Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Maldonado | Analyst: John Pavalasky | Bill Number: SB 173

Related Bills: See Legislative History | Telephone: 845-4335 | Introduced Date: February 9, 2005

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Health Savings Account (HSA) Deduction Conformity

SUMMARY

Starting in 2006 this bill would allow the same deduction on California returns for contributions to an HSA as is allowed on the federal return.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to conform to the federal HSA provisions to simplify the preparation of California tax returns.

EFFECTIVE/OPERATIVE DATE

This bill would be effective immediately and operative for taxable years beginning on or after January 1, 2006.

POSITION

Pending.

Summary of Suggested Amendments

Technical amendments are necessary and are provided.

ANALYSIS

FEDERAL/STATE LAW

Present federal and state laws contain a number of provisions dealing with the tax treatment of health expenses and health insurance coverage including Archer medical savings accounts (MSA). See Attachment I for a detailed discussion of these provisions.

In addition, starting in 2004, Public Law (P.L.) 108-173 created HSAs, that provide tax-favored treatment, modeled after individual retirement account (IRA) provisions, for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. See Attachment II for a detailed discussion of these provisions.

Board Position:			Department Director	Date
_____ S	_____ NA	_____ NP		
_____ SA	_____ O	_____ NAR	Gerald H. Goldberg	3/25/05
_____ N	_____ OUA	__X__ PENDING		

HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents. Earnings in the accounts are tax deferred until distribution and, if used for qualified medical expenses, are never taxed. Amounts can be rolled over tax-free into an HSA from another HSA or from an MSA.

Within limits, contributions to HSAs are deductible in the year made if made by or on behalf of an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual on that individual's behalf. Thus, for example, contributions made by an eligible individual's family members are deductible by the eligible individual to the extent the contribution would be deductible if made directly by the eligible individual.

Eligible individuals are defined as individuals who are covered by a "high deductible health plan" that has a deductible of at least $1,000 for self-only coverage or $2,000 for family coverage and that has an out-of-pocket expense limit of no more than $5,000 in the case of self-only coverage and $10,000 in the case of family coverage. An eligible individual may have no other health plan that is not a "high deductible health plan" except for worker's compensation insurance, tort liability insurance, auto insurance, or other similar liability insurance provided by regulations. In addition, the following types of insurance are permitted and will not disqualify an otherwise eligible individual:

- Insurance for a specified disease or illness.
- Insurance that provides a fixed payment for hospitalization.
- Coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

The maximum contribution amount that is deductible is equal to the lesser of the following:

- The deductible amount in the taxpayer's "high deductible health plan."
- The maximum deductible permitted under an MSA, as adjusted for inflation. For 2004, that amount is $2,600 in the case of self-only coverage and $5,150 in the case of family coverage.

Contributions in excess of the maximum contribution amount are generally subject to a 6% excise tax.

Distributions from HSAs for qualified medical expenses are not includible in gross income. However, distributions that are not for qualified medical expenses are taxable and also subject to an additional 10% penalty tax. The additional 10% penalty tax does not apply after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Current California Law

California law is conformed to the federal rules for MSAs and allows a deduction equal to the amount deducted on the federal return. California imposes a 10% additional tax rather than the 15% additional federal tax on distributions from an MSA not used for qualified medical expenses.

However, California has not conformed to any of the federal HSA provisions. The California return starts with federal adjusted gross income (AGI) and requires adjustments to be made for differences between federal and California law. Adjustments relating to HSAs are required under current law, as follows:

- A taxpayer taking an HSA deduction on the federal return is required to increase AGI on the taxpayer's California return by the amount of the federal deduction.
- Any interest earned on the account is added to AGI on the taxpayer's California return.
- Any contribution to an HSA (including salary reduction contributions made through a cafeteria plan) made on the employee's behalf by their employer is not excluded from income and is added to AGI on the employee's California return.

Since a tax-free rollover from an MSA to an HSA is not allowed under California law, any distribution from an MSA that is rolled into an HSA must be added to AGI on the taxpayer's California return. Additionally, under California law that MSA distribution is not treated as being made for qualified medical expenses and is, therefore, subject to the MSA 10% penalty tax.

