STATE OF CALIFORNIA
Franchise Tax Board

Summary Analysis of Amended Bill

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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.

Summary of Suggested Amendments

The January 3, 2018, amendments resolved all of the technical concerns discussed in the department's analysis of the bill as introduced on February 17, 2017, and changed the effective and operative date of the bill from January 1, 2017 to January 1, 2018.

Except for the "Effective/Operative Date," "Federal Law," "This Bill," "Technical Considerations," "Implementation Considerations," and "Support/Opposition," sections, the remainder of the department's analysis of the bill as introduced February 17, 2017, still applies.

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, 2018.

Federal Law

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).

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 2018, a High Deductible Plan is a health plan that has an annual deductible that is at least $1,350 for self-only coverage or $2,700 for family coverage and has an annual out-of-pocket expense limit less than or equal to $6,650 for self-only coverage and $13,300 for family coverage.

[1] AGI includes all gross income reduced by "above-the-line" deductions. Above-the-line deductions include certain trade or business deductions, contributions to an Archer medical savings account (MSA), alimony paid, and contributions to pension and annuity plans.

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 2018, the indexed amount is $3,450 for self-only coverage and $6,900 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.

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.

This Bill

For taxable years beginning on or after January 1, 2018, this bill would, under the Personal Income Tax Law, conform to federal law, with modifications, as discussed below:

1. Allows 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 2.5 percent instead of the federal rate of 20 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. Allows 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. Allows direct rollovers from MSAs to HSAs, as well as between HSAs, without penalty.
6. Adopts 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. Allows 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[2] 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. Allows 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. Allows 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 2.5-percent additional tax on early distributions.

[2] The Consumer Price Index for All Urban Consumers (CPI-U) is used for cost-of-living adjustments, as provided in IRC section 223(g)(1)(B), as of the specified date of January 1, 2015.

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.

Taxpayers that receive nonqualified distributions from an HSA on or after January 1, 2018, where nondeductible contributions had been made prior to January 1, 2018, could be considered to be taxed twice on the same income, because the bill requires nonqualified distributions to be fully included in taxable income. A remedy to consider is a partial exclusion of nonqualified distributions for state tax purposes to the extent that contributions were previously nondeductible from California gross income.

Economic Impact

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 1140 as Amended on January 3, 2018
Assumed Enactment after June 30, 2018, ($ in Millions)

Fiscal Year	Revenue
2018-2019	- $110
2019-2020	- $85
2020-2021	- $100

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

Revenue Discussion

Using Franchise Tax Board data, it was determined that California taxpayers contributed $430 million to HSAs in 2015. This amount was grown to reflect changes in the economy over time, resulting in an estimated $600 million HSA deduction in taxable year 2018. It is estimated that employer contributions, on behalf of employees, increasing total contributions by 25 percent bringing the total to $750 million. Applying a marginal personal income tax rate and corporate tax rate of approximately 9 percent, the estimated revenue loss for 2018 would be $70 million.

The tax year estimates are converted to fiscal years and then rounded to arrive at the amounts shown in the above table.

Support/Opposition

Support

California Association of Health Underwriters, National Association of Insurance and Financial Advisors of California, and Independent Insurance Agents and Brokers of California.

Opposition

California Labor Federation, California Professional Firefighters, California State Council of Service Employees International Union (SEIU California), California School Employees Association, Consumer's Union, Health Access California, State Building and Construction Trades Council, and Western Center on Law and Poverty.

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