Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Liu | Analyst: LuAnna Hass | Bill Number: AB 2617

Related Bills: See Legislative History | Telephone: 845-7478 | Amended Date: April 8, 2002

Attorney: Patrick Kusiak | Sponsor: ______

SUBJECT: Exclusion/Cafeteria Plans/Include Insurance For Long-Term Care

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ______________________.

____ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended ______________________.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ______________________.

____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED ______________________ STILL APPLIES.

__X__ OTHER - See comments below.

SUMMARY

This bill would make changes to state tax law regarding cafeteria plans and their exclusion from gross income.

SUMMARY OF AMENDMENTS

The April 8, 2002, amendments removed the bill's provision that related to the deduction for medical savings accounts and replaced it with the provisions discussed in this analysis.

PURPOSE OF THE BILL

It appears the purpose of this bill is to encourage taxpayers to purchase long-term care insurance by including the insurance as an eligible cafeteria plan benefit.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2002.

POSITION

Pending.

Board Position:			Department Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR	Gerald H. Goldberg	5/8/02
____ N	____ OUA	__X__ PENDING		

ANALYSIS

FEDERAL/STATE LAW

A cafeteria plan (also called a Section 125 Plan or Flexible Benefit Plan) is an arrangement in which an employee may choose between cash and benefits without altering the tax treatment of the nontaxable benefit. Cafeteria plans can be as simple as premium payment on a pre-tax basis, or as complex as an offering of an array of benefits with an allowance provided by the company, so an employee may pick and choose those benefits that meet their needs. Flexible Spending Accounts (FSA) are also offered under cafeteria plans and generally consist of either a Medical Reimbursement account or a Dependent Care Reimbursement account. A reimbursement account allows an employee to set aside funds on a pre-tax basis for later reimbursement of medical or dependent care expenses on a tax-free basis. However, premiums for health insurance may not be reimbursed under a Medical Reimbursement FSA. Expenses reimbursed through an FSA must be incurred during the participant's period of coverage under the FSA, which may not exceed 12 months. Any participant in a cafeteria plan must forfeit any unused money to the plan at the end of the coverage period. The plan may use the forfeitures to offset administrative expenses, or may reallocate dollars back to plan participants on a reasonable and uniform basis.

Under federal income tax laws, a cafeteria plan is defined as a written plan where all participants are employees, and the participants may choose among two or more benefits consisting of cash and qualified benefits. Generally, a cafeteria plan does not include any plan that provides for deferred compensation. Qualified benefit means benefits (other than certain specified benefits) that are excluded from gross income of the employee. Any product that is advertised, marketed, or offered as long-term care insurance cannot be a qualified cafeteria plan benefit.

Existing income tax law allows certain tax benefits to taxpayers for expenditures made to purchase long-term care insurance and for the expenses related to providing services necessary to care for a chronically ill individual.

Under federal law, long-term care services are defined as necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance or personal care services required by a chronically ill individual.

The unreimbursed expenses for qualified long-term care services that are provided to the taxpayer, the taxpayer's spouse, or the taxpayer's dependents are allowed as a medical expense deduction. Any amount received under a long-term care insurance contract (regardless of whether the contract reimburses expenses or pays benefits on a per diem or other periodic basis) is treated as a reimbursement for expenses actually incurred for medical care.

Generally, under current federal and state law all medical expenses, including direct out of pocket medical expenses, health insurance, long-term care expenses, and long-term care insurance, are added together, and only the amount in excess of 7.5% of AGI is deductible as an itemized deduction for an individual. Long-term care insurance premiums, like medical care insurance premiums, are explicitly treated as medical expenses and are deductible on a graduated scale based on the individual's age as of the last day of the taxable year.

Age of Individual	Maximum Deduction
40 or less	$200
More than 40 but not more than 50	375
More than 50 but not more than 60	750
More than 60 but not more than 70	2,000
More than 70	2,500

Self-employed individuals are allowed an above-the-line deduction for medical insurance and long-term care premiums in an amount equal to the applicable percentage of the amount paid during the taxable year:

Current federal and state law provide specific tax benefits to an employee for medical and long-term care insurance. Any employer contributions to accident and health plans and qualified cafeteria plan benefits are excluded from an employee's gross income. In addition, gross income excludes the receipt of benefits from long-term care insurance. Gross income does include employer-provided coverage for qualified long-term care services when the coverage is provided through a flexible spending arrangement.

