Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Maldonado and Runner	Analyst:	John Pavalasky	Bill Number:	SB 25
Related Bills:	See Legislative History	Telephone:	845-4335	Introduced Date:	December 4, 2006
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Health Savings Account (HSA) Deduction Conformity

SUMMARY

Starting with taxable year 2006, this bill would allow the same deduction on California personal income tax returns for contributions to an HSA as is allowed on the federal personal income tax return for the taxable year. It would also allow amended returns to be filed for taxable year 2006 to claim the deduction and refund penalties assessed on amounts rolled over from an Archer medical savings account (MSA) for that taxable year.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to conform to the federal HSA provisions to simplify the preparation of California tax returns.

EFFECTIVE/OPERATIVE DATE

This bill would be effective immediately and retroactively operative for taxable years beginning on or after January 1, 2006.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

Technical amendments are necessary and are provided. Department personnel are available to work with the author to resolve any other issues that arise as the bill moves through the legislative process.

Board Position:			Department Director	Date
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ANALYSIS

FEDERAL/STATE LAW

Current Federal Law

Health Savings Accounts

Under federal law individuals with a high deductible health plan (HDHP), and no other health plan other than a plan that provides certain permitted coverage, may establish a health savings account (HSA). In general, HSAs provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. In general, HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents.

Within limits, contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual in determining adjusted gross income (i.e. “above-the-line”). Contributions to an HSA are excludable from income and employment taxes if made by the employer. Earnings on amounts in HSAs are not taxable. Distributions from an HSA for qualified medical expenses are not includible in gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 10%. The 10% additional tax does not apply if the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100 percent of the annual deductible under the HDHP,[1] or (2) (for 2007) $2,850 in the case of self-only coverage and $5,650 in the case of family coverage.[2] Contributions in excess of the maximum contribution amount are generally subject to a 6% excise tax.

Health flexible spending arrangements and health reimbursement arrangements

Arrangements commonly used by employers to reimburse medical expenses of their employees (and their spouses and dependents) include health flexible spending arrangements (FSAs) and health reimbursement accounts (HRAs). Health FSAs typically are funded on a salary reduction basis, meaning that employees are given the option to reduce current compensation and instead have the compensation used to reimburse the employee for medical expenses. If the health FSA meets certain requirements, then the compensation that is foregone is not includible in gross income or wages and reimbursements for medical care from the health FSA are excludable from gross income and wages. Health FSAs are subject to the general requirements relating to cafeteria plans, including a requirement that a cafeteria plan generally may not provide deferred compensation. This requirement often is referred to as the “use-it-or-lose-it rule.”

[1] The limits are indexed for inflation. For 2006, a high deductible plan is a health plan that has a deductible that is at least $1,050 for self-only coverage or $2,100 for family coverage and that has an out-of-pocket expense limit that is no more than $5,250 in the case of self-only coverage and $10,500 in the case of family coverage.
[2] These amounts are indexed for inflation.

HRAs operate in a manner similar to health FSAs, in that they are an employer-maintained arrangement that reimburses employees for medical expenses. Some of the rules applicable to HRAs and health FSAs are similar, e.g., the amounts in the arrangements can only be used to reimburse medical expenses and not for other purposes. Some of the rules are different. For example, HRAs cannot be funded on a salary reduction basis and the use-it-or-lose-it rule does not apply. Thus, amounts remaining at the end of the year may be carried forward to be used to reimburse medical expenses in the next year. Reimbursements for insurance covering medical care expenses are allowable reimbursements under an HRA, but not under a health FSA.

Subject to certain limited exceptions, health FSAs and HRAs constitute other coverage under the HSA rules.

Tax Relief and Health Care Act (TRHCA) of 2006 (Public Law 109-432), enacted December 20, 2006

Starting in 2007, the TRHCA made the following six changes to HSAs:

1. <u>FSA and HRA Terminations to Fund HSAs</u>

   Certain amounts in a health FSA or HRA are allowed to be distributed from the health FSA or HRA and contributed through a direct transfer to an HSA without violating the otherwise applicable requirements for such arrangements. The amount that can be distributed from a health FSA or HRA and contributed to an HSA may not exceed an amount equal to the lesser of (1) the balance in the health FSA or HRA as of September 21, 2006, or (2) the balance in the health FSA or HRA as of the date of the distribution.

