

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Nunez/Perata Analyst: Anne Mazur Bill Number: ABX1 1

Related Bills: ABX1 2 Telephone: 845-5404 Amended Date: December 17, 2007
December 13, 2007

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT:	Enforcement of Individual Health Care Mandate/Health Care Premium Refundable Credit/ Require Employers To Establish Section 125, Cafeteria Plans
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SUMMARY

This bill, which would be known as the Health Care Security and Cost Reduction Act, would do the following:

- Beginning July 1, 2010, require each California resident to be enrolled in and maintain at least the minimum health care coverage (individual mandate).
- Permit the Managed Risk Medical Insurance Board (MRMIB) to enter into an agreement with the Franchise Tax Board (FTB) to recoup any state funds advanced for health care coverage on behalf of noncompliant individuals.
- For taxable years 2010 through 2014, establish a refundable income tax credit based on the amount of health care premiums paid for individuals of a specified income class and state the intent of the Legislature to allow this credit to be advanceable.
- In addition, state the intent of the Legislature to enact a health care coverage income tax credit not to exceed \$50 million dollars annually, subject to an appropriation for certain individuals of a specified age.
- Beginning January 1, 2010, require certain employers to set up a cafeteria plan under Internal Revenue Code (IRC) section 125 (125 plan mandate).

This bill would make other changes to several California Codes related to the health care program, including establishing the California Health Trust Fund to provide health care coverage and pay program expenses. Discussion in this analysis is limited to those provisions of the bill that affect the FTB.

SUMMARY OF AMENDMENTS

The December 13, 2007, amendments deleted legislative intent language to enact comprehensive health care reform and added provisions that would carry out such reform, including but not limited to establishing an individual mandate, health insurance market and health care provider reforms, encouraging wellness, expanding subsidized programs, and stating intent regarding implementation and funding.

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The December 17, 2007, amendments added language that would establish an income tax credit for individuals and intent language related to income tax credits. The amendments added language to provide that the entire act would become inoperative if any individual provision of the act were to be invalidated by a court. In addition, the amendment also made various substantive and technical changes to health care related provisions that would not impact FTB.

This is the department's first analysis of this bill.

PURPOSE OF THE BILL

According to the language of the bill, it would be the intent of the Legislature in enacting this bill to accomplish the goal of universal health care for all California residents.

EFFECTIVE/OPERATIVE DATE

If enacted during the special session, this bill would be effective on the 91st day after adjournment of this special session. The bill provides specific operative dates for the various provisions. Such operative dates are discussed below for the provisions that would impact FTB. Generally, however, the bill specifies that its provisions would be operative upon the date that the Director of Finance determines and informs the Secretary of State that there are sufficient state resources to implement those provisions.¹

POSITION

Pending.

Summary of Suggested Amendments

Language is provided to correct technical errors relating to grammar and references.

ECONOMIC IMPACT

To the extent that the individual mandate encourages taxpayers to participate in section 125 plans (described below) or other tax-favored methods to purchase health insurance, there would be a reduction in personal income tax revenue. The amount of tax reduction resulting from this increased use of tax-favored expenditures depends on the estimated behavioral responses to the provisions of this bill. In addition, the tax reduction amounts are secondary to the expenditure and social impacts of this bill.

¹ The bill would state the Legislature's intent to fund the provisions of the bill in part by fees paid by employers not making health care expenditures for employees in specified amounts. The U.S. Court of Appeals for the 4th Circuit in *Retail Industry Leaders Association v. Fielder* (2007) 475 F.3d 180, ruled that Maryland's Fair Share Health Care Fund Act (Act) is preempted by ERISA (Federal Employee Retirement Income Security Act of 1974) because the Act directly regulates employers' provision of health care benefits, and therefore has a "connection with" covered employers' ERISA plans. More recently, on December 26, 2007, in *Golden Gate Restaurant Association v. City and County of San Francisco*, No. C 06-06997 JSW, 2007 U.S. Dist. LEXIS 94112 (N.D. Cal), a federal district court struck down a universal health care mandate for San Francisco on similar grounds. Although the effects of these decisions on the applicable laws of states, including California, is unknown, similar mandates involving covered ERISA plans may also be preempted by ERISA.

