

Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Garrick Analyst: David Scott Bill Number: AB 854
 Related Bills: See Legislative History Telephone: 845-5806 Introduced Date: February 17, 2011
 Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Health Savings Account (HSA) Deduction Conformity

SUMMARY

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

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

Summary of Suggested Amendments

Amendments 1 to 13 would resolve the department's technical concerns regarding unnecessary references to public law act sections.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to help create cost-effective options for people to save for unknown future healthcare costs.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and specifically operative for taxable years beginning on or after January 1, 2012.

ANALYSIS

FEDERAL/STATE 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.

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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).¹ 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 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.

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 taxable year 2011, a high deductible plan is a health plan that has an annual 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 1/12 of the indexed amount for coverage, (for 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.

¹ 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 a medical savings account (MSA), alimony paid, and contributions to pension and annuity plans.

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. Typically, health FSAs 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."

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.

After December 20, 2006, and before January 1, 2012, 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.

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 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.

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 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

Starting with taxable years beginning on or after January 1, 2012, this bill would conform to the federal HSA provisions, 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 2½ 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 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 by the HSA trustee or other person providing an individual with an HDHP.
5. Allows certain amounts in health FSAs or HRAs 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.
6. Conforms to repeal of annual deductible limitation on HSA contributions.

7. Determines the Consumer Price Index for a calendar year as of the close of the 12-month period ending on March 31 of the calendar year (rather than August 31 as under prior 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).
8. Allows individuals who become covered under an HDHP in a month other than January 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.
9. Conforms to an exception to the comparable contribution requirements 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.
10. Allows a one-time contribution to an HSA of amounts distributed from an 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 the distribution would otherwise be includible in income. In addition, such distributions are not subject to the 2½ percent additional tax on early distributions.

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 (Public Law 108-173). Suggested amendments are attached to remove the unnecessary references.

LEGISLATIVE HISTORY

Appendix A contains a comprehensive listing of HSA conformity legislation.

OTHER STATES' INFORMATION

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

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

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 854 For Taxable Years Beginning On or After January 1, 2012 Enactment Assumed After June 30, 2011 (\$ in Millions)		
2011-12	2012-13	2013-14
-\$33	-\$65	-\$70

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

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Pro: HSA's have been used to defray the costs associated with HDHP, provide a cost effective alternative for individuals to obtain health care coverage, and allow taxpayers to take control of their own healthcare costs. Conformity to the federal HSA rules would provide that alternative that most other states provide, to California taxpayers.

Con: Some taxpayers may say that HSAs favor the rich or healthy people in helping them to control their healthcare costs. When those healthy people are removed from the pool of traditional healthcare insurance, the premiums increase for those that remain in the traditional insurance pool resulting in higher costs for those taxpayers that use traditional healthcare insurance. This increased cost could result in more individuals not being able to afford the traditional healthcare insurance they need.

LEGISLATIVE STAFF CONTACT

David Scott
Legislative Analyst, FTB
(916) 845-5806
david.scott@ftb.ca.gov

Patrice Gau-Johnson
Asst. Legislative Director, FTB
(916) 845-5521
patrice.gau-johnson@ftb.ca.gov

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 and 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.

Bill Number	Action	Status
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 and 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.

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

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 854
As Introduced on February 17, 2011

AMENDMENT 1

On page 2, strike out lines 1 to 16, inclusive, and insert:

SECTION 1. Section 17072 of the Revenue and Taxation Code is repealed.

~~17072. (a) Section 62 of the Internal Revenue Code, relating to adjusted gross income defined, shall apply, except as otherwise provided.~~

~~(b) Section 62(a)(2)(D) of the Internal Revenue Code, relating to certain expenses of elementary and secondary school teachers, shall not apply.~~

~~(c) Section 62(a)(21) of the Internal Revenue Code, relating to attorneys fees relating to awards to whistleblowers, shall not apply.~~

SEC. 2. Section 17072 is added to the Revenue and Taxation Code, to read:

17072. (a) Section 62 of the Internal Revenue Code, relating to adjusted gross income defined, shall apply, except as otherwise provided.

(b) Section 62(a)(2)(D) of the Internal Revenue Code, relating to certain expenses of elementary and secondary school teachers, shall not apply.

(c) Section 62(a)(21) of the Internal Revenue Code, relating to attorneys fees relating to awards to whistleblowers, shall not apply.

(d) The deduction allowed by Section 17216, relating to health savings accounts, is allowed in computing adjusted gross income.

(e) The amendments made to this section by the act adding this subdivision shall apply only to taxable years beginning on or after January 1, 2012.

AMENDMENT 2

On page 2, line 17, strikeout "SEC. 2.", and insert:

SEC. 3.

AMENDMENT 3

On page 2, line 25, strikeout "SEC. 3.", and insert:

SEC. 4.

AMENDMENT 4

On page 2, line 34, strikeout "SEC. 4.", and insert:

SEC. 5.

AMENDMENT 5

On page 3, line 3, strikeout "SEC. 5.", and insert:

SEC. 6.

AMENDMENT 6

On page 3, line 11, strikeout "SEC. 6.", and insert:

SEC. 7.

AMENDMENT 7

On page 3, line 19, strikeout "SEC. 7.", and insert:

SEC. 8.

AMENDMENT 8

On page 3, line 23, strikeout "as added by", strikeout lines 24 through 25, inclusive,
and insert:

as

AMENDMENT 9

On page 3, line 29, strikeout "as added", strikeout line 30, and on line 31, strikeout
"and Modernization Act of 2003 (Public Law 108-173)".

AMENDMENT 10

On page 3, line 35, strikeout "as added", strikeout line 36, and on line 37, strikeout
"and Modernization Act of 2003 (Public Law 108-173)".

AMENDMENT 11

On page 4, line 1, strikeout “SEC. 8.”, and insert:

SEC. 9.

AMENDMENT 12

On page 4, line 13, strikeout “as added by”, strikeout line 14, on line 15, strikeout “and Modernization Act of 2003 (Public Law 108-173)”, and on line 16, strikeout “health savings accounts, and insert:

Reports

AMENDMENT 13

On page 5, line 4, strikeout “SEC. 9.”, and insert:

SEC. 10.