2. <u>Repeal of Annual Deductible Limitation on HSA Contributions</u>

   Limits on the annual deductible contributions that can be made to an HSA are modified so that the maximum deductible contribution is not limited to the annual deductible under the HDHP. Thus, starting in 2007, the maximum aggregate annual contribution that can be made to an HSA is $2,850 (for 2007) in the case of self-only coverage and $5,650 (for 2007) in the case of family coverage.

3. <u>Modification of Cost-of-Living Adjustment</u>

   In the case of adjustments made for any taxable year beginning after 2007, the Consumer Price Index for a calendar year is determined as of the close of the 12-month period ending on March 31 of the calendar year (rather than August 31 as under present law) for the purpose of making cost-of-living adjustments for the HSA dollar amounts that are indexed for inflation (i.e., the contribution limits and the high-deductible health plan requirements).

4. <u>Contribution Limitation Not Reduced for Part-Year Coverage</u>

   In general, starting in 2007, individuals who become covered under a high deductible plan in a month other than January are allowed to make the full deductible HSA contribution for the year rather than, as under prior law, being required to prorate the deduction based on the number of months the individual was enrolled in an HDHP.

5. <u>Exception to Requirement for Employers to Make Comparable Health Savings Account Contributions</u>

   Enacts an exception to the comparable contribution requirements to allow employers to make larger HSA contributions for nonhighly compensated employees than for highly compensated employees. For example, an employer is permitted to make a $1,000 contribution to the HSA of each nonhighly compensated employee for a year without making contributions to the HSA of each highly compensated employee.

6. <u>One-Time Distribution from Individual Retirement Plans to Fund HSAs</u>

   Allows a one-time contribution to an HSA of amounts distributed from an individual retirement arrangement (IRA). The contribution must be made in a direct trustee-to-trustee transfer. Amounts distributed from an IRA under these rules are not includible in income to the extent that the distribution would otherwise be includible in income. In addition, such distributions are not subject to the 10-percent additional tax on early distributions.

<u>Current California Law</u>

California has not conformed to any of the federal HSA provisions. The California personal income tax return starts with federal adjusted gross income (AGI) and requires adjustments to be made for differences between federal and California law. Adjustments relating to HSAs are required under current law, as follows:

- A taxpayer taking an HSA deduction on the federal personal income tax return is required to increase AGI on the taxpayer’s California personal income tax return by the amount of the federal deduction.
- Any interest earned on the account is added to AGI on the taxpayer’s California return.
- Any contribution to an HSA, including salary reduction contributions made through a cafeteria plan, made on the employee's behalf by their employer is added to AGI on the employee’s California return.

Although California has not conformed to HSAs, California law is conformed to the federal rules for Archer medical savings accounts (MSAs) and allows a deduction equal to the amount deducted on the federal return for the same taxable year. California imposes a 10% additional tax rather than the 15% additional federal tax on distributions from an MSA not used for qualified medical expenses.

Because a tax-free rollover from an MSA to an HSA is not allowed under California law, any distribution from an MSA that is rolled into an HSA must be added to AGI on the taxpayer’s California return and as that MSA distribution is not treated as being made for qualified medical expenses it would, therefore, be subject to the MSA 10% additional tax.

Additionally, a federal tax-free qualified HSA funding distribution is not allowed under California law because California specifically does not conform to Internal Revenue Code (IRC) section 223, relating to HSAs, even though California conforms to IRC section 408, relating to IRAs.

Under California law any distribution from an IRA to a HSA must be added to AGI on the taxpayer's California return and would be subject to a 2 ½% additional tax under the rules for premature distributions under IRC section 72.