To date, staff has not determined the behavioral responses that are estimated to occur under the provisions of this bill. Furthermore, staff understands that Jon Gruber,² who has developed the model to simulate the primary impacts of this proposal, will be developing his own estimates of these secondary impacts. As such, and because the impacts that department staff would be estimating are secondary, a revenue estimate will not be produced for this bill.

ENFORCEMENT OF THE INDIVIDUAL MANDATE

EFFECTIVE/OPERATIVE DATE

If enacted during the special session, this bill would be effective on the 91st day after adjournment of this special session. The bill indicates that this provision would be specifically operative beginning on or after July 1, 2010; however, the bill also expressly states that implementation of this provision is contingent on the appropriation of funds for this purpose in the annual Budget Act or other legislation.

ANALYSIS

FEDERAL/STATE LAW

The federal Health Insurance Portability and Accountability Act (HIPAA) was enacted in 1996 and among other things, establishes certain requirements that must be followed in the dissemination and distribution of health care related data. The provisions of HIPAA include specified guidelines for the transfer, storage, use, and destruction of personal health information, which includes premium payment data.

Under current state law, any fines, fees, penalties, forfeitures, restitution orders, or fines, or any other amounts imposed by a superior or municipal court in California that is delinquent for 90 days or more, can be referred to FTB for collection. After issuing a preliminary notice to the debtor, FTB is authorized to collect the debts referred by the courts in the same manner as authorized for collection of a delinquent personal income tax liability. FTB's costs attributable to this collection program are reimbursed through the amount FTB collects for the program, not to exceed 15%. In general, the county or state fund originally owed the debt receives the net collections after reduction by the amount of FTB's departmental costs.

FTB is responsible for the collection of delinquent vehicle registration fees assessed by the Department of Motor Vehicles (DMV). DMV retains management responsibility for all accounts assigned to FTB for collection. After issuance of a notice and demand to the debtor, FTB is authorized to collect the debts assigned by DMV in the same manner as authorized for collection of a delinquent personal income tax liability. FTB is reimbursed costs of collection based on a percentage of the amount of revenue realized.

² Professor of Economics at the Massachusetts Institute of Technology.

The Department of Industrial Relations (DIR) may refer cases to FTB for collection that consist of delinquent fees, wages, employers' assessments, penalties, costs, and interest. After issuance of a notice and demand to the debtor, FTB is authorized to collect the debts referred by DIR in the same manner as authorized for collection of a delinquent personal income tax liability. FTB is reimbursed for actual costs of collections, depending on the debt type.

Current state law authorizes FTB to use administrative collection tools in order to collect delinquent tax and non-tax debt liabilities. Collection actions include, but are not limited to, attaching bank accounts, garnishing wages, or filing a Notice of State Tax Lien with the county recorder.

Current state law prohibits the disclosure of any taxpayer information, except as specifically authorized by statute. California law permits FTB to release individual tax return information to specific state agencies. Agencies must have a specific reason for requesting the information, including investigating items of income disclosed on any return or report, verifying eligibility for public assistance, locating absent parents to collect child support, or locating abducted children. For some agencies, only limited information may be released, such as the taxpayer's social security number and address.

THIS BILL

This bill would, beginning July 1, 2010, require every California resident³ to be enrolled in and maintain at least minimum "creditable" health care coverage, as defined.⁴ The bill would provide that individuals who meet specified criteria would be exempt from the individual mandate. For purposes of enforcing the individual mandate, this bill would require MRMIB to do the following:

- Establish and maintain a statewide education and awareness program to inform California residents of their obligation under the individual mandate.
- In consultation with the State Department of Health Care Services, identify and implement methods and strategies to establish multiple entry points and opportunities for enrollment in public or private coverage.
- Establish methods by which individuals who have not obtained health care coverage to be informed of the methods available to obtain affordable coverage through public programs, the statewide purchasing pool established under this bill to be administered by MRMIB,⁵ and commercial coverage.

³ The bill would define "California resident" as an individual who is a resident as defined by a specified Government Code section or is physically present in the state for at least six months, having entered with an employment commitment or to obtain employment, regardless of whether employed at the time the individual applies or is accepted for health care coverage. The Government Code generally determines residency as "the place where one remains when not called elsewhere for labor or other special or temporary purpose, and to which he or she returns in seasons of repose."

⁴ The bill specifies that individuals would not be required to comply with the mandate— notwithstanding the July 1, 2010, date—until other provisions of the bill, such as those relating to minimum creditable coverage and income tax credit, are implemented, and only for the period those provision remain operative.

