

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: McClintock Analyst: LuAnna Hass Bill Number: SB 1487
Related Bills: See Legislative History Telephone: 845-7478 Introduced Date: February 19, 2002
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Medical Savings Accounts Deduction/Eliminates Limitation

SUMMARY

This bill would remove the limitation on the number of taxpayers allowed to have an Archer medical savings account (MSA) and eliminate the cut-off date (at the state level) for the federal pilot program.

PURPOSE OF THE BILL

It appears the purpose of this bill is to allow state taxpayers to continue to take a deduction for contributions to MSA's, regardless of the federal pilot cut-off date.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately, and apply to taxable years beginning on or after January 1, 2002.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Under federal law, "Archer MSAs" are trusts organized for the sole purpose of paying qualified medical expenses of the account holder, their spouse, and any dependent, as defined for income tax purposes, of the account holder. MSA's are available to individuals that are covered under a health plan that has a high deductible and is either a small-employer-sponsored health plan or a health plan for self-employed individuals. An individual is not eligible for an MSA if they are covered under any other health plan, unless the other coverage is for any benefit provided by permitted insurance or coverage for accidents, disability, dental, vision, or long-term care. Permitted insurance includes coverage for liabilities under worker's compensation, torts, ownership and use of property (automobiles), insurance for a specialized disease, or insurance providing a fixed payment for hospitalization.

Board Position:

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Department Director

Date

Alan Hunter for GHG

04/02/02

Under the federal pilot program that began in 1997, contributions to an MSA are deductible as an adjustment to gross income if made by an eligible individual or excludable from gross income if made by the employer of an eligible individual on behalf of that individual. However, an employee cannot have a deduction in the same year as the employer's exclusion. Earnings on amounts in an MSA are not taxable prior to distribution, and distributions from an MSA for qualifying medical expenses are not taxable. Withdrawals for non-medical expenses are taxable and subject to a 15% penalty. If an individual makes a withdrawal for non-medical purposes and is either 65, becomes disabled, or dies, the 15% penalty does not apply.

Generally, under this federal pilot program, the MSA deduction/exclusions are limited to a maximum of 750,000 taxpayers. Previously uninsured individuals are not taken into consideration in determining whether the cap is reached. The pilot program was scheduled to end December 31, 2000, but was recently extended to December 31, 2003. Generally, no new contributions could be made to MSAs after the cut-off date except for those who were participating in the pilot program.

California law conforms to the federal law on MSAs but provides that the state deduction is equal to the amount allowed to that individual on the federal income tax return for the same taxable year. However, withdrawals for non-medical expenses are subject to a 10% state penalty rather than the 15% federal penalty.

Existing federal and state law allows individuals to deduct certain expenses, such as medical expenses (which must exceed 7.5% of adjusted gross income (AGI)), charitable contributions, interest, and taxes, as itemized deductions.

THIS BILL

For California purposes, this bill would:

- remove the cut-off date for the federal Archer MSA pilot project, and
- remove the limitation on the number of taxpayers allowed to participate in an Archer MSA.

IMPLEMENTATION CONSIDERATIONS

As stated under state law, California conforms to the federal law on MSAs but provides a state deduction equal to the federal deduction for the same taxable year. Due to federal legislation enacted March 9, 2002, the federal pilot program cut-off date has been extended to December 31, 2003, and after that date no new participants or contributions would be allowed other than those individuals already participating. This bill would eliminate the cut-off date for state purposes. It would also disregard the federal limit on the number of taxpayers that could participate in an MSA. If the author's intent is to allow additional participation (other than those already participating) at the state level beyond the federal cut-off date, this bill would not accomplish that goal. State law allows the deduction but only so long as there is a federal deduction. Those additional state taxpayers would not be allowed a deduction since there would have been no federal deduction allowed.

LEGISLATIVE HISTORY

AB 1631 (Pescetti, 2001/2002) would have allowed both a credit and a deduction for any contributions made to a California medical savings account (MSA). This bill died in the Assembly Revenue and Taxation Committee.

AB 2335 (Poochigian, 1997/98) would have made various changes to the existing MSA provisions, including a deduction for an individual's contributions to a California MSA. This bill failed passage in the Assembly Revenue and Taxation Committee.

SB 38 (Lockyer, Stats. 96, Ch. 954) conformed state law to the federal MSA law enacted in 1996.

OTHER STATES' INFORMATION

Review of *Illinois, Michigan, Massachusetts, Minnesota, and New York* income tax laws found a comparable deduction that conforms to the federal deduction for MSAs for each state except Massachusetts. These states were reviewed because of the similarities between California income tax laws and their tax laws.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Although this bill is effective for taxable years beginning on or after January 1, 2002, the numerical limitation of 750,000 under federal law has not been exceeded. Therefore, the only current impact will be due to the elimination of the December 31, 2003 cut-off year. As a result, revenues will not be impacted until taxable year 2004.

Revenue losses will depend on the number of MSA plans established after the December 31, 2003, cut-off year. Due to the fact there are very few California taxpayers that have established MSA plans to date, revenue losses are expected to be negligible.

Revenue Discussion

Federal law placed a numerical limitation on the number of plans in the amount of 750,000 as well as a cut-off year for eligibility as of December 31, 2003. Currently, if a taxpayer qualifies to take a deduction under federal law, they will also qualify under California law. According to the National Center for Policy Analysis, only 54,000 plans had been sold as of December of 1998. According to Internal Revenue Service Announcement 2001-99, less than 100,000 plans had been established by July 1, 2001.

Available data indicates that approximately 3,800 California residents reported MSA deductions for taxable year 1999. Some companies such as Medsave.com do not recommend establishing MSA plans in a few states such as California. This company indicates that it is likely the MSA plan will be more expensive than the HMOs or other health plans available.

ARGUMENTS/POLICY CONCERNS

This bill would create a minor difference between federal and California tax law relating to MSA's, which would contradict the state's current general conformity to the treatment of MSA's under the Internal Revenue Code.

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