ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Morrell | Analyst: David Scott | Bill Number: AB 726

Related Bills: See Legislative History | Telephone: 845-5806 | Introduced Date: February 17, 2011

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Exclusion/Payments Or Distributions From Retirement Account Paid Into Health Savings Accounts/Waive Early Distribution Penalty

SUMMARY

This bill would exclude from gross income amounts paid or distributed from a taxpayer's 401K account to a Health Savings Account (HSA) and waive the 2½ percent early withdrawal penalty.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

Summary of Suggested Amendments

Amendment one resolves the department's technical consideration.

Additional amendments may be necessary to resolve the department's implementation concerns, below, at the discretion of the author.

PURPOSE OF THE BILL

The purpose of the bill appears to be to help create options for people to pay for unknown future healthcare costs.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2011.

Board Position:			Executive Officer	Date
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ANALYSIS

FEDERAL LAW

Qualified Retirement Plans

A distribution from a qualified retirement plan under IRC section 401(a), a qualified annuity plan under IRC section 403(a), a tax-sheltered annuity under IRC section 403(b) (a “403(b) annuity”), an eligible deferred compensation plan maintained by a state or local government under IRC section 457 (a “governmental 457 plan”), or an individual retirement arrangement under IRC section 408 (an “IRA”) generally is included in income for the year distributed.[1] These plans are referred to collectively as “eligible retirement plans.” In addition, a distribution from a qualified retirement or annuity plan, a 403(b) annuity, or an IRA received before age 59½, generally is subject to a 10 percent early-withdrawal tax on the amount includible in income, unless an exception applies under IRC section 72(t). Such exceptions apply to distributions that are: (1) used for the health insurance premiums of an unemployed individual; (2) used for medical expenses; (3) attributable to the employee's being disabled; (4) made to a beneficiary (or to the estate of the employee) on or after the date of the death of the employee; (5) made to an employee who separates from service at age 55 or older; (6) made to individuals called to active duty; and (7) used for first-time home purchases.

A special rule applies to simple retirement accounts under IRC section 408(p). In the case of a distribution from a simple retirement account that does not meet one of the IRC section 72(t) exceptions, and that is made within two years of the date an individual first participates in a qualified salary-reduction arrangement maintained by an employer, the early-withdrawal tax is 25 percent of any amount includible in income, instead of 10 percent of such amount.

An eligible rollover distribution from a qualified retirement or annuity plan, a 403(b) annuity, a governmental 457 plan, or a distribution from an IRA, generally can be rolled over within 60 days to another plan, annuity, or IRA. The IRS has the authority to waive the 60-day requirement if failure to waive the requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual. Any amount rolled over is not includible in income (and thus not subject to the 10-percent early-withdrawal tax).

Distributions from a qualified retirement or annuity plan, 403(b) annuity, a governmental 457 plan, or an IRA are generally subject to income tax withholding unless the recipient elects otherwise. An eligible rollover distribution from a qualified retirement or annuity plan, 403(b) annuity, or governmental 457 plan is subject to income tax withholding unless the distribution is rolled over to another plan, annuity or IRA by means of a direct trustee-to-trustee transfer.

Certain amounts held in a qualified retirement plan that includes a qualified cash-or-deferred arrangement (a 401(k) plan) or in a 403(b) annuity may not be distributed before severance from employment, age 59½, death, disability, or financial hardship of the employee. Amounts deferred under a governmental 457 plan may not be distributed before severance from employment, age 70½, or an unforeseeable emergency of the employee.

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[1] IRC sections 402(a), 403(a), 403(b), 408(d), and 457(a).

Health Savings Accounts (HSA)

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).[2] 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).

Generally, an employer's contribution to an HSA on behalf of an employee must be the same amount or percent for all employees with the same coverage (self-only or family coverage). The employer may make larger contributions for the non-highly compensated than for the highly compensated. 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.

A taxpayer is allowed to make a one-time contribution to an HSA of amounts distributed from an individual retirement plan (other than simplified employee pension plan or a simple retirement account). The contribution must be made in a direct trustee-to-trustee transfer. Amounts distributed from an individual retirement plan 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.

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 being required to prorate the deduction based on the number of months the individual was enrolled in an HDHP.

