Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

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Bill Number: SB 1263

Related Bills: See Legislative History
Telephone: 845-4142
Introduced Date: February 9, 2006

Attorney: Patrick Kusiak
Sponsor:

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

SUMMARY

This bill would allow taxpayers to deduct a percentage of the cost to purchase long term care (LTC) insurance.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to provide an incentive to California taxpayers to buy LTC insurance to reduce the future dependence on public funding.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. The bill specifies that it would be operative for taxable years beginning on or after January 1, 2007.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

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 defined as an individual unable to perform (without substantial assistance from another individual) at least two of the activities of daily living (ADLs) for a period of at least 90 days due to loss of functional capacity. ADLs 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.

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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 adjusted gross income (AGI) is deductible as an itemized deduction for an individual.

LTC 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. The amounts are adjusted annually for inflation. The amounts in the following table are for 2006:

Age of Individual	Maximum Deduction
40 or less	$280
More than 40 but not more than 50	$530
More than 50 but not more than 60	$1,060
More than 60 but not more than 70	$2,830
More than 70	$3,530

A self-employed individual (or a partner or a more-than-2%-shareholder of an S corporation) can deduct as a business expense 100% of the amount paid during the tax year for medical insurance on himself, his spouse and his dependents.

Current federal and state law provides 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.

THIS BILL

This bill would allow taxpayers to deduct a percentage of the cost of LTC insurance as an above-the-line deduction when calculating AGI. The deduction would start at 25% of the amount paid or incurred by the taxpayer for the cost of the insurance in the 2007 tax year and increase incrementally to a 100% deduction beginning in the 2012 tax year as follows:

Beginning In	Long-Term Care Insurance Deductible
2007	25%
2008	40%
2009	55%
2010	70%
2011	85%
2012 and thereafter	100%

The above-the-line 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. Also, the deduction 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 2007 and 2012 that is not allowed as a deductible expense under this bill would still be allowed as a medical expense, subject to present law limitations.

The policy may cover the taxpayer, the taxpayer's spouse or domestic partner, as defined in Section 297 of the Family Code, and the taxpayer's dependents.

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

IMPLEMENTATION CONSIDERATIONS

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

This bill would require FTB to report annually to the Legislature the total number of taxpayers claiming the deduction, the AGI of those taxpayers, the total amount of the deductions claimed, and the additional information FTB deems useful to evaluate the deduction. The information requested would be difficult to provide as current tax forms do not include reporting and capture of specific deductions and the corresponding dollar amounts.

TECHNICAL CONSIDERATIONS

This bill uses the term "long-term care insurance." This term is defined in Internal Revenue Code Section 7702B, which California law conforms to pursuant to Section 17020.6 of the Revenue and Taxation Code. It may be desirable to include in the proposed Section 17205 an explicit cross-reference to that definition.

LEGISLATIVE HISTORY

AB 64 (Alquist, 2001-2002), as amended on January 16, 2002, had similar provisions to this bill; however, it failed passage in the Assembly Revenue and Taxation Committee.

FISCAL IMPACT

The present forms have limited space available for additional lines. If this bill requires an additional line on the tax return, these changes could increase the forms from two to three pages. As a result, the department would incur additional costs for printing, processing, and system changes. The additional costs have not been determined at this time. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested.

ECONOMIC IMPACT

Revenue Estimate

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

Estimated Revenue Impact of SB 1263 As Introduced February 9, 2006 ($ In Millions)						
2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
a/	-$10	-$20	-$30	-$45	-$60	-$80

a/ Loss of less than $500,000

This estimate assumes a deduction for state income tax purposes only. If a federal bill were enacted to provide a deduction for AGI for LTC insurance premiums, revenue losses would increase substantially.

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

Revenue Discussion

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

Using the most current LTC policy information, the number of policies in force in California by 2007 is expected to be roughly 640,000.

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. As a result, LTC insurance policy premiums can range from $800 to $3,400 annually. To determine revenue losses for this bill, an estimated average annual premium of $1,800 was used. Multiplying the number of policies by the average annual premium derives total premiums of $1,150 million (640,000 x $1,800 = $1,150 million).

Using tax return data, it was estimated that the portion of total premiums attributed to taxpayers whose AGI is $100,000/$200,000 or less (single and head of household/married filing joint) is approximately 90%. Generally, employer paid premiums is insignificant at 0.5% of total premiums, resulting in 99.5% of taxpayers paying their own premiums ($1,150 million x 90% x 99.5% = $1,030 million). For 2007, the deduction percentage proposed by this bill is 25% ($1,030 million x 25% = $260 million).

The deduction proposed by this bill would effectively reduce the annual cost of an LTC policy. As a result, an "inducement to purchase" rate was calculated and applied. The rate increases incrementally each year to reflect the phase-in of the deduction. Reduction adjustments were also applied to: (1) reflect the rate at which qualified taxpayers would report the deduction on their tax returns and (2) reflect offsetting revenue gains (estimated at 10%) as the deduction is in place of the itemized deduction allowed under current law for medical expenses that benefits only those taxpayers that itemize. These adjustments reduce the $260 million down to $140 million.

For tax year 2007, applying a marginal tax rate of 6.5% results in an estimate of $9 million ($140 million x 6.5% = $9 million). Tax 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.

LEGISLATIVE STAFF CONTACT

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