THIS BILL

Starting with taxable year 2006, this bill would conform to the federal HSA provisions in effect for 2006, as follows:

1. Allows the same above-the-line deduction for contributions to an HSA by or on behalf of an individual and adopts the rules applicable to the trust itself in order for the trust to be exempt from tax. In addition, the disqualified distribution penalty applicable to HSAs is modified for California purposes to be 2 ½% instead of the federal rate of 10% to be consistent with the other California penalty provisions applicable to IRAs. Consistent with general conformity policy in other areas, the federal 6% excise tax on excess contributions and the federal estate tax provisions are not being conformed to by this bill.
2. Allows the same exclusion from an employee's gross income for the amount of any contributions to an HSA (including salary reduction contributions made through a cafeteria plan) made on the employee's behalf by their employer.
3. Allows rollovers from MSAs to be made to HSAs, as well as rollovers between HSAs, without penalty.
4. Adopts the same $50 penalty for failure to make required reports.

This bill would also allow amended returns to be filed for taxable year 2006 to claim the deduction and refund penalties assessed on amounts rolled over from an Archer medical savings account (MSA) for that taxable year.

IMPLEMENTATION CONSIDERATIONS

This bill currently does not propose to conform to the six changes made to HSAs by the TRHCA enacted on December 20, 2006, that apply to 2007 and later years. Thus, the HSA rules for 2007 and later years would be different for California taxpayers even after the passage of this bill. The author may wish to provide California rules for 2007 and later years that are the same as those contained in the TRHCA.

TECHNICAL CONSIDERATIONS

In 2005, AB 115 (Stats. 2005, Ch. 691) changed the "specified date" of conformity to federal law from January 1, 2001, to January 1, 2005, for taxable years beginning on or after January 1, 2005. That act specifically did not conform to the federal HSA provisions by adding Revenue & Taxation Code sections 17131.4, 17131.5, 17215.1, and 17215.4 to explicitly provide for that nonconformity for taxable years beginning on or after January 1, 2005. Once conformity to the federal HSA provisions contained in this bill is enacted and becomes operative for taxable years beginning on or after January 1, 2006, those sections providing explicit nonconformity should only apply to the 2005 taxable year and should be repealed once the statute of limitations has expired. The attached amendments would resolve this issue as well as make technical style changes.

LEGISLATIVE HISTORY

AB 84 (Nakanishi, 2007/2008) is nearly identical to this bill except that conformity to the federal HSA provisions would apply starting with tax year 2008. That bill is currently in the Assembly Revenue and Taxation Committee.

AB 142 (Plescia, 2007/2008) is nearly identical to this bill except that conformity to the federal HSA provisions would apply starting with tax year 2008. That bill is currently in the Assembly Revenue and Taxation Committee.

AB 245 (DeVore, 2007/2008) is nearly identical to this bill except that conformity to the federal HSA provisions would apply starting with tax year 2007. That bill is currently in the Assembly Revenue and Taxation Committee.

SB 1584 (Runner and Ackerman, 2005/2006) would have retroactively conformed to the federal HSA provisions starting with tax year 2004 and would allow amended returns to be filed. That bill was held in the policy committee.

SB 1787 (Ackerman, 2005/2006) would have retroactively conformed to the federal HSA provisions starting with tax year 2004 and would allow amended returns to be filed. That bill was held in the policy committee.

AB 2010 (Plescia, 2005/2006) was nearly identical to this bill except that conformity to the federal HSA provisions would apply starting with tax year 2007. That bill was held in the policy committee.

SB 173 (Maldonado, 2005/2006) was nearly identical to this bill. That bill was held in the policy committee.

AB 661 (Plescia, 2005/2006) was nearly identical to this bill. That bill was held in the policy committee.