⁵ The purchasing pool would be officially known as the California Cooperative Health Insurance Purchasing Program, or Cal-CHIP, established by this bill.

- Establish methods to ensure that uninsured individuals obtain the minimum required creditable coverage, including authorizing MRMIB to pay the cost of health care coverage on behalf of an individual after being uninsured for at least 62 days,
- Establish methods by which funds advanced for coverage may be recouped by the state from individuals for whom coverage is purchased.
- By March 15, 2010, and before entering any agreements with other agencies or departments, as described, report to the Legislature the methods MRMIB will use to identify individuals with and without coverage, how individuals will be notified of the availability of coverage and timeframe to enroll, actions to enroll the uninsured, and actions to be taken against individuals that do not enroll.

This bill authorizes MRMIB to enter into an agreement with FTB to use its civil authority and procedures in compliance with notice and other due process requirements imposed by law to collect funds owed to the state that were advanced on behalf of uninsured individuals.

Additionally, the bill would require that to the extent possible, existing reporting processes employed throughout the state to report on the employment and tax status of individuals and other existing mechanisms are to be used to implement the enforcement of the individual mandate. Relevant state agencies are required to cooperate with MRMIB and other responsible entities in undertaking these activities and implementing these provisions of this bill.

IMPLEMENTATION CONSIDERATIONS

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

1. Although the bill permits MRMIB to enter into an agreement with FTB for the collection of the unpaid health care premiums, the bill lacks authorization for FTB to use its civil authorities and compliance procedures for the collection of these debts as if they were tax debts. Specific statutory authorization is required to enable FTB to use its administrative collection tools and information sources for this purpose.
2. The bill is silent regarding the author's intent relating to the payment priority of debts. FTB collects several different types of debts, the priority for payment of which is established by statute. Clarification is needed to determine where health care coverage debts would fall in relation to general fund debts collected by FTB.
3. This bill requires the utilization of existing employment and tax data processes to administer the mandate, but lacks express authorization for FTB to provide tax data to MRMIB for non-tax related purposes. An express exception to current disclosure restrictions relating to tax data is necessary to enable FTB to implement this provision. The exception should also expressly exclude any federal tax data maintained in FTB's records to preserve and comply with existing disclosure agreements and requirements related to federal tax data.

4. With an implementation date of the mandate of July 1, 2010, FTB anticipates referrals from MRMIB for collection of unpaid premiums would be expected to occur within six months of that date. In light of the budget and approval process for new information technology and procurement, FTB does not believe successful implementation of an automated collection system and start up of a new collection workload could be achieved within this timeframe. As described in Footnote 4, this situation could result in delay of the start date for the individual mandate.
5. The bill needs statutory direction on how the Legislature intends FTB to handle special circumstances for health care accounts relating to bankruptcy claims, decedent claims, or lien processing to prevent disputes between FTB, the client agency, and health care recipients.
6. The health care data that FTB would receive for the enforcement of the individual mandate consists of qualified health care data that is subject to HIPAA requirements related to the handling, storage, transmission, and use of this type of sensitive data. If FTB is determined to be bound by HIPAA, to the extent that existing systems and processes related to data security and transmission of tax data are inadequate in meeting the HIPAA requirements, additional costs would be incurred to develop a compliant system and program. The "Fiscal Impact" estimate below includes estimates of these additional costs.

LEGISLATIVE HISTORY

ABX1 2 (Author not indicated, 2007/2008) is substantially similar to this bill. It would enact the California Health Care Reform and Cost Control Act, which would create a new entity to serve as a health care purchasing pool and make other changes to health care related provisions of several California Codes. It would require every individual in this state to maintain a minimum policy of health care coverage for himself or herself and his or her dependents. It would state the intent to finance the new programs through contributions from various sources, including payments by acute care hospitals and employers. The bill is currently in the Assembly Health Committee.

AB 8 (Nunez, 2007/2008) would have created CalCHIPP to serve as a health care purchasing pool for employers and make other changes to health care related provisions of several California Codes. It would require employers to make health care expenditures or elect to pay an in-lieu fee to a specified fund. It would also require employers to set up a cafeteria plan under IRC section 125. The bill was vetoed by Governor Schwarzenegger. See attached veto message in Appendix 1.

