STATE OF CALIFORNIA
Franchise Tax Board

Bill Analysis

Author: Seyarto, et. al	Sponsor:	Bill Number: SB 230
	Related Bills: See Legislative History	Introduced January 23, 2023, and Amended March 15, 2023

SUBJECT

Health Savings Account Deduction Conformity

SUMMARY

This bill, under the Personal Income Tax Law (PITL) and Corporation Tax Law (CTL), 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 taxable years beginning on or after January 1, 2023, and before January 1, 2028.

RECOMMENDATION

No position.

SUMMARY OF AMENDMENTS

The March 15, 2023, amendments removed the provisions relating to a deduction for a small employer that contributes to the health savings account of their employee and replaced them with the provisions discussed in this analysis.

This is the department's first analysis of the bill.

REASON FOR THE BILL

The reason for this bill is to incentivize the use of HSAs.

ANALYSIS

For taxable years beginning on or after January 1, 2023, and before January 1, 2028, this bill would conform to federal law, with modifications, as discussed below:

- 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.

- 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.
- Allows direct rollovers from Archer Medical Savings Accounts (MSAs) to HSAs, as well as between HSAs, without penalty.
- Allows an above-the-line deduction for contributions to an HSA by or on behalf of an individual.
- Conforms to the federal rules regarding HSAs and modifies the definition of an "eligible individual" to mean an individual who has an adjusted gross income (AGI) as follows:
  - For spouses filing joint returns, heads of household, and surviving spouses (as defined) less than $87,000.
  - For other individuals, less than $42,000.
  - The AGI amounts would be adjusted annually using the tax bracket indexing.
- Allows the imposition of tax on unrelated business income HSAs that are trusts.
- Modifies the gross income inclusion for amounts not used for qualified medical expenses. Taxpayers who made a contribution for the HSA beneficiary and were not allowed to take the deduction at the time of the contribution would be able to exclude amounts not used for qualified medical expenses if they would be allowed a deduction during a taxable year beginning on or after January 1, 2023, and before January 1, 2028.
- The 20% additional tax on distributions not used for qualified medical expenses would not apply.
- Requires reports to be made by the HSA trustee or other person providing an individual with a High Deductible Plan to the Franchise Tax Board (FTB) and to the beneficiary, in the form and manner as FTB may require.

This bill would require FTB to provide a report to the Legislature odd-numbered year for which the provisions are operative. The report would be required to include the number of deductions allowed and the total dollar amount of the deductions. The reporting requirements would be treated as an exception to the prohibition against disclosure of tax information applicable to FTB.

These provisions would be repealed by its own terms on December 1, 2028.

Effective/Operative Date

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2023 and before January 1, 2028.

Federal/State Law

Federal 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 (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%. The 20% 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. An employer may provide an HSA to their employees if the employee has a high deductible health plan (HDHP) and no other coverage with exceptions. An HDHP has a higher annual deductible than typical health plans and a maximum limit on the sum of the annual deductible and out of pocket medical expenses that the employee pays for covered expenses (co-payments and other amounts, not including premiums).

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 2022, an HDHP 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 $7,050 for self-only coverage and $14,100 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 2022, the indexed amount is $3,650 for self-only coverage and $7,300 for family coverage. The maximum contribution is increased by $1,000 per year for catch-up contributions for persons over age 55.

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. An individual 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% additional tax rather than the 20% 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% 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% additional tax under the rules for premature distributions.

Under Revenue and Taxation Code (RTC) 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.

This bill requires the FTB to prepare a report on the performance of the deduction allowed by this bill in an odd numbered year in which the provisions of the act are operative which would taxable years beginning on or after January 1, 2023. If the author's intent is to be able to review a report that contains complete information for the 2023 taxable year, it is recommended that the report due date be no earlier than

May of 2025 to provide information for the 2023 taxable year. The due date for the 2023 personal income tax return is April 15, 2024, with extension that becomes October 15, 2024. The department needs approximately six months to complete return processing and to compile the needed data to prepare a report. If the reporting due date remains unchanged, FTB would be unable to provide the requested data and the report would be incomplete.

Technical Considerations

For consistency and clarity with the federal law, on page 4, line 6, it is recommended that the reference to "Section 17651" be removed and instead reference "Section 17651 or Section 23731" for the imposition of tax on unrelated business income of charitable, etc. organizations. Additionally, it is recommended that RTC section 17072 be added and amended to reference IRC section 62(a)(19) that defines AGI to include the HSA deduction under IRC section 223.

Policy Considerations

None noted.

LEGISLATIVE HISTORY

AB 727 (Choi, 2021-22), AB 1140 (Obernolte, 2017/2018), and AB 989 (Cooper, 2017/18), would have conformed California personal income tax law to the federal HSA deduction rules for individuals. All three bills 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 SB 230 as Amended March 15, 2023.
Assumed Enactment after June 30, 2023

($ in Millions)

Fiscal Year	Revenue
2023-2024	-$1.9
2024-2025	-$1.2
2025-2026	-$1.3

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

FTBLegislativeServices@ftb.ca.gov