THIS BILL

Starting in 2006 this bill would conform California law to the federal HSA provisions as follows:

1. Allows the same above-the-line deduction of contributions to an HSA by or on behalf of an individual and adopts the rules applicable to the trust itself in order for the trust to be exempt from tax. In addition, the disqualified distribution penalty applicable to HSAs is modified for California purposes to be 2 ½% instead of the federal rate of 10% to be consistent with the other California penalty provisions applicable to IRAs. The federal 6% excise tax on excess contributions and the federal estate tax provisions are not being conformed to by this bill.

2. Allows the same 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.

3. Allows rollovers from MSAs to be made to HSAs as well as rollovers between HSAs without penalty.

4. Adopts the same penalty for failure to make required reports.

TECHNICAL CONSIDERATIONS

The bill contains incorrect cross-references to federal Public Law 108-173 that enacted the HSA provisions being conformed to by this bill. Amendments 1 and 2 are provided to resolve this issue.

LEGISLATIVE HISTORY

AB 2315 (Maldonado/ Nakanishi, 2003/2004), as amended May 17, 2004, was substantially the same as this bill but did not pass out of the fiscal committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. *Florida* does not impose a personal income tax so a comparison to Florida is not relevant. *Illinois, Michigan,* and *New York* conform to the federal deduction for contributions to HSAs. However, *Massachusetts* and *Minnesota* have not conformed to the new federal HSA provisions. Note that legislation was introduced during February 2005 to conform *Minnesota* to the federal HSA provisions for the same years as allowed under federal law.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses annually beginning in 2005-06.

Estimated Revenue Impact of SB 173 As Introduced 2/9/05 Effective For Taxable Years Beginning On Or After January 1, 2006 [$ In Millions]		
2005-06	2006-07	2007-08
-$5	-$18	-$23

Revenue Discussion

The revenue impact of the bill would be determined by the amount of HSA deductions taken on tax returns in any given year beginning on or after January 1, 2006, and the marginal tax rate of qualified taxpayers reporting such deductions.

Revenue estimates were based on federal projections for this provision in the Medicare Prescription Drug, Improvement, and Modernization Act of 2003. That is, the department projected a proportionate impact for California under conformity based on a composite percentage that reflects what we feel would be California's portion of total dollar contributions to these accounts and our marginal tax rates relative to federal tax rates. Additionally, according to recent news articles, some financial institutions are just now starting to add HSAs to their offerings. Federal projections are adjusted to reflect the delay in conformity to tax year 2006 as well as the delay in some financial institutions offering these accounts.

ARGUMENTS/POLICY CONCERNS

California's non-conformity to federal HSA provisions for any transactions that occur in the years before this bill would apply are not addressed in the bill. For example, since the amounts contributed during 2004 and 2005 are not deductible for state purposes and the earnings in the account or rollover from an MSA are taxable by California, the taxpayer will have a basis in the account for state but not federal purposes. Any subsequent non-qualified distribution that would otherwise be included in the taxpayer's income would need to be adjusted to account for this California basis. However, this bill does not provide any rules with respect to how that California basis adjustment will be made. The author may wish to provide rules similar to those that required the recovery of California basis before the amounts would be taxable as was done under the Individual Retirement Account (IRA) provisions when a similar delayed conformity to federal law occurred. Department staff is available to assist in resolving this and any other concerns as this bill moves through the legislative process.

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ATTACHMENT I – TAX TREATMENT OF HEALTH EXPENSES AND HEALTH INSURANCE COVERAGE

Overview

Present federal and state laws contain a number of provisions dealing with the tax treatment of health expenses and health insurance coverage.