THIS BILL

For state income tax purposes, this bill would make two changes regarding cafeteria plans. Specifically, it would:

1. Expand the definition of "qualified benefit" to include insurance for long-term care.
2. Allow any unused amounts in a cafeteria plan account for long-term care insurance to be rolled over to the succeeding taxable years.

Although this bill would make the changes above, it **would not** provide any additional tax benefits (see Implementation Considerations).

IMPLEMENTATION CONSIDERATIONS

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

This bill would allow insurance for long-term care to be included in the definition of qualified benefit under a cafeteria plan, but would not alter the tax treatment of long-term care insurance. The qualified benefits under Section 125 of the Internal Revenue Code (IRC) are excluded from gross income under other provisions of tax law, not because they are provided as a qualified benefit under IRC Section 125. This section of law simply states that the choice of cash or a qualified benefit under a cafeteria plan does not alter the tax-free treatment of those otherwise non-taxable benefits. <u>Since long-term care services provided through an FSA are not excluded from gross income under any other provision of federal or state tax law, this bill would provide no additional tax benefit to a participant in an FSA.</u>

This bill uses phrases that are undefined, i.e., “insurance for long-term care” and “employee reimbursement account.” The absence of a definition to clarify these phrases could lead to disputes with taxpayers and could complicate the administration of this provision. In addition, the phrase “employee reimbursement account” creates a difference between federal and state law since federal regulations relating to Internal Revenue Code Section 125 use the phrase “flexible spending arrangement.”

TECHNICAL CONSIDERATIONS

The provisions of this bill do not reflect the statutory language generally used to create an exception in state law with regard to a provision that conforms to federal law. Department staff is available to assist the author with drafting amendments to address the technical aspects.

LEGISLATIVE HISTORY

AB 2281 (Alquist, 1999/2000) and AB 64 (Alquist, 2001/2002) would have allowed taxpayers to deduct a percentage of the cost of long-term care insurance when calculating adjusted gross income. Both bills died in the Assembly Revenue and Taxation Committee.

OTHER STATES’ INFORMATION

A review of *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York* found that these states generally follow federal law relating to exclusions from income and cafeteria plans. Therefore, none of these states allow long-term care insurance as a qualified cafeteria plan benefit. The laws of these states were reviewed because their tax laws are similar to California’s income tax laws.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until the implementation concerns have been resolved.

ECONOMIC IMPACT

This bill as written provides no tax benefit; therefore, it would not impact revenues under the Personal Income Tax Law.

LEGAL IMPACT

Under federal and state law, long-term care insurance is specifically excluded from the definition of a qualified cafeteria plan benefit. This bill would create a difference between federal and California tax law relating to cafeteria plans, which would contradict the state’s current general conformity to the treatment of cafeteria plans under the Internal Revenue Code. Since federal tax law would still prohibit long-term care insurance as a qualified benefit, the inclusion of long-term care insurance in a cafeteria plan (for state tax purposes) could disqualify the entire cafeteria plan for federal tax purposes. This disqualification would have the effect of making the benefits included in a cafeteria plan that are otherwise nontaxable benefits subject to federal tax.

ARGUMENTS/POLICY CONCERNS

This bill would allow any unused funds in a cafeteria plan account for long-term care insurance to be rolled over to succeeding taxable years. Generally, cafeteria plans including FSAs are federally created and any funds placed in an FSA must be forfeited to the plan at the end of the plan period if unused. Therefore, it is unclear how the participant could roll over funds for state tax purposes, but not for federal purposes. Assuming the bill were amended to provide an exclusion for amounts used to pay for long-term care insurance, allowing those amounts to be rolled over from one year to another would likely be considered to establish a plan that provides for deferred compensation, contrary to federal rules. This rollover could also jeopardize the federal treatment of the plan as a cafeteria plan.

As stated under “Federal/State Law” an FSA is a reimbursement account that allows an employee to set aside funds on a pre-tax basis for later reimbursement of expenses incurred during the participant’s period of coverage under the FSA. Generally, under this bill, the participant would set aside sufficient funds during the plan period to cover long-term care insurance premiums for that period. If the intent of this bill is to allow the pre-tax funds set aside for long-term care insurance to be rolled over to grow, then this provision would be considered a plan that provides for deferred compensation, which conflicts with existing provisions of law that prohibit cafeteria plans from providing deferred compensation.

LEGISLATIVE STAFF CONTACT

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