Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Gaines	Analyst:	David Scott	Bill Number:	AB 1129
Related Bills:	See Legislative History	Telephone:	845-5806	Introduced Date:	February 22, 2013
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Health Savings Account Deduction Conformity

SUMMARY

This bill would allow the same deduction on a California personal income tax return for contributions to a Health Savings Account (HSA) as is allowed on a federal individual income tax return for the same taxable year.

RECOMMENDATION

No position.

REASON FOR THE BILL

The reason for 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, 2013.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

Health Savings Accounts

Under federal law, eligible individuals may establish an HSA, which provides tax-favored treatment for current medical expenses, as well as the ability to save on a tax-favored basis for future medical expenses. An HSA is a tax-exempt trust or custodial account created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents. Generally, individuals are eligible to establish an HSA when they are covered by a high-deductible health plan (High Deductible Plan) and have no other health coverage (with the exception of plans providing certain permitted benefits/coverage).

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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; however, distributions made from an HSA that are used for non-qualified medical expenses are includible in gross income and are subject to an additional tax of 20 percent. The 20 percent additional tax is inapplicable 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 comparable participating employees with the same level of coverage (self-only or family coverage). For purposes of making contributions to HSAs of non-highly compensated employees, highly compensated employees are not treated as comparable participating employees, thus employers are permitted, but not required, to make larger contributions to HSAs of non-highly compensated employees than the employer makes to the HSAs of highly compensated employees. However, employer contributions to the HSAs of highly compensated employees may not exceed employer contributions to the HSAs of non-highly compensated employees.

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 a High Deductible Plan 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 a High Deductible Plan.

For taxable year 2013, a High Deductible Plan is a health plan that has an annual deductible that is at least $1,250 for self-only coverage or $2,500 for family coverage and has an annual out-of-pocket expense limit less than or equal to $6,250 for self-only coverage and $12,500 for 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 2013, the indexed amount is $3,250 for self-only coverage and $6,450 for 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 6 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 (Spending Arrangements) and Health Reimbursement Arrangements (Reimbursement Arrangements)

Arrangements commonly used by employers to reimburse medical expenses of their employees (and their spouses and dependents) include Spending Arrangements and Reimbursement Arrangements. Typically, Spending Arrangements 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 Spending Arrangement meets certain requirements, then neither the compensation that is foregone nor the reimbursements for medical care from the Spending Arrangement are includible in gross income or wages. Spending Arrangements are subject to the general requirements relating to cafeteria plans, including the 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.”

Reimbursement Arrangements operate in a manner similar to Spending Arrangements in that they are an employer-maintained arrangement that reimburses employees for medical expenses. Some of the rules applicable to Reimbursement Arrangements and Spending Arrangements 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, Reimbursement Arrangements 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 a Reimbursement Arrangement, but not under a Spending Arrangement.

Subject to certain limited exceptions, Spending Arrangements and Reimbursement Arrangements constitute other coverage under the HSA rules.

After December 20, 2006, and before January 1, 2012, certain amounts in a Spending Arrangement or Reimbursement Arrangement are allowed to be distributed and contributed through a direct transfer to an HSA without violating the otherwise applicable requirements for such arrangements. The amount that can be contributed to an HSA may not exceed an amount equal to the lesser of (1) the balance in the Spending Arrangement or Reimbursement Arrangement as of September 21, 2006, or (2) the balance in the Spending Arrangement or Reimbursement Arrangement as of the date of the distribution.

Current California Law

California law has no provisions comparable to the federal HSA provisions. As a result, a taxpayer must reverse the federal treatment of deductions, interest, and contributions related to their HSA on their California income tax return.

Although California has not conformed to HSAs, California law does conform to the federal rules for medical savings accounts, 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 a medical savings account used for non-qualified medical expenses.

Because a tax-free rollover from a medical savings account to an HSA is unavailable under California law, any distribution from a medical savings account that is rolled into an HSA must be added to AGI on the taxpayer's California return; and, the distribution is subject to the MSA 10 percent additional tax as it is treated as being made for a purpose other than a qualified medical expenses.

Additionally, a tax-free qualified HSA funding distribution is unavailable 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. 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

For taxable years beginning on or after January 1, 2013, this bill would conform to federal law, with modifications, as discussed below:

1. Allow an above-the-line deduction for contributions to an HSA by or on behalf of an individual.
2. Adopts the federal rules applicable to the HSA trust itself in order for the trust to be exempt from tax for California purposes.
3. Modifies the federal disqualified distribution penalty applicable to HSAs 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 6 percent excise tax on excess contributions and the federal estate tax provisions would be inapplicable.
4. Allow an 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.
5. Allow direct rollovers from medical savings accounts to HSAs, as well as between HSAs, without penalty.
6. Adopt the federal $50 penalty for failure to make required reports by the HSA trustee or other person providing an individual with a High Deductible Plan.
7. Allow certain amounts in Health Spending Arrangements or Reimbursement Arrangements to be distributed from the Health Spending Arrangements or Reimbursement Arrangements and contributed through a direct transfer to an HSA without violating the otherwise applicable requirements for such arrangements.
8. Uses 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 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 Plan requirements).
9. Allow individuals who become covered under an High Deductible Plan 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 High Deductible Plan.

10. Allow 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.
11. Allow 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.

LEGISLATIVE HISTORY

AB 854 (Garrick, 2011/2012), similar to this bill, would have conformed California personal income tax law to the federal HSA deduction rules. AB 854 failed to pass from the Assembly by the constitutional deadline.

AB 326 (Garrick, 2009/2010), similar to this bill, would have conformed California personal income tax law to the federal HSA deduction rules. AB 326 failed to pass from the Assembly by the constitutional deadline.

SB 353 (Dutton, 2009/2010), a similar to this bill, would have conformed California personal income tax law to the federal HSA deduction rules. SB 353 failed to pass from the Senate by the constitutional deadline.

SB 1262 (Aanestad, 2009/2010), similar to this bill, would have conformed California personal income tax law to the federal HSA deduction rules. SB 1262 failed to pass from the Senate by the constitutional deadline.

SBX6 13 (Dutton, 2009/2010), similar to this bill, would have conformed California personal income tax law to the federal HSA deduction rules. SBX6 13 failed to pass from the Senate by the constitutional deadline.

SBX8 47 (Dutton, 2009/2010), similar to this bill, would have conformed California personal income tax law to the federal HSA deduction rules. SBX8 47 failed to pass from the Senate by the constitutional deadline.

OTHER STATES' INFORMATION

Only two states that have an income tax (California and New Jersey), remain out of conformity with the federal HSA deduction rules. Pennsylvania's conformity is modified to limit deductions to employers making contributions to employee HSA accounts.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 1129 As Introduced on February 22, 2013 For Taxable Years Beginning On or After January 1, 2013 Assumed Enactment After June 30, 2013 ($ in Millions)		
2013-14	2014-15	2015-16
-$100	-$70	-$80

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: Some could argue that conformity to the federal HSA rules would allow California taxpayers to take control of their own healthcare costs by defraying the costs associated with a High Deductible Plan and providing a cost-effective alternative for individuals to obtain health care coverage.

Con: Some may argue that conformity with federal HSA provisions could reduce affordability and availability of traditional healthcare insurance because the people most likely to reduce risk in an insurance pool, e.g., healthier lifestyles would also be the most likely to leave traditional healthcare insurance should federal HSA benefits be allowed at the state level.

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