Employer-provided health coverage

In general, employer contributions to an accident or health plan are excludable from an employee's gross income (and wages for employment tax purposes).[1] This exclusion generally applies to coverage provided to employees (including former employees) and their spouses, dependents, and survivors. Benefits paid under employer-provided accident or health plans are also generally excludable from income to the extent they are reimbursements for medical care.[2] If certain requirements are satisfied, employer-provided accident or health coverage offered under a cafeteria plan is also excludable from an employee's gross income and wages.[3] Present law provides for two general employer-provided arrangements that can be used to pay for or reimburse medical expenses of employees on a tax-favored basis: FSAs and health reimbursement arrangements (HRAs). While these arrangements provide similar tax benefits (i.e., the amounts paid under the arrangements for medical care are excludable from gross income and wages for employment tax purposes), they are subject to different rules. A main distinguishing feature between the two arrangements is that while FSAs are generally part of a cafeteria plan and contributions to FSAs are made on a salary reduction basis, HRAs cannot be part of a cafeteria plan and contributions cannot be made on a salary-reduction basis.[4]

Amounts paid or accrued by an employer within a taxable year for a sickness, accident, hospitalization, medical expense, or similar health plan for its employees are generally deductible as ordinary and necessary business expenses.[5]

Self-employed individuals

The exclusion for employer-provided health coverage does not apply to self-employed individuals. However, under present law, self-employed individuals (i.e., sole proprietors or partners in a partnership)[6] are entitled to deduct 100% of the amount paid for health insurance for themselves and their spouse and dependents.[7]

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1 IRC Sections 106, 3132(a)(2), and 3306(b)(2).

2 IRC Section 105. In the case of a self-insured medical reimbursement arrangement, the exclusion applies to highly compensated employees only if certain nondiscrimination rules are satisfied. (IRC Section 105(h)). Medical care is defined as under IRC Section 213(d) and generally includes amounts paid for qualified long-term care insurance and services.

3 IRC Sections 125, 3121(a)(5)(G), and 3306(b)(5)(G). Long-term care insurance and services may not be provided through a cafeteria plan.

4 Notice 2002-45, 2002-28 I.R.B. 93 (July 15, 2002); Rev. Rul. 2002-41, 2002-28 I.R.B. 75 (July 15, 2002).

5 IRC Section 162.

6 Self-employed individuals include more than 2% shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to IRC Section 1372.

7 IRC Section 162(l).

Itemized deduction for medical expenses

Under present law, individuals who itemize deductions may deduct amounts paid during the taxable year (to the extent not reimbursed by insurance or otherwise) for medical care of the taxpayer, the taxpayer's spouse, and dependents, to the extent that the total of such expenses exceeds 7.5% of the taxpayer's adjusted gross income (AGI).[8]

Archer MSA

In general

In general, before 2006,[9] an MSA is a tax-exempt trust or custodial account created exclusively for the benefit of the account holder that is subject to rules similar to those applicable to individual retirement arrangements.[10]

Within limits, contributions to an MSA are deductible in determining adjusted gross income if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an MSA are not includible in gross income in the year earned (i.e., inside buildup is not taxable). Distributions from an MSA for qualified medical expenses are not includible in gross income. Distributions not used for qualified medical expenses are includible in gross income and subject to an additional 15% tax unless the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Qualified medical expenses are generally defined as under Internal Revenue Code (IRC) Section 213(d), except that qualified medical expenses do not include expenses for health insurance other than long-term care insurance, premiums for health coverage during any period of continuation coverage required by federal law, and premiums for health care coverage while an individual is receiving unemployment compensation under federal or state law. For purposes of determining the itemized deduction for medical expenses, distributions from an MSA for qualified medical expenses are not treated as expenses paid for medical care under IRC Section 213.

Eligible individuals

MSAs are available only to employees of a small employer who are covered under an employer-sponsored high deductible health plan and to self-employed individuals covered under a high deductible health plan.[11] An employer is a small employer if it employed, on average, no more than 50 employees on business days during either of the two preceding calendar years. An individual is not eligible for an MSA if he or she is covered under any other health plan that is not a high deductible health plan (other than a plan providing certain limited types of coverage). Individuals entitled to benefits under Medicare are not eligible individuals. Eligible individuals do not include individuals who may be claimed as a dependent on another person's tax return.

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[8] IRC Section 213. The adjusted gross income percentage is 10% for purposes of the alternative minimum tax. (IRC Section 56(b)(1)(B).