AB 2315 (Maldonado/ Nakanishi, 2003/2004), as amended May 17, 2004, was substantially the same as this bill. That bill was held in the fiscal committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. *Florida* does not impose a personal income tax so a comparison to Florida is not relevant. *Illinois, Massachusetts, Michigan, Minnesota,* and *New York* conform to the federal deduction for contributions to HSAs.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses:

Estimated Revenue Impact for SB 25 Effective with Taxable Years Beginning On Or After 1/1/06 ($ in Millions)			
2006-07	2007-08	2008-09	2009-10
-$5	-$16	-$23	-$28

Estimates assume enactment after June 30, 2007. This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue impact of this bill would be determined by (1) the amount of contributions to health savings accounts deducted on tax returns, (2) the amount of employer contributions to health savings accounts made on behalf of employees (including salary reduction contributions), and (3) the amount of balances in Archer medical savings accounts rolled over to health savings accounts and marginal tax rates of taxpayers deducting or excluding such contributions.

1. For the 2004 taxable year, tax return data indicates 7,500 returns reflected HSA adjustments on Schedule CA totaling $20 million. This means that these taxpayers made tax-deductible contributions for federal purposes that were reversed for state purposes. Recent articles indicate the number of HSAs nationwide doubled during 2005 and again in 2006. To derive the estimates, this substantial growth rate is used through 2007 and is decreased thereafter to more sustainable rates. For 2006 and 2007, contributions by California individual taxpayers to HSAs are estimated at $80 million ($20 million x 2 x 2 = $80 million) and $155 million. Applying a marginal tax rate of 7% results in a revenue loss for 2006 and 2007 of $5.6 million ($80 million x 7% = $5.6 million) and $10.9 million ($155 million x 7% = $10.9 million), respectively.

2. Contributions made by an employer on behalf of an employee (including salary reduction contributions made through a cafeteria plan) cannot be identified on a tax return. It is not known how many additional HSAs may exist as a result of this contribution arrangement. Data indicate that 6% of employers offer HSA-eligible HDHPs. It is believed that most of these employers pay the premium for the HDHP rather than contribute to the employee's HSA. The rationale is that the premium is often less than the amount of the deductible that can be contributed to the HSA. In addition, HSA balances are portable and not owned by the employer. For purposes of an estimate, it is assumed that employer contributions on behalf of an employee are roughly one-quarter of that by individuals, or $20 million in 2006 ($80 million x 25% = $20 million) and $40 million in 2007 ($155 million x 25% = $40 million). Applying a marginal tax rate of 7% results in an additional revenue loss of $1.4 million for 2006 ($20 million x 7% = $1.4 million) and $2.8 million for 2007 ($40 million x 7% = $2.8 million).

3. The following is the estimate for the potential rollover of balances in Archer MSAs. For the 2002 taxable year, tax return data indicate deductible MSA contributions totaling $11.6 million reported on 4,600 returns. It is possible that balances in some MSAs have already been rolled over. In addition, there is no requirement that balances have to be rolled over. It is assumed that half of these accounts (2,300) would be rolled over and that each account has an average balance of $6,250. This balance equates to two-and-a-half years of average contributions (2.5 years x $2,500 average annual contribution = $6,250). Applying a marginal tax rate of 7% results in a loss of an additional $1 million (2,300 x $6,250 x 7% = $1.0 million). It is anticipated that rollovers would likely occur in the initial one or two years of conformity. Therefore, the $1 million loss is divided between 2007 and 2008, or $0.5 million each taxable year.

The estimate for the 2006 taxable year totals $7 million ($5.6 million + $1.4 million = $7 million). The $7 million estimate is reduced by 25%, or down to $5 million. The reduction adjustment accounts for those taxpayers who for one reason or another do not file an amended return for a refund. The estimate for taxable year 2007 is a revenue loss of $14 million ($10.9 million +$2.8 million + $0.5 million = $14.2 million). Taxable year estimates are converted to cash flow fiscal year revenue estimates reflected in the table. For example, the 2007-08 cash flow estimate consists of $5 million loss for 2006 plus $14 million loss for 2007 plus $2 million loss for 2008 due to reduced estimated tax payments, or a total of $21 million loss. The portion of the estimate that is applicable to the 2006 taxable year ($5 million loss) is accrued back to 2006-07. This results in an estimate of $16 million loss for 2007-08 ($21 million - $5 million = $16 million) shown in the table.

