

**Franchise Tax Board**

**ANALYSIS OF ORIGINAL BILL**

Author: Aanestad Analyst: David Scott Bill Number: SB 1262  
 Related Bills: See Legislative History Telephone: 845-5806 Introduced Date: February 19, 2010  
 Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Health Savings Account Deduction Conformity

**SUMMARY**

This bill would require the Public Employees' Retirement System to offer a high deductible health plan and a Health Savings Account to public employees and retired annuitants.

This bill would also allow a deduction on California personal income tax returns for contributions to an HSA similar to the HSA deduction allowed on the federal individual income tax return for the same taxable year.

**PURPOSE OF THE BILL**

According to the author's office, this bill would provide cost-effective comprehensive health care coverage by using HSA-compatible plans for Californians, including state employees.

**EFFECTIVE/OPERATIVE DATE**

This bill would be effective January 1, 2011, and specifically operative for taxable years beginning on or after January 1, 2010.

**POSITION**

Pending.

**SUMMARY OF SUGGESTED AMENDMENTS**

Amendments 1-21 correct unnecessary references to a federal act, and to renumber the bill section numbers for deleted sections.

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 an 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 (AGI).<sup>1</sup> 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 percent. The 10-percent 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,<sup>2</sup> or (2) (for 2010) \$3,050 in the case of self-only coverage and \$6,150 in the case of family coverage.<sup>3</sup> Contributions in excess of the maximum contribution amount are generally subject to a six-percent excise tax.

##### *Health Flexible Spending Arrangements (FSAs) and Health Reimbursement Arrangements (HRAs)*

Arrangements commonly used by employers to reimburse medical expenses of their employees (and their spouses and dependents) include health FSAs and 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."

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<sup>1</sup> Adjusted Gross Income (AGI) includes all gross income reduced by "above-the-line" deductions. Above-the-line deductions include certain trade or business deductions, contributions to an MSA, alimony paid, and contributions to pension and annuity plans.

<sup>2</sup> The limits are indexed for inflation. For 2010, a high deductible plan is a health plan that has a deductible that is at least \$1,200 for self-only coverage or \$2,400 for family coverage and that has an out-of-pocket expense limit that is no more than \$5,950 in the case of self-only coverage and \$11,900 in the case of family coverage.

<sup>3</sup> 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. FSA and HRA Terminations to Fund HSAs

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. Repeal of Annual Deductible Limitation on HSA Contributions

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.

3. Modification of Cost-of-Living Adjustment

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 HDHP requirements).

4. Contribution Limitation Not Reduced for Part-Year Coverage

In general, starting in 2007, individuals who become covered under an HDHP 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. Exception to Requirement for Employers to Make Comparable HSA Contributions

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

6. One-Time Distribution from Individual Retirement Arrangements (IRAs) to Fund HSAs

A one-time contribution to an HSA of amounts distributed from an individual IRA is allowed. 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.

Current California Law

California has not conformed to any of the federal HSA provisions. The California personal income tax return starts with federal 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 a 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.
- Contributions to an HSA made on the employee's behalf by their employer are added to AGI on the employee's California return. These include salary-reduction contributions made through a cafeteria plan

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 percent additional tax rather than the federal 15-percent additional 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 be subject to the MSA 10-percent additional tax.

Additionally, a federal tax-free qualified HSA funding distribution is not allowed under California law because California specifically does not conform to 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 an HSA must be added to AGI on the taxpayer's California return and would be subject to a two and one-half percent additional tax under the rules for premature distributions.

### THIS BILL

This bill would require CalPERS to offer HDHPs and set up HSAs for current public employee and retired annuitant members of PERS as part of their available healthcare plans.

In addition, starting with taxable year 2010, this bill would conform to the federal HSA provisions, as follows:

1. Allow 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 two and one-half percent instead of the federal rate of 10 percent to be consistent with the other California penalty provisions applicable to IRAs. Consistent with general conformity policy in other areas, the federal six percent excise tax on excess contributions and the federal estate tax provisions would not be conformed to by this bill.
2. Allow 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. Allow rollovers from MSAs to be made to HSAs, as well as rollovers between HSAs, without penalty.
4. Adopt the same \$50 penalty for failure to make required reports.

### IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

### TECHNICAL CONSIDERATIONS

Several sections of this bill, unnecessarily reference Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003. California conforms to those Internal Revenue Code (IRC) sections as of the specified date of January 1, 2005, which includes that Act, unless specifically stated that the section shall not apply. Suggested amendments are attached.

The language of the bill, adding provision to the Government Code, references the IRC. However, it does not specify which version of the IRC is to be used. Department staff is available to assist the author's office in clarifying this issue in the bill.

## **LEGISLATIVE HISTORY**

Appendix A contains a comprehensive listing of prior legislation regarding the conformity to federal HSA rules. Recent HSA legislation is listed below.

AB 326 (Garrick, 2009/2010) was a nearly identical to this bill. It would have provided that conformity to the federal HSA provisions would have applied starting in taxable year 2010. That bill failed to pass the Assembly Revenue and Taxation Committee.

SB 353 (Dutton 2009/2010) was nearly identical to this bill, except that conformity to the federal HSA provisions would apply starting in taxable year 2009. This bill was returned to the Secretary of the Senate pursuant to Joint Rule 56.

AB 2041 (Villines, 2009/2010), a similar bill, would provide for conformity to the federal HSA provisions starting in taxable year 2010. AB 2041 is currently in Assembly Rules.

SBX6 13 (Dutton, 2009/2010) is almost identical to this bill. It would provide for conformity to the federal HSA provisions and would apply starting in taxable year 2010. SBX6 13 is currently in Senate Rules.

SBX8 47 (Dutton, 2009/2010) is almost identical to this bill. It would provide for conformity to the federal HSA provisions and would apply starting in taxable year 2010. SBX8 47 is currently in Senate Rules.

## **OTHER STATES' INFORMATION**

As of 2009, only four states, which have an income tax, do not conform to the federal HSA deduction rules (Alabama, California, New Jersey and Wisconsin). Pennsylvania allows a deduction for employer's contribution only, not for individuals.

## **FISCAL IMPACT**

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

## ECONOMIC IMPACT

### Revenue Estimate

Estimated Revenue Impact of SB 1262 Operative for Tax Years Beginning On or After January 1, 2010 Enactment Assumed September 30, 2010 (\$ millions)		
2010-11	2011-12	2012-13
-\$55	-\$65	-\$55

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

## LEGISLATIVE STAFF CONTACT

Legislative Analyst  
David Scott  
(916) 845-5806  
[david.scott@ftb.ca.gov](mailto:david.scott@ftb.ca.gov)

Revenue Manager  
Monica Trefz  
(916) 845-4002  
[monica.trefz@ftb.ca.gov](mailto:monica.trefz@ftb.ca.gov)

Legislative Director  
Brian Putler  
(916) 845-6333  
[brian.putler@ftb.ca.gov](mailto:brian.putler@ftb.ca.gov)

Analyst	David Scott
Telephone #	(916) 845-5806
Attorney	Pat Kusiak

FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SB 1262

AMENDMENT 1

On page 4, lines 33 through line 36, ~~strikeout "as added by Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law 108-173),"~~

AMENDMENT 2

After page 4, line 39, and before page 5, line 1, insert:

(c)This section shall remain in effect only until January 1, 2015 and as of that date is repealed.

AMENDMENT 3

On page 5, lines 4 through 6, ~~strikeout "as added by Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law 108-173),"~~

AMENDMENT 4

On page 5, between lines 9 and 10, insert:

(c)This section shall remain in effect only until January 1, 2015 and as of that date is repealed.

AMENDMENT 5

On page 5, ~~strikeout lines 10 through 40~~, on page 6, ~~strikeout lines 1 through 6, inclusive~~.

AMENDMENT 6

On page 6, line 7, ~~strikeout "SEC.9."~~ and insert:

SEC. 6.

AMENDMENT 7

On page 6, lines 10 through 12, ~~strikeout "as added by Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law 108-173),"~~

AMENDMENT 8

On page 6, between lines 14 and 15, insert:

(c)This section shall remain in effect only until January 1, 2015 and as of that date is repealed.

AMENDMENT 9

On page 6, line 15, ~~strikeout "SEC. 10."~~ and insert:

SEC. 7.