[9] IRC Section 220. The Working Families Tax Relief Act (WFTRA) of 2004 (Public Law 108-311) extended Archer MSAs through December 31, 2005.

[10] IRC Section 220.

[11] Self-employed individuals include more than 2% shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to IRC Section 1372.

Treatment of contributions

Individual contributions to an MSA are deductible (within limits) in determining adjusted gross income (i.e., “above-the-line” deductions). In addition, employer contributions are excludable from gross income and wages for employment tax purposes (within the same limits), except that this exclusion does not apply to contributions made through a cafeteria plan. In the case of an employee, contributions can be made to an MSA either by the individual or by the individual's employer, but not by both.

The maximum annual contribution that can be made to an MSA for any year is 65% of the annual deductible under the high deductible health plan in the case of self-only coverage and 75% of the annual deductible in the case of family coverage.

If an employer provides a high deductible health plan coupled with MSAs for employees and makes employer contributions to the MSAs, the employer must make available a comparable contribution on behalf of all employees with comparable coverage during the same period. Contributions are considered comparable if they are either of the same amount or the same percentage of the deductible under the high deductible health plan. If employer contributions do not satisfy the comparability rule during a period, then the employer is subject to an excise tax equal to 35% of the aggregate amount contributed by the employer to MSAs for that period.

Definition of high deductible health plan

A high deductible health plan is a health plan with an annual deductible of at least $1,700 and no more than $2,500 in the case of self-only coverage and at least $3,350 and no more than $5,050 in the case of family coverage.[12] In addition, the maximum out-of-pocket expenses with respect to allowed costs must be no more than $3,350 in the case of self-only coverage and no more than $6,150 in the case of family coverage. Out-of-pocket expenses include deductibles, co-payments, and other amounts (other than premiums) that the individual must pay for covered benefits under the plan. A plan does not fail to qualify as a high deductible health plan merely because it does not have a deductible for preventive care as required under state law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is certain permitted insurance or is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

Treatment of death of account holder

Upon death, any balance remaining in the decedent's MSA is includible in his or her gross estate. If the account holder's surviving spouse is the named beneficiary of the MSA, then, after the death of the account holder, the MSA becomes the MSA of the surviving spouse and the amount of the MSA balance may be deducted in computing the decedent's taxable estate, pursuant to the estate tax marital deduction.[13] If, upon the account holder's death, the MSA passes to a named beneficiary other than the decedent's surviving spouse, the MSA ceases to be an MSA as of the date of the decedent's death, and the beneficiary is required to include the fair market value of the MSA assets as of the date of death in gross income for the taxable year that includes the date of death. The

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[12] The deductible and out-of-pocket expenses dollar amounts are for 2003. These amounts are indexed for inflation in $50 increments.

[13] IRC Section 2056.

amount includible in gross income is reduced by the amount in the MSA used, within one year after death, to pay qualified medical expenses incurred prior to the death. If there is no named beneficiary for the decedent's MSA, the MSA ceases to be an MSA as of the date of death, and the fair market value of the assets in the MSA as of such date is includible in the decedent's gross income for the year of the death.

Limit on number of MSAs; termination of MSA availability

The number of taxpayers benefiting annually from an MSA contribution is limited to a threshold level (generally 750,000 taxpayers). The number of MSAs established has not exceeded the threshold level.

After 2005[14] no new contributions can be made to MSAs except by or on behalf of individuals who previously had MSA contributions and employees who are employed by a participating employer.

[14] IRC Section 220. The Working Families Tax Relief Act (WFTRA) of 2004 (Public Law 108-311) extended Archer MSAs through December 31, 2005.

ATTACHMENT II – DETAILED DESCRIPTION OF FEDERAL HSA PROVISIONS

In general

Starting in 2004, Public Law 108-173 creates HSAs that provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. In general, HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents that are subject to rules similar to those applicable to individual retirement arrangements.[15]

Within limits, contributions to HSAs are deductible if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Contributions in excess of the maximum contribution amount are generally subject to a 6% excise tax.[16] Distributions from HSAs for qualified medical expenses are not includible in gross income. Distributions that are not for qualified medical expenses are includible in gross income and subject to an additional 10% tax. The additional 10% tax does not apply after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Eligible individuals

Eligible individuals are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan. Individuals entitled to benefits under Medicare are not eligible to make contributions to an HSA. Eligible individuals do not include individuals who may be claimed as a dependent on another person's tax return.