ARGUMENTS/POLICY CONCERNS

California's non-conformity to federal HSA provisions for any transactions that occur in the years before this bill would be operative are not addressed in the bill. For example, because the amounts contributed during 2004 and 2005 are not deductible for state purposes and the earnings in the account or rollover from an MSA are taxable by California, the taxpayer will have a basis in the account for state but not federal purposes. Any subsequent non-qualified distribution that would otherwise be included in the taxpayer's income would need to be adjusted to account for this California basis; however, this bill does not provide any rules with respect to how that California basis recovery adjustment will be made. The author may wish to provide rules similar to those that required the recovery of California basis before the amounts would be taxable as was done under the Individual Retirement Account provisions when a similar delayed conformity to federal law occurred. Department staff is available to assist in resolving this and any other concerns as this bill moves through the legislative process.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 25
As Introduced December 4, 2006

AMENDMENT 1

On page 2, line 10, after "apply" strikeout "only to each taxable year" and insert:

to taxable years

AMENDMENT 2

On page 2, line 12, after "SEC. 2." insert:

Section 17131.4 of the Revenue and Taxation Code is amended to read:

17131.4. <u>(a)</u> Section 106(d) of the Internal Revenue Code, relating to contributions to health savings accounts, shall not apply.
<u>(b) This section shall apply to taxable years beginning on or after January 1, 2005, and before January 1, 2006. This section shall remain in effect only until January 1, 2011, and as of that date is repealed.</u>

SEC. 3. Section 17134.5 of the Revenue and Taxation Code is amended to read:

17131.5. <u>(a)</u> Section 125(d)(2)(D) of the Internal Revenue Code, relating to the exception for health savings accounts, shall not apply.
<u>(b) This section shall apply to taxable years beginning on or after January 1, 2005, and before January 1, 2006. This section shall remain in effect only until January 1, 2011, and as of that date is repealed.</u>

SEC. 4.

AMENDMENT 3

On page 2, line 14, after "For" strikeout "each taxable year" and insert:

taxable years

AMENDMENT 4

On page 2, line 19, strikeout "SEC. 3." and insert:

SEC. 5.

AMENDMENT 5

On page 2, line 21, after “For” strikeout “each taxable year” and insert:

taxable years

AMENDMENT 6

On page 2, line 26, strikeout “SEC. 4.” and insert:

SEC. 6.

AMENDMENT 7

On page 3, line 5, after “apply” strikeout “only to each taxable year” and insert:

to taxable years

AMENDMENT 8

On page 3, line 7, strikeout “SEC. 5.” and insert:

SEC. 7. Section 17215.1 of the Revenue and Taxation Code is amended to read:

17215.1. (a) Section 220(f)(5) of the Internal Revenue Code, relating to rollover contributions, shall not apply.

(b) This section shall apply to taxable years beginning on or after January 1, 2005, and before January 1, 2006. This section shall remain in effect only until January 1, 2011, and as of that date is repealed.

SEC. 8. Section 17215.4 of the Revenue and Taxation Code is amended to read:

17215.4. (a) Section 223 of the Internal Revenue Code, relating to health savings accounts, shall not apply.

(b) This section shall apply to taxable years beginning on or after January 1, 2005, and before January 1, 2006. This section shall remain in effect only until January 1, 2011, and as of that date is repealed.

SEC. 9.

AMENDMENT 9

On page 3, line 9, after “For” strikeout “each taxable year” and insert:

taxable years

AMENDMENT 10

On page 3, line 26, strikeout “SEC. 6.” and insert:

SEC. 10.

AMENDMENT 11

On page 4, line 26, after “apply” strikeout “only to each taxable year” and insert:

to taxable years

AMENDMENT 12

On page 4, line 28, strikeout “SEC. 7.” and insert:

SEC. 11.

AMENDMENT 7

On page 5, line 21, strikeout “SEC. 8.” and insert:

SEC. 12.