STATE OF CALIFORNIA
Franchise Tax Board

Bill Analysis

Author: Choi

Sponsor:

Related Bills: See Legislative History

Bill Number: AB 727

Introduced: February 16, 2021

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

Not applicable.

REASON FOR THE BILL

The reason for this bill is to incentivize the use of HSA thereby helping individuals save for unplanned medical costs that are not covered by insurance.

ANALYSIS

For taxable years beginning on or after January 1, 2021, and before January 1, 2026, 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 defining HSAs.
3. 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.
4. Allows direct rollovers from Medical Savings Accounts (MSAs) to HSAs, as well as between HSAs, without penalty.

5. 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).
6. 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.
7. Allows employers to make a contribution to an employee's HSA under a cafeteria plan and that contribution would not be considered a disqualified deferred compensation.
8. Allow 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 the distribution would otherwise be includible in income. In addition, such distributions are not subject to the additional tax on early distributions.

Effective/Operative Date

As a tax levy, this bill would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2021, and before January 1, 2026.

Federal/State Law

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). 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 2020, a High Deductible Plan is a health plan that has an annual deductible that is at least $1,400 for self-only coverage or $2,800 for family coverage and has an annual out-of-pocket expense limit less than or equal to $6,900 for self-only coverage and $13,800 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 2020, the indexed amount is $3,550 for self-only coverage and $7,100 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 six (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.

State 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 MSAs, and allows a deduction equal to the amount deducted on the federal return for the same taxable year. California imposes a 12.5 percent additional tax rather than the 20 percent additional federal tax on distributions from a MSA used for non-qualified medical expenses.

Because a tax-free rollover from a MSA to an HSA is unavailable under California law, any distribution from a MSA 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 12.5 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 2.5 percent additional tax under the rules for premature distributions.

Under Revenue and Taxation Code section 41, legislation that would create a new tax expenditure, which includes a credit, deduction, exclusion, exemption, or any other tax benefit as provided for by the state, is required to include specific goals, purposes, objectives, and performance measures to allow the Legislature to evaluate the effectiveness of the tax benefit.

Implementation Considerations

The department has identified the following implementation considerations, and is available to work with the author's office to resolve these and other considerations that may be identified.

Taxpayers that receive nonqualified distributions from an HSA on or after January 1, 2021, where nondeductible contributions had been made prior to January 1, 2021, 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.

Federal law requires reports to be made by the HSA trustee or other person providing an individual with a High Deductible Plan to the IRS. The author may wish to add the reporting requirement for state purposes to enforce the penalty for failure to file, similar to the federal requirement.

Technical Considerations

Subdivision (d) of Section 17072 would conform to 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), subdivision (d) of Section 17072 should provide for conformity to both IRC section 62(a)(19), as well as conformity to IRC section 223 as modified by Section 17217.

Policy Considerations

This bill would not impose a penalty or additional tax on distributions made from an HSA that are used for non-qualified medical expenses.

LEGISLATIVE HISTORY

AB 1140 (Obernolte, 2017/2018) and AB 989 (Cooper, 2017/18), similar to this bill, would have conformed California personal income tax law to the federal HSA deduction rules. Both AB 1140 and AB 989 did not pass from the Assembly by the constitutional deadline.

PROGRAM BACKGROUND

None noted.

FISCAL IMPACT

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 727 as Introduced on February 16, 2021
Assumed Enactment after June 30, 2021

($ in Millions)

Fiscal Year	Revenue
2021-2022	-$120
2022-2023	-$95
2023-2024	-$110

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

LEGAL IMPACT

None noted.

APPOINTMENTS

None noted.

SUPPORT/OPPOSITION

To be determined.

ARGUMENTS

To be determined.

LEGISLATIVE CONTACT

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