Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Alquist	Analyst:	LuAnna Hass	Bill Number:	AB 64
Related Bills:	See Legislative History	Telephone:	845-7478	Introduced Date:	12/06/2000
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Long-Term Care Insurance Deduction/FTB Report To Legislature Annually Regarding Deduction Utilization

SUMMARY

This bill would allow taxpayers to deduct a percentage of the cost of long-term care insurance when calculating adjusted gross income (AGI). The deduction would start at 25% of the amount paid or incurred by the taxpayer for the cost of the insurance in the 2002 tax year and increase incrementally to a 100% deduction beginning in the 2007 tax year. The deduction would not be allowed for married filing joint taxpayers with AGI greater than $200,000 and all other taxpayers with AGI greater than $100,000.

This bill would require the Franchise Tax Board (FTB) to report annually to the Legislature on this deduction.

EFFECTIVE DATE

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

LEGISLATIVE HISTORY

AB 2281 (Alquist), an identical bill as amended on May 22, 2000, failed passage in the Assembly Revenue and Taxation Committee.

SPECIFIC FINDINGS

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. A chronically ill individual is generally defined as an individual unable to perform (without substantial assistance from another individual) at least two of the activities of daily living (ADL's) for a period of at least 90 days due to loss of functional capacity. The ADL's include eating, toileting, transferring, bathing, dressing, and continence. A chronically ill individual also may require substantial supervision to protect such individual from threats to health and safety concerns due to severe cognitive impairment.

Board Position:			Department Director	Date
____ S	____ NA	____ NP	Gerald H. Goldberg	1/29/01
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____ N	____ OUA	__X__ PENDING		

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:

Taxable Years	Applicable Percentage
1999 through 2001	60
2002	70
2003 and thereafter	100

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 or similar arrangement.

A recently enacted state law provides a $500 non-refundable long-term caregiver credit for each applicable individual for which the taxpayer is an eligible caregiver. An applicable individual may be the taxpayer, spouse of the taxpayer, or a qualifying dependent that has been certified to have long-term care needs. The definition of qualifying dependent is broader than the definition used for the dependency exemption credit.

Under the Personal Income Tax Law, this bill would permit the deduction of the cost of long-term care insurance as an above-the-line deduction in computing AGI and would phase in the deduction for the cost of long-term care insurance to 100% as follows:

Beginning In	Long-Term Care Insurance Deductible
2002	25%
2003	40%
2004	55%
2005	75%
2006	85%
2007 and thereafter	100%

The above-the-line deduction outlined above would not be allowed for married filing joint taxpayers with AGI greater than $200,000 and all other taxpayers with AGI greater than $100,000. The deduction also would not be allowed if the taxpayer's employer paid or incurred more than 50% of the cost of the long-term care insurance. Any amount paid for long-term care insurance during the phase-in period between 2002 and 2007 that is not allowed as a deductible expense under this bill would still be allowed as a medical expense (subject to present law limitations).

Other States

A majority of other states follow federal law allowing a medical deduction limited to expenses in excess of 7.5% of AGI. Generally, medical expenses include direct out-of-pocket medical expenses, health insurance, and long-term care insurance or expenses.

Illinois allows a long-term care insurance deduction for amounts paid to insure self, spouse, and dependents, for the amount not federally deducted. This deduction is only available to the self-employed, partners in partnerships, or S corporation shareholders.

Implementation Considerations

This bill would require FTB to report annually to the Legislature the total number of taxpayers claiming the deduction, the AGIs of those taxpayers, the total amount of the deductions claimed, and any other information the FTB deems useful to evaluate the deduction. The information requested would be difficult to provide, as the current return process does not include the capture of specific deductions or their dollar amounts.

To capture this information, a line would be added to the tax forms for the deduction amount. Implementation would require programming changes to capture the deduction, additional time to key the deduction, and an increase in taxpayer correspondence and phone calls received. Approximately 425,000 taxpayers would be eligible to claim this deduction.

