies typically offer lower premiums to policy holders, but provide less coverage for routine health care, and require higher deductibles than other types of health insurance. For policies to qualify for the deduction, deductibles must be between $1,500 and $2,250 for individual coverage and between $3,000 and $4,500 for families [Section 10-16-116(3), C.R.S.]. Additionally, qualifying catastrophic health insurance policies must be issued by an employer, cover all employees who elect coverage, be priced according to specifications in law, and meet other requirements. According to the Division of Insurance (Division) within the Department of Regulatory Agencies, no insurer in Colorado is currently selling catastrophic health insurance that qualifies for the deduction.

The deduction was established in 1994 by House Bill 94-1094, which also established provisions allowing employers who do not provide other health plans to offer employees catastrophic health insurance. In 2013, House Bill 13-1266 clarified that catastrophic health plans that individuals can purchase through Connect for Health Colorado do not qualify for the deduction. Specifically, under Section 10-16-116(6)(a), C.R.S., "catastrophic health insurance" is distinct from a "catastrophic plan" (more commonly called a "catastrophic health plan"), which is purchased directly by individuals through Connect for Health Colorado. While catastrophic health plan payments do not qualify for the deduction, wages withheld to pay for these plans are generally excluded from federal taxable income under federal law, which also effectively excludes them from Colorado taxable income because the State uses federal taxable income as the basis for calculating Colorado taxable income.

The deduction is structured to automatically apply when employers withhold wages to pay for catastrophic health insurance, with Section 10-16-116(5)(b), C.R.S., stating that employers should withhold wages for catastrophic health insurance premiums on a pre-tax basis for state income tax purposes. The employee and employer must sign an "Employees Election Regarding Catastrophic Health Insurance" (Form DR 0811) form to document their election to have wages withheld to pay for catastrophic health insurance. This form is maintained by the employer and is not filed with the Department of Revenue (Department). Department guidance states that employers must report premiums withheld in the form of a letter on the employer's letterhead, which is furnished to the employee and the Department. According to Department guidance, the letter must indicate why premiums may be deducted when calculating an employee's Colorado taxable income during that year. If an employer does not properly withhold the wages on a pre-tax basis and/or the wages were included in the individual's federal taxable income, taxpayers can claim the deduction using line 18 for "Other Subtractions" on their Subtractions from Income Schedule (Form DR 0104AD), which is filed with their income tax return.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Catastrophic Health Insurance Deduction. We inferred, based on statutory language and Department guidance, that the intended beneficiaries are individuals who have wages withheld by their employer to pay for catastrophic health insurance.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the expenditure. Based on our review of statute, legislative history, and news articles from the period when the expenditure was created, we considered a potential purpose: to reduce taxpayers' costs for catastrophic health insurance by reducing their Colorado tax liability. During the 1990s, both state and federal governments introduced several new types of insurance policies, savings accounts, and corresponding tax benefits intended to help lower health care costs. The deduction, created in 1994, appears to be part of this policy effort.

IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the deduction is meeting its purpose because no purpose is provided in statute or its enacting legislation. However, we found that the deduction does not appear to be meeting the potential purpose we considered for this evaluation because qualifying catastrophic health insurance does not appear to be sold in Colorado and few taxpayers claimed the deduction in a prior year, and it is possible that these taxpayers may have claimed the deduction in error.

Statute does not provide performance measures for the deduction. We created and applied the following performance measure to determine whether the deduction is meeting the potential purpose we considered:

PERFORMANCE MEASURE: *To what extent has the deduction reduced costs for catastrophic health insurance?*

RESULT: We found that the Catastrophic Health Insurance Deduction is not reducing taxpayers' costs for catastrophic health insurance because it does not appear that qualifying policies are being sold in the state.

According to the Division, there are currently no insurers offering catastrophic health insurance in Colorado that appear to qualify for the deduction. Although catastrophic health plans are available through Connect for Health Colorado, and provide similar coverage, as discussed, these plans do not qualify for the deduction under Section 10-16-116(6)(a), C.R.S., because the plans do not cover all employees who elect coverage and are not otherwise covered under Medicare or another policy, as required by Section 10-16-116(3)(d), C.R.S.

