

Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Harkey Analyst: Jane Raboy Bill Number: AB 2576
Related Bills: See Legislative History Telephone: 845-5718 Introduced Date: February 21, 2014
Attorney: Bruce Langston Sponsor: _____

SUBJECT: Health Savings Account Deduction Conformity

SUMMARY

This bill would allow a contribution deduction for a Health Savings Account (HSA) under the Personal Income Tax Law (PITL) and would mirror the federal law relating to HSAs.

RECOMMENDATION

No position.

Summary of Suggested Amendments

Amendments are suggested to resolve technical concerns.

REASON FOR THE BILL

The reason for the bill is to 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, 2014.

ANALYSIS

FEDERAL/STATE LAW

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; except for plans providing certain permitted benefits and 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.² The additional tax is inapplicable if the distribution is made after death, disability, or after the date the account beneficiary attains 65 years of age.

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 the 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 the 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 excludable from 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 from an IRA.

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 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, alimony paid, and contributions to pension and annuity plans.

² The federal rate of additional tax on non-qualified HSA distributions increased from 10 percent to 20 percent for distributions made on or after January 1, 2011, (Section 9004 of the Patient Protection and Affordable Care Act, Public Law 111-148).

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 qualified 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 qualified 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. Conversely, 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.

THIS BILL

For taxable years beginning on or after January 1, 2014, 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. Adopt the federal rules applicable to the HSA trust itself in order for the trust to be exempt from tax for California purposes.
3. Modify the federal disqualified distribution tax applicable to HSAs to be 2½ percent instead of the federal rate of 20³ percent. 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.

³ Proposed Amendment 7 recommends a technical correction to the federal rate of additional tax from 20 percent to 10 percent, based on the "specified date" of conformity for the federal rate as of January 1, 2009.

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. Use 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 a 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 a 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 excludible from 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 from an IRA.

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

Amendments 1 to 12 are suggested to delete unnecessary language and make minor technical corrections.

LEGISLATIVE HISTORY

AB 1129 (Gaines, 2013/2014), similar to this bill, would have conformed California PITL to the federal HSA deduction rules. AB 1129 failed to pass out of the Assembly by the constitutional deadline.

AB 854 (Garrick, 2011/2012), similar to this bill, would have conformed California PITL to the federal HSA deduction rules. AB 854 failed to pass out of the Assembly by the constitutional deadline.

AB 326 (Garrick, 2009/2010), similar to this bill, would have conformed California PITL to the federal HSA deduction rules. AB 326 failed to pass out of the Assembly by the constitutional deadline.

SB 353 (Dutton, 2009/2010), similar to this bill, would have conformed California PITL to the federal HSA deduction rules. SB 353 failed to pass out of the Senate by the constitutional deadline.

SB 1262 (Aanestad, 2009/2010), similar to this bill, would have conformed California PITL to the federal HSA deduction rules. SB 1262 failed to pass out of the Senate by the constitutional deadline.

SBX6 13 (Dutton, 2009/2010), similar to this bill, would have conformed California PITL to the federal HSA deduction rules. SBX6 13 failed to pass out of the Senate by the constitutional deadline.

SBX8 47 (Dutton, 2009/2010), similar to this bill, would have conformed California PITL to the federal HSA deduction rules. SBX8 47 failed to pass out of the Senate by the constitutional deadline.

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.

Massachusetts follows the federal deductibility of contributions to medical and health savings accounts.

Minnesota conforms to the federal treatment as of March 18, 2010, for medical savings accounts, health savings accounts, and flexible spending accounts.

Florida, Illinois, and New York laws do not provide a deduction comparable to the deduction allowed by this bill.

FISCAL IMPACT

This bill would impact the department’s printing, processing, and programming costs. 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

Estimated Revenue Impact of AB 2576 As Introduced February 21, 2014 For Taxable Years Beginning On or After January 1, 2014 Assumed Enactment After June 30, 2014 (\$ in Millions)		
2014-15	2015-16	2016-17
- \$80	- \$55	- \$55

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

Proponents: Supporters could argue that conformity to the federal HSA treatment would allow a California taxpayer 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.

Opponents: Some could argue that conformity to the federal HSA treatment would fail to provide an affordable alternative for individuals to obtain health care coverage.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2576
AS INTRODUCED FEBRUARY 21, 2014

AMENDMENT 1

On page 2, line 10, strikeout "attorney's", and insert:

attorneys

AMENDMENT 2

On page 2, line 28, after "relating to", strikeout:

the

AMENDMENT 3

On page 2, strikeout lines 34 to 38, inclusive, and on page 3, strikeout lines 1 and 2, inclusive.

AMENDMENT 4

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

SEC. 4

AMENDMENT 5

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

SEC. 5

AMENDMENT 6

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

SEC. 6

AMENDMENT 7

On page 3, lines 30-31, strikeout "for "20 percent," contained therein.", and insert:
for "10 percent", contained therein.

AMENDMENT 8

On page 3, lines 23-24, strikeout "Code relating to health savings accounts shall", and insert:

Code, relating to health savings accounts, shall

AMENDMENT 9

On page 3, line 32, strikeout "SEC. 8", and insert:

SEC. 7

AMENDMENT 10

On page 4, line 2, strikeout "medical savings accounts for" ,and insert:
reports

AMENDMENT 11

On page 4, line 5, strikeout "health savings accounts", and insert:
reports

AMENDMENT 12

On page 4, line 31, strikeout "SEC. 9" and insert:
SEC. 8