An individual with other coverage in addition to a high deductible health plan is still eligible for an HSA if such coverage is certain permitted insurance or permitted coverage. Permitted insurance is: (1) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such other similar liabilities as the Secretary may prescribe by regulations; (2) insurance for a specified disease or illness; and (3) insurance that provides a fixed payment for hospitalization. Permitted coverage is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

A high deductible health plan is a health plan that has a deductible that is at least $1,000 for self-only coverage or $2,000 for family coverage and that has an out-of-pocket expense limit that is no more than $5,000 in the case of self-only coverage and $10,000 in the case of family coverage.[17] Out-of-pocket expenses include deductibles, co-payments, and other amounts (other than premiums) that the individual must pay for covered benefits under the plan. The annual deductible maximum and minimum and out-of-pocket expense amounts are indexed for inflation. A plan is not a high deductible health plan if substantially all of the coverage is for permitted coverage or coverage that may be provided by permitted insurance, as described above.

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[15] As under MSAs, this provision provides that the present-law requirement applicable to insurance companies that certain policy acquisition expenses must be capitalized and amortized (IRC Section 848) does not apply in the case of any contract that is a health account.

[16] Ordering rules apply to determine the nature of any distributed excess contributions.

[17] Special rules apply for determining whether a health plan that is a preferred provider organization plan meets the requirements of a high deductible plan.

Tax treatment of and limits on contributions

Contributions made by or on behalf of an eligible individual are deductible by the individual. Thus, for example, contributions made by an eligible individual's family members are deductible by the eligible individual to the extent the contribution would be deductible if made by the individual. In addition, employer contributions to an HSA (including salary reduction contributions made through a cafeteria plan) are excludable from gross income and wages for employment tax purposes to the extent the contribution would be deductible if made by the employee.[18] All contributions by or on behalf of an eligible individual are aggregated for purposes of the maximum annual contribution limit. Contributions to medical savings accounts (MSAs) reduce the annual contribution limit for HSAs.

The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100% of the annual deductible under the high deductible health plan, or (2) the maximum deductible permitted under an MSA, as adjusted for inflation.[19] For 2004, the amount of the maximum high deductible is estimated to be $2,600 in the case of self-only coverage and $5,150 in the case of family coverage.

This provision increases the annual contribution limits for individuals who have attained age 55 by the end of the taxable year. In the case of policyholders and covered spouses who are 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by $500 in 2004, $600 in 2005, $700 in 2006, $800 in 2007, $900 in 2008, and $1,000 in 2009 and thereafter. Contributions, including catch-up contributions cannot be made once an individual is eligible for Medicare.

Amounts can be rolled over into an HSA from another HSA or from an MSA.

If an employer makes contributions to employees' HSAs, the employer must make available comparable contributions on behalf of all employees with comparable coverage during the same period. Contributions are considered comparable if they are either of the same amount or the same percentage of the deductible under the plan. The comparability rule is applied separately to part-time employees (i.e., employees who are customarily employed for fewer than 30 hours per week). The comparability rule does not apply to amounts transferred from an employee's HSA, health flexible spending arrangements (FSA), or MSA or to contributions made through a cafeteria plan.

If employer contributions do not satisfy the comparability rule during a period, then the employer is subject to an excise tax equal to 35% of the aggregate amount contributed by the employer to HSAs for that period. The excise tax is designed as a proxy for the denial of the deduction for employer contributions. In the case of a failure to comply with the comparability rule that is due to reasonable cause and not willful neglect, the Secretary may waive part or all of the tax imposed to the extent that the payment of the tax would be excessive relative to the failure involved. For purposes of the comparability rule, employers under common control are aggregated.

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[18] Employer contributions to an HSA are excludable from wages for employment tax purposes if, at the time of payment, it is reasonable to believe that the employee will be able to exclude such payment from income.

