

Author: Cooper, et al. Analyst: Jon Feenstra Bill Number: AB 989  
Related Bills: See Prior Telephone: 845-4870 Amended Date April 6, 2017  
Analysis Attorney: Bruce Langston 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**

## **SUMMARY OF AMENDMENTS**

The April 6, 2017, amendments added a funding mechanism for administrative costs, an author, and a co-author. The amendments did not resolve the department's implementation concerns, technical considerations, and policy concerns discussed in the department's analysis of the bill as introduced February 16, 2017, and additional technical considerations were identified. Except for the "Effective/Operative Date," "This Bill," "Technical Considerations," and "Economic Impact," the remainder of the department's analysis of the bill as introduced February 16, 2017, still applies. The revised "Support/Opposition" section and the "Fiscal Impact" section have been restated below for convenience.

## **REASON FOR THE BILL**

The reason for this bill is to help make medical expenses more affordable for hardworking individuals and families and give them a greater incentive to plan and prepare for their medical expenses now, and into the future.

## **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, 2019, contingent on a budget measure specifically appropriating funds to the Franchise Tax Board (FTB) for costs to administer the bill's provisions.

## **THIS BILL**

For taxable years beginning on or after January 1, 2019, contingent on a budget measure specifically appropriating funds to the FTB for its costs to administer the bill's provisions, this bill would 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 individual retirement accounts (IRA). 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 medical savings accounts to HSAs, as well as between HSAs, without penalty.
6. 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.
7. 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).
8. 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.
9. 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.
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 2.5 percent additional tax on early distributions.

## **IMPLEMENTATION CONSIDERATIONS**

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

Taxpayers that receive nonqualified distributions from an HSA on or after January 1, 2019, where nondeductible contributions had been made prior to January 1, 2019, 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.

## TECHNICAL CONSIDERATIONS

Subdivision (d) of Section 17072 would conform to Internal Revenue Code (IRC) Section 62(a)(19) “as modified by Section 17217.” Because Section 17217 refers to IRC Section 223 as opposed to IRC Section 62(a)(19), the phrase “as modified by Section 17217” should be deleted.

For clarity, the phrase “any budget measure” used throughout the bill should be replaced with the phrase “the annual Budget Act” in each instance.

The operative dates of this bill are not clear. It is recommended that the operative dates be modified to taxable years beginning on or after January 1 of the taxable year immediately following the effective date of the first budget measure specifically appropriating funds to the FTB for its costs to administer each section, and no earlier than taxable years beginning on or after January 1, 2019.

## FISCAL IMPACT

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

## ECONOMIC IMPACT

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 989* As Amended April 6, 2017 Assumed Enactment After June 30, 2017 (\$ in Millions)		
2017-18	2018-19	2019-20
n/a	-\$50	-\$95

\*Estimates assume that the FTB is appropriated funds for the cost of administering the bill’s provisions.

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

## Revenue Discussion

Using FTB data, it was determined that California taxpayers contributed \$450 million to HSAs in 2014. This amount was grown to reflect changes in the economy over time, resulting in an estimated \$750 million HSA deduction in taxable year 2019. It is estimated that employer contributions, on behalf of employees, would increase contributions by 25 percent bringing the total deduction to \$950 million. Applying a marginal tax rate of 9 percent, the estimated revenue loss for 2019 would be \$85 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<sup>1</sup>**

Support: California Association of Health Underwriters; California Association of Joint Powers Authorities; California Chapter of the American College of Emergency Physicians; California Taxpayers Association; Independent Insurance Agents and Brokers of California; and National Association of Insurance and Financial Advisors of California.

Opposition: California Labor Federation; California Nurses Association; California Pan-Ethnic Health Network; California Professional Firefighters; California School Employees Association; California Tax Reform Association; Consumers Union; Health Access California; and Western Center on Law & Poverty.

## **POLICY CONCERNS**

Penalties are intended to ensure compliance to the requirements of the tax law. Federal law includes a \$50 penalty for failure to make required reports by the HSA trustee or other person providing an individual with a High Deduction Plan. This bill lacks a similar provision.

## **LEGISLATIVE STAFF CONTACT**

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<sup>1</sup> From Assembly Revenue and Taxation Committee analysis, dated March 30, 2017.