STATE OF CALIFORNIA
Franchise Tax Board

Bill Analysis

Author: DeMaio	Sponsor:	Bill Number: AB 781
	Related Bills: See Legislative History	Amended March 28, 2025

SUBJECT

Health Savings Account (HSA) Deduction Conformity

SUMMARY

This bill, under the Personal Income Tax Law (PITL), would allow a similar deduction on a California personal income tax return for contributions to a HSA as is allowed on a federal individual income tax return for taxable years beginning on or after January 1, 2026, and before January 1, 2031. In addition, this bill would amend the Public Utilities Code.

This is the Franchise Tax Board's (FTB) first analysis of the bill and only addresses the provisions that would impact the FTB.

RECOMMENDATION

No position—The three-member Franchise Tax Board has not formally voted or taken a position on this bill.

SUMMARY OF AMENDMENTS

The March 28, 2025, amendments removed intent language relating to the administration of taxes and fees, and replaced it with the provisions discussed in this analysis.

REASON FOR THE BILL

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

ANALYSIS

For taxable years beginning on or after January 1, 2026, and before January 1, 2031, 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 rollovers from Archer Medical Savings Accounts (MSAs) to HSAs, as well as between MSAs, without penalty.
- Allows an above-the-line deduction for contributions to an HSA by or on behalf of an individual.
- Allows the imposition of tax on unrelated business income for 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, 2026, and before January 1, 2031.
- Requires reports to be made by the HSA trustee or other person providing an individual with a High Deductible Health Plan (HDHP) to the FTB and to the beneficiary, in the form and manner as FTB may require.

These provisions would be repealed on December 1, 2031.

Effective/Operative Date

This bill would be effective January 1, 2026, and specifically operative for taxable years beginning on or after January 1, 2026, and before January 1, 2031.

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 an 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).

The recently enacted One Big Beautiful Bill Act of 2025 (OBBA) includes provisions that make permanent that an HDHP cover telehealth services before the deductible was met without disqualifying individuals from using their HSAs. Additionally, the OBBA allows Bronze and Catastrophic level plans to be treated as an HDHP.

Individuals who become covered under an HDHP 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 an HDHP.

For taxable year 2024, an HDHP is a health plan that has an annual deductible that is at least $1,600 for self-only coverage or $3,200 for family coverage and has an annual out-of-pocket expense limit less than or equal to $8,050 for self-only coverage and $16,100 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 2024, the indexed amount is $4,150 for self-only coverage and $8,300 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 Individual Retirement Accounts (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

None noted.

Technical Considerations

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

For consistency of terminology, in Section 17072(d) consider replacing, "For each taxable year beginning on or after…" with "For taxable years beginning on or after."

The following consideration has been included because this analysis is being published after October 2, 2025, the date SB 711 (McNerney, Chapter 231, Statutes of 2025) was chaptered.

This bill would amend RTC section 17131.4. Chapter 231 of the Statutes of 2025 (SB 711, McNerney) amended Section 17131.4, and those amendments took effect on October 1, 2025. To avoid repealing the amendments made by SB 711, the author may want to amend the bill to use the current version of RTC section 17131.4.

Policy Considerations

Under 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. As a new tax expenditure, the author may wish to include specific goals, purposes, objectives, and performance measures to allow the Legislature to evaluate the effectiveness of the tax benefit.

LEGISLATIVE HISTORY

SB 711 (McNerney, Chapter 231 Statutes of 2025), under the PITL, the Administration of Franchise and Income Tax Law, and Corporate Tax Law, would conform to specified sections of the IRC and modify conformity to the limitation on real property like-kind exchanges.

SB 230 (Seyarto, et. al, 2023/2024), under the PITL, would have allowed the same deduction on a California personal income tax return for contributions to an 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. This bill did not pass out of the Senate by the constitutional deadline.

AB 727 (Choi, 2021/2022), AB 1140 (Obernolte, 2017/2018), and AB 989 (Cooper, 2017/2018), would have conformed California PITL to the federal HSA deduction rules for individuals. All three bills did not pass out of the Assembly by the constitutional deadline.

PROGRAM BACKGROUND

None noted.

FISCAL IMPACT

FTB’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 781 as Amended March 28, 2025
Assumed Enactment after June 30, 2025

($ in Millions)

Fiscal Year	Revenue
2025-2026	-$40
2026-2027	-$70
2027-2028	-$70

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.

Revenue Discussion

Based on data from the FTB, California taxpayers contributed approximately $580 million to HSAs in 2022. This amount was grown to reflect changes in the economy over time, resulting in an estimated $770 million in HSA contribution deductions for taxable year 2026. In addition, it is estimated that about $150 million in employer contributions, on behalf of employees, would no longer be subject to California personal income tax, bringing the total amount deducted or excluded to approximately $920 million. Applying an average tax rate of 7.5% would result in an estimated revenue loss of $70 million in the 2026 taxable year.

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

LEGAL IMPACT

None noted.

APPOINTMENTS

None noted.

SUPPORT/OPPOSITION

None on file.

ARGUMENTS

None on file.

LEGISLATIVE CONTACT

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