[19] The annual contribution limit for an HSA is the sum of the limits determined separately for each month, based on the individual's status and health plan coverage as of the first day of the month.

Taxation of distributions

Distributions from an HSA for qualified medical expenses of the individual and his or her spouse or dependents generally are excludable from gross income. In general, amounts in an HSA can be used for qualified medical expenses even if the individual is not currently eligible for contributions to the HSA. [20]

Qualified medical expenses generally are defined as amounts eligible for deduction under IRC Section 213(d) and include expenses for diagnosis, cure, mitigation, treatment, or prevention of disease, including prescription drugs, transportation primarily for and essential to such care, and qualified long-term care expenses. Qualified medical expenses do not include expenses for insurance other than for (1) long-term care insurance, (2) premiums for health coverage during any period of continuation coverage required by federal law, and (3) premiums for health care coverage while an individual is receiving unemployment compensation under federal or state law. For purposes of determining the itemized deduction for medical expenses, distributions from an HSA for qualified medical expenses are not treated as expenses paid for medical care under IRC Section 213.

Distributions from an HSA that are not for qualified medical expenses are includible in gross income. Distributions includible in gross income are also subject to an additional 10% tax unless made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Ordering rules apply to determine the extent to which distributions are attributable to nondeductible contributions.

Tax treatment of HSAs after death

Upon death, any balance remaining in the decedent's HSA is includible in his or her gross estate.

If the HSA holder's surviving spouse is the named beneficiary of the HSA, then, after the death of the HSA holder, the HSA becomes the HSA of the surviving spouse and the amount of the HSA balance may be deducted in computing the decedent's taxable estate, pursuant to the estate tax marital deduction. The surviving spouse is not required to include any amount in gross income as a result of the death; the general rules applicable to the HSA apply to the surviving spouse's HSA (e.g., the surviving spouse is subject to income tax only on distributions from the HSA for nonqualified expenses). The surviving spouse can exclude from gross income amounts withdrawn from the HSA for expenses incurred by the decedent prior to death, to the extent they otherwise are qualified medical expenses.

If, upon death, the HSA passes to a named beneficiary other than the decedent's surviving spouse, the HSA ceases to be an HSA as of the date of the decedent's death, and the beneficiary is required to include the fair market value of HSA assets as of the date of death in gross income for the taxable year that includes the date of death. The amount includible in income is reduced by the amount in the HSA used, within one year after death, to pay qualified medical expenses incurred by the decedent prior to the death. As is the case with other HSA distributions, whether the expenses are qualified medical expenses is determined as of the time the expenses were incurred. In computing taxable income, the beneficiary may claim a deduction for that portion of the federal estate tax on the decedent's estate that was attributable to the amount of the HSA balance.

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[20] However, in any year for which a contribution is made to an HSA, withdrawals from the HSA maintained by that individual generally are excludable from income only if the individual for whom the expenses were incurred was covered under a high deductible plan for the month in which the expenses were incurred. The rule does not apply for continuation coverage or coverage while the individual is receiving unemployment compensation even if for an individual who is not an eligible individual.

If there is no named beneficiary of the decedent's HSA, the HSA ceases to be an HSA as of the date of death, and the fair market value of the assets in the HSA as of such date is includible in the decedent's gross income for the year of the death.

This rule applies in all cases in which there is no named beneficiary, even if the surviving spouse ultimately obtains the right to the HSA assets (e.g., if the surviving spouse is the sole beneficiary of the decedent's estate).

Reporting requirements

Employer contributions are required to be reported on the employee's Form W-2. Trustees of HSAs may be required to report to the Secretary of the Treasury amounts with respect to contributions, distributions, and other matters as determined appropriate by the Secretary. In addition, providers of health insurance are required to report information as may be prescribed by the Secretary.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 173
As Introduced February 9, 2005

AMENDMENT 1

On page 3, line 11, strikeout "medicare" and insert:

Medicare

AMENDMENT 2

On page 4, line 12, strikeout "Section 201 of the medicare" and insert:

Section 1201 of the Medicare