AMENDMENT 10

On page 6, lines 17 through 20, ~~as added by Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law 108-173),~~ and insert:

as amended by Section 404(c) of the Gulf Opportunity Zone Act of 2005 (Public Law 109-135,

AMENDMENT 11

On page 6, between lines 22 and 23, insert:

(c) This section shall remain in effect only until January 1, 2015 and as of that date is repealed.

AMENDMENT 12

On page 6, line 23, ~~SEC. 11.~~ and insert:

SEC. 8.

AMENDMENT 13

On page 6, lines 27 through line 29, ~~as added by Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law 108-173),~~ and insert:

as amended by Section 404(c) of the Gulf Opportunity Zone Act of 2005 (Public Law 109-135, and by Title III of the Tax Relief and Health Care Act of 2006 (Public Law 109-432),

AMENDMENT 14

On page 6, lines 32 through 34, ~~as added by Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law 108-173),~~

AMENDMENT 15

On page 7, line 3, strikeout "SEC. 12." and insert:

SEC. 9.

AMENDMENT 16

On page 7, lines 10 and 11, strikeout ", relating to individual retirement accounts"

AMENDMENT 17

On page 7, lines 15 through 17, strikeout ", as added by Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law 108-173), relating to Health Savings accounts"

AMENDMENT 18

On page 7, line 21, strikeout "relating to qualified tuition programs"

AMENDMENT 19

On page 7, lines 23 and 24, strikeout "relating to Coverdell education savings accounts"

AMENDMENT 20

On page 7, line 25, after "who", insert:

satisfied both of the following conditions

AMENDMENT 21

On page 8, line 4, strikeout "SEC. 13.", and insert:

SEC. 10.

## APPENDIX A

### Legislative History

Bill Number	Action	Status
AB 84 (Nakanishi/Smyth, 2007/2008)	Conformity to the federal HSA provisions starting in taxable year 2008.	This bill was held in the Assembly Revenue and Taxation Committee.
AB 142 (Plescia, 2007/2008)	Conformity to the federal HSA provisions would apply starting in taxable year 2008.	This bill was held in the Assembly Revenue and Taxation Committee.
AB 245 (DeVore, 2007/2008)	Conformity to the federal HSA provisions would apply starting in taxable year 2008.	This bill was held in the Assembly Revenue and Taxation Committee.
AB 2292 (Garrick, 2007/2008)	Conformity to the federal HSA provisions would apply starting with taxable year 2008.	This bill failed to pass the Assembly Revenue and Taxation Committee.
ABX1 4 (Nakanishi, 2007/2008)	Conformity to the federal HSA provisions would apply starting with taxable year 2008.	This bill was held at the Assembly desk.
SBX1 10 (Maldonado, 2007/2008)	Conformity to the federal HSA provisions would have applied retroactively starting with taxable year 2006 and would have allowed amended returns to be filed.	This bill failed to pass the Senate Health Committee.
SB 25 (Maldonado and Runner, 2007/2008)	Retroactively conform to the federal HSA provisions starting with taxable year 2006 and would have allowed amended returns to be filed.	This bill was held in the Senate Revenue and Taxation Committee.
AB 661 (Plescia, 2005/2006)	Conformity to the federal HSA provisions would apply starting with taxable year 2006.	This bill was held in the Assembly Revenue and Taxation Committee.
AB 2010 (Plescia, 2005/2006)	Conformity to the federal HSA provisions would apply starting with taxable year 2007.	This bill was held in the Assembly Revenue and Taxation Committee.
SB 173 (Maldonado, 2005/2006)	Conformity to the federal HSA provisions would apply starting with taxable year 2006.	This bill was held in the Senate Revenue and Taxation Committee.
SB 1584 (Runner and Ackerman, 2005/2006)	Conformity to the federal HSA provisions would apply starting with taxable year 2006	This bill was held in the Senate Revenue and Taxation Committee.
SB 1787 (Ackerman, 2005/2006)	Retroactively conformed to the federal HSA provisions starting with taxable year 2004 and would have allowed amended returns to be filed.	This bill was held in the Senate Revenue and Taxation Committee.
AB 2315 (Maldonado/ Nakanishi, 2003/2004)	Conformity to the federal HSA provisions would apply starting with taxable year 2006.	This bill was held in the Assembly Appropriations Committee.