Further, although the Department did not have comprehensive data available to measure the use of the deduction in prior years, it appears that taxpayers rarely claimed it. Specifically, the Department conducted a study of Tax Year 2017 filings to determine which expenditures were being claimed on the "Other Subtractions" line of the Colorado Income Tax Return, which is where taxpayers would claim the deduction, and found that a minimal number of taxpayers claimed the deduction that year. Due to the small number of taxpayers who claimed the deduction, taxpayer confidentiality requirements [Section 39-21-305(2)(b), C.R.S.] prevent us from reporting the specific number of taxpayers who claimed it. Given the current lack of qualifying plans in the state and the small number of taxpayers who claimed the deduction in prior years, it is possible that these taxpayers may have claimed the deduction in error. For example, the taxpayers may have claimed it for amounts spent on catastrophic health plans that they purchased directly from Connect for Health Colorado, which would not have been eligible for the deduction.

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

We were unable to determine the Catastrophic Health Insurance Deduction's revenue impact to the State because taxpayers do not have to report amounts withheld pre-tax for catastrophic health insurance payments, and any amounts claimed on the Subtractions from Income Schedule are included on the same reporting line as several other deductions and cannot be disaggregated. However, as discussed, the Department's review of 2017 tax returns showed that the deduction appears to have been used by few taxpayers in prior years and had a minimal revenue impact to the State. Due to Section 39-21-305(2)(b), C.R.S., which protects the confidentiality of tax information, we could not provide the exact revenue impact of the deduction due to the small number of taxpayers claiming it.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Since the Division is not aware of any insurance that meets the requirements to qualify for the deduction and the Department found few taxpayers who claimed the deduction in Tax Year 2017, eliminating the Catastrophic Health Insurance Deduction would have a minimal impact on intended beneficiaries. If the deduction is eliminated, any taxpayers who currently benefit from it would see a corresponding increase in their state income taxes. However, according to Department staff, taxpayers may potentially be eligible to exclude amounts withheld from wages to pay for catastrophic health insurance from taxable income under federal law, which would automatically result in a deduction on their state taxes because Colorado uses federal taxable income to calculate state income tax.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Out of the 42 states that impose a state income tax, Colorado is the only state that treats catastrophic health insurance and catastrophic health plans as separate types of insurance and the only state that has a specific catastrophic health insurance deduction.

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

Under federal law, taxpayers may be eligible to exclude amounts withheld from wages to pay for catastrophic health insurance from federal taxable income. Claiming a federal deduction would also effectively result in a reduction in taxpayers' Colorado taxable income because Colorado uses federal taxable income as the basis for calculating Colorado taxable income.

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

The Department could not provide comprehensive data on the deduction because GenTax, its tax reporting and information system, does not capture this information. In addition, the Department does not require taxpayers to submit the "Employees Election Regarding Catastrophic Health Insurance" (Form DR 0811), so we were not able to determine how many employees have elected to have employers withhold pre-tax wages to pay for catastrophic health insurance. In order to collect this information, the Department would need to require employers to submit their employees' election forms and report the amount they withhold from employees' wages for qualifying catastrophic insurance on a form that could be captured by GenTax. However, according to the Department, this type of change would require additional resources to develop the form and complete the necessary programming in GenTax 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 would likely not be cost effective to implement these changes, since it appears that eligible insurance is not currently sold in the state.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REPEALING THE CATASTROPHIC HEALTH INSURANCE DEDUCTION. As discussed above, there are likely few, if any, taxpayers who are able to claim the deduction. Specifically, the Division is not aware of any insurers who are offering qualifying catastrophic health insurance in the state and a study by the Department identified a minimal number of taxpayers who claimed the deduction in Tax Year 2017. Catastrophic health plans, which are distinct from catastrophic health insurance, are sold in the state through Connect for Health Colorado, but are not eligible for the deduction. However, these plans qualify for federal deductions, which would result in a reduction in Colorado taxable income due to Colorado using federal taxable income as the basis for state taxable income. Therefore, it appears that the deduction may not be necessary for taxpayers to receive the benefit that was intended and the General Assembly could consider repealing it.

IF THE GENERAL ASSEMBLY DOES NOT REPEAL THE CATASTROPHIC HEALTH INSURANCE DEDUCTION, THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES. Statute and the enacting legislation for the deduction do not state its purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of this evaluation we considered the following potential purpose: to reduce taxpayers' costs for catastrophic health insurance by reducing their Colorado tax liability. 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 deduction is meeting its potential purpose. However, the General Assembly may want to clarify its intent for the deduction by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding its purpose and allow our office to more definitively assess the extent to which the deduction is accomplishing its intended goal(s).