Technical Considerations

This bill uses a term that is undefined, i.e., "long-term care insurance." The absence of a definition to clarify this term could lead to disputes with taxpayers and could complicate the administration of this deduction. Amendment One would resolve this concern.

LEGISLATIVELY MANDATED REPORTS

This bill would require FTB to report to the Legislature annually on taxpayer utilization of the deduction.

FISCAL IMPACT

Departmental Costs

For Current year 2001 - 2002, the costs of implementation are estimated to be $519,644, or approximately 7.6 personnel years. For Budget year 2002-2003 the ongoing costs are estimated to be $104,318, or approximately 3.0 personnel years.

This analysis assumes that the addition of a line to the tax forms will not create the need for an additional page in the tax booklet. If other legislation is enacted and, combined with this legislation, requires more pages in the tax booklet, the costs of this legislation would increase.

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of AB 64 As Introduced 12/06/00 [$ In Millions]						
2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
minor loss	-$6	-$12	-$20	-$29	-$42	-$56*

* When bill is fully implemented.

The bill would be effective with taxable years beginning on or after January 1, 2002. If a federal bill were also enacted to provide a deduction for AGI for long-term care insurance premiums, state revenue losses would increase substantially because of taxpayer response.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The amount of deductible premiums and the marginal tax rate of taxpayers with policies in force would determine the revenue impact of this bill.

This revenue estimate assumes the long-term care insurance policies are considered “qualified long-term care insurance policies” as defined in Section 7702B of the Internal Revenue Code.

The estimate was derived primarily in the following steps:

1. Projected the net number of policies in force each year by California resident taxpayers: approximately 425,000 by 2002 and growing to approximately 465,000 by 2007. The number of total policies grows each year by the net of new policies purchased and policies that lapse for both mortality and non-mortality reasons.

2. Estimated an average annual premium of $1,700. A policy's annual premium is a function of many variables including the type of policy and coverage selected, age, health status, and the cost of care in the area where one resides.

3. Estimated the portion of total premiums attributed to taxpayers whose AGI is $100,000/$200,000 or less (single/joint and head of household), using tax return data arrayed by AGI class.

4. Calculated and applied an "inducement to purchase" rate that increases incrementally each year. The proposed deduction effectively reduces the annual cost of a long-term care policy and the rate increases incrementally each year to reflect the phase-in of the proposed deduction and also taxpayer behavior.

5. Determined an average marginal tax rate for California taxpayers with long-term care policies in force and who benefit from the proposed deduction (6.5%). The average marginal tax was calculated by performing a simulation using sample tax return data.

6. Estimated offsetting revenue gains due to the proposed deduction (for AGI) in place of the present law, limited medical expense deduction (from AGI). Liability year estimates were converted to the cash-flow estimates above. Cash flow estimates reflect the ability of some taxpayers to accelerate tax benefits by adjusting their estimated tax payments.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD’S
PROPOSED AMENDMENTS TO AB 64
As Introduced December 6, 2000

AMENDMENT 1

On page 2, amend lines 23 to 36 as follows:

(b) For purposes of this section~~,~~:
(1) “Long-term care insurance” means insurance provided pursuant to a qualified long-term care insurance contract, within the meaning of Section 7702B of the Internal Revenue Code.
(2) “~~applicable~~ Applicable percentage” means:
~~(1)~~ (A) Twenty-five percent for any taxable year beginning on or after January 1, 2002, and before January 1, 2003.
~~(2)~~ (B) Forty percent for any taxable year beginning on or after January 1, 2003, and before January 1, 2004.
~~(3)~~ (C) Fifty-five percent for any taxable year beginning on or after January 1, 2004, and before January 1, 2005.
~~(4)~~ (D) Seventy percent for any taxable year beginning on or after January 1, 2005, and before January 1, 2006.
~~(5)~~ (E) Eighty-five percent for any taxable year beginning on or after January 1, 2006, and before January 1, 2007.
~~(6)~~ (F) One hundred percent for any taxable year beginning on or after January 1, 2007.