For 2010 and 2011, 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 $5,900 in the case of self-only coverage and $11,900 in the case of family coverage.

The maximum aggregate annual contribution that can be made to an HSA is the sum of the monthly contribution limits. The monthly contribution limit is 1/12th of the indexed amount for coverage, (for 2010 and 2011) $3,050 in the case of self-only coverage and $6,150 in the case of family coverage. The maximum contribution is increased by $1,000 per year for catch-up contributions for persons over age 55. Contributions in excess of the maximum contribution amount are generally subject to a six percent excise tax.

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[2] 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.

STATE LAW

Qualified Retirement Plans

California generally conforms to the federal retirement plan rules,[3] including the additional tax on early distributions.[4] However, the additional tax on early distributions is generally modified to be 2½ percent for California purposes rather than the 10 percent federal early-distribution tax. For simple retirement plans, the early-distribution tax is modified to be six percent of any amount includible in income rather than the federal penalty of 25 percent of such amount.

Health Savings Accounts

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 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 15 percent 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 be subject to the MSA 10 percent additional tax.

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[3] R&TC section 17501 conforms to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, etc., as of the specified date of January 1, 2009, with modifications. However, California conforms to certain IRC sections within that subchapter without regard to taxable year, including IRC sections 401, 403, and 408; thus, California automatically conforms to any federal changes to these sections. Similarly, R&TC section 17551 conforms to Subchapter E of Chapter 1 of Subtitle A of the IRC, relating accounting periods and methods of accounting, as of the specified date of January 1, 2009, with modifications. However, California generally conforms to IRC section 457 without regard to taxable year, except for allowable elective deferrals; thus, California automatically conforms to federal changes made to IRC section 457, except for federal changes to allowable elective deferrals.

[4] R&TC section 17081 conforms to Part II of Subchapter B of Chapter 1 of Subtitle A of the IRC, as of the "specified date" of January 1, 2009, with modifications to IRC section 72(t) under R&TC section 17085(c).

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 2½ percent additional tax under the rules for premature distributions.

THIS BILL

This bill would allow distributions or payments made from a taxpayer's 401K plan to an HSA to be excluded from gross income for state income tax purposes. In addition, those distributions or payments that would normally be subject to a 2 ½ percent penalty under state law would not be subject to the penalty. This bill excludes the amount of the distribution from gross income, but only if the taxpayer deposits the full amount of the distribution into a health savings account within 60 days of receipt. The bill would prohibit the transfer from the 401K account to an HSA by a direct trustee-to-trustee transfer.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

- California does not conform to federal HSA rules. The bill does not provide a definition for a health savings account. As a result, any account labeled as an HSA, whether or not is meets the federal requirements of an HSA, could potentially be funded as an HSA. The absence of definitions to clarify what an HSA is could lead to disputes with taxpayers and would complicate the administration of this exclusion from gross income. If the author's intent is to follow the federal definition, the bill should be amended with cross-referencing to the applicable federal provisions.
- The language of the bill would allow a payment or distribution to "a health saving account." The distribution or payment could go to someone else's HSA, other than the taxpayer's. If this is not the author's intent, it is recommended that the bill be amended.
- The bill would allow the exclusion from gross income, but only if the full amount that was distributed is contributed to an HSA. For a non-qualified lump sum distribution from a 401K, there may be withholding of federal income tax and possibly state income taxes, depending on how the 401K account distributions are set up. Any taxpayer receiving a distribution will not get the full amount in hand and will need to add an amount of offset the federal tax withheld.

<u>TECHNICAL CONSIDERATION</u>

Revenue and Taxation Code section 17085 (c)(3), as amended by this bill, uses the word “distribution,” which should be changed to “distributions” as “payments” is used previously. An amendment has been attached to make this correction.

LEGISLATIVE HISTORY

AB 854 (Garrick, 2011/2012) would conform California law to the federal HSA provisions starting in taxable year 2011. This bill is currently in the Assembly Revenue and Taxation Committee.

See Appendix A.

OTHER STATES’ INFORMATION

Early Distributions

The states surveyed for tax treatment of early distributions 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.

A review of these states’ laws found that *Illinois* generally exempts retirement plan contributions and distributions from gross income, and does not impose an additional tax on early distributions. *Massachusetts* does not allow tax-deferred retirement plan contributions, thus such distributions are not taxable until the full amount of the taxpayer's contributions that were previously subject to *Massachusetts* taxes are recovered, and there is no additional tax on early distributions. *Michigan* and *Minnesota* generally follow the federal rules that apply to retirement plan contributions and distributions, but do not impose an additional tax on early distributions. *New York* generally follows the federal rules that apply to retirement plan contributions and distributions, except that an individual who has reached the age of 59½ may exclude up to $20,000 of certain pension distributions to the extent the payments are includible in federal gross income and not otherwise excluded as government pension payments, and there is no additional tax on early distributions. *Florida* does not impose personal income tax. Thus, this provision is not applicable to *Florida*.

HSAs

As of September 2010, only three states that have an income tax (California, New Jersey and Wisconsin) do not conform to the federal HSA deduction rules. Pennsylvania allows a deduction for employer’s contribution only, not for individuals.

FISCAL IMPACT

The additional costs have not been determined at this time. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 726 For Taxable Years Beginning On Or After January 1, 2011 Enactment Assumed After June 30, 2011 ($ in Millions)		
2011-12	2012-13	2013-14
-$2.3	-$1.5	-$1.5

SUPPORT/OPPOSITION

Support: None provide by the author.

Opposition: None provided by the author.

ARGUMENTS

Pro: California is only one of three states that do not conform to the federal HSA rules. This bill provides a tax-favorable vehicle for California taxpayers to fund an HSA without full conformity to all of the federal HSA provisions.

Con: Some may argue this bill would conflict with federal tax policy on waiving the ten percent penalty for withdrawal from a 401K plan.

POLICY CONCERNS

Although a number of bills have been introduced to conform to federal HSA rules, the legislature has not adopted legislation conforming to those rules. As a result, California does not recognize HSAs as tax-favored vehicles for providing for healthcare costs. This bill would create an additional difference between the federal and state tax treatment of HSAs and distributions from 401K plans.

This bill limits the exclusion to only distributions from a 401K account. There are other types of accounts that are within the definition of “eligible retirement account.” Owners of the other types of accounts (e.g. IRA accounts) could view this as unfair treatment. A distribution from an IRA account to an HSA would result in the taxpayer being assessed a 2½ percent additional tax, on top of the distribution being included in gross income, whereas, if the distribution is made from a 401K, there would be no tax assessed. The result is two different treatments for the same type of transaction. Additionally, federal law does not provide a waiver of the ten percent penalty for a withdrawal from a 401K plan to fund an HSA. Allowing the penalty waiver for state purposes is in conflict with federal tax policy.

Federal law allows a one-time distribution from an Individual Retirement Plan (other than simplified employee pension plan or a simple retirement account) to an HSA. In addition, federal law does not provide a waiver of the 10 percent penalty for withdrawals from 401K to HSAs. Consequently, the provisions of this bill appear at odds with federal HSA and 401K policy.

This bill allows unlimited contributions to HSAs. Federal tax law provides specific limits on the amounts that can be contributed to an HSA.

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Appendix A
Legislative History

Bill Number	Action	Status
AB 326 (Garrick, 2009/2010)	Conformity to the federal HSA provisions starting in taxable year 2010.	This bill was held in the Assembly Revenue and Taxation Committee.
SB 353 (Dutton, 2009/2010)	Conformity to the federal HSA provisions starting in taxable year 2009.	This bill was held in the Senate Revenue and Taxation Committee.
SB 1262 (Aanestad, 2009/2010)	Conformity to the federal HSA provisions starting in taxable year 2010.	This bill was held in the Assembly Rules Committee.
SB 1262 (Dutton, 2009/2010)	Conformity to the federal HSA provisions starting in taxable year 2010.	The bill was held in the Senate Rules Committee.
SBX6 13 (Dutton, 2009/2010)	Conformity to the federal HSA provisions starting in taxable year 2010.	The bill was held in the Senate Rules Committee.
SBX8 47 (Dutton, 2009/2010)	Conformity to the federal HSA provisions starting in taxable year 2010.	The bill was held in the Senate Rules Committee.
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.

Bill Number	Action	Status
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.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 726
as Introduced on February 17, 2011

AMENDMENT 1

On page 3, line 1, strikeout "distribution" and insert:

distributions