SB 48 (Perata, 2007/2008), prior to the June 25, 2007, amendment would have established the California Health Care Coverage and Cost Control Act, which would require every individual with income subject to the Personal Income Tax to maintain a minimum policy of health care beginning January 1, 2011. The bill would have also permitted employers to elect to pay a fee in lieu of making health care expenditures and mandate certain employers to adopt and maintain an IRC section 125 plan. The bill was held in the Assembly Appropriations Committee.

SB 840 (Kuehl, et al., 2007/2008) would create the California Health Insurance System that would provide health care benefits to all individuals in the state. It would also create the California Health Insurance Premium Commission. FTB's Executive Officer would be required to be a member of the commission. This bill was held in the Assembly Appropriations Committee.

SB 840 (Kuehl, 2005/2006) would have established the California Health Insurance System and California Health Insurance Premium Commission. FTB's Executive Officer would be required to be a member of the commission. The bill was vetoed by Governor Schwarzenegger. See attached veto message in Appendix II.

AB 1952 (Nation, 2005/2006) would have established the California Essential Health Benefits Program and require FTB to distribute information regarding newly mandated health care coverage requirements. This bill was held in the Assembly Appropriations Committee.

AB 1528 (Cohn, et al., Stats. 2003, Ch. 702) contained provisions stricken prior to enactment that would have required California residents to have minimum essential health care benefits and FTB to distribute a form that provides information about those requirements.

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.

Of these states, only *Massachusetts* has enacted comprehensive health care reform similar to what is proposed by this bill. Key components and dates of the *Massachusetts* legislation are as follows:

- Health Reform is signed into law April 12, 2006.
- Effective July 1, 2007, with some exceptions, adults must have health insurance.
- All employers with 11 or more full-time-equivalent employees must offer a section 125 plan that meets certain standards. Employers who fail to do this may be charged part of the cost when an employee needs state help to pay for urgently needed medical care.
- Effective October 1, 2007, employers with 11 or more full-time-equivalent employees must make a "fair and reasonable" contribution toward an employee health plan or pay a state assessment of up to \$295 per employee, per year.
- By December 31, 2007, adults must show that they have enrolled in a health insurance plan or lose their 2007 personal exemption credit.
- By January 1, 2008, penalties increase for adults who do not have insurance to equal half the premium of the lowest-cost Health Connector-certified insurance plan.
- The Health Connector offers subsidized programs for low income individuals and unsubsidized programs for other individuals and small employers.

PROGRAM BACKGROUND

FTB currently collects debts referred from courts of 43 counties and maintains an inventory of approximately 1.1 million cases. In August 2004, legislation was enacted (SB 246, Stats. 2004, Ch. 380) making FTB's Court Ordered Debt (COD) program permanent and requiring FTB to expand participation to all 58 counties and superior courts. To meet this requirement, FTB initiated the Court Ordered Debt Expansion (CODE) Project to develop and implement a scalable collection and billing system. CODE is in development, and the department expects it to be functional by August 2009. CODE is expected to administer an inventory of approximately 8 million cases from potentially 190 different courts.

FISCAL IMPACT

FTB's implementation plans for the collection of health care premiums is contingent on the business requirements the client agency (MRMIB) would prescribe to determine both system and program functionality. In addition, it appears that HIPAA requirements, which are not currently incorporated into FTB systems or processes, would apply. Assuming that the business requirements would mirror similar non-tax debt collection programs administered by FTB, one-time system development costs are estimated to be approximately \$29.9 million (including 161.5 personnel years) spread over a two-year development schedule. Additional time to secure procurement of resources would be needed to implement this system. Ongoing annual system maintenance costs of approximately \$3.4 million (including 35.1 personnel years) would be required to implement this bill. System costs reflect costs developed for implementation of the CODE system, with adjustments made for risk factors associated with the following:

- Concurrent start up of both MRMIB and FTB systems,
- Timeline constraints (i.e., implementation is assumed to be required within a relatively short timeframe),
- Unknown business requirements, and
- Unknown HIPAA requirements.

One-time program support—i.e., departmental business area—costs are estimated to be approximately \$500,000 and annual ongoing program support costs are estimated to be approximately \$5.6 million (including 75 personnel years). Program costs reflect costs consistent with those required to administer the COD non-tax debt collection operations. When FTB and MRMIB agree upon business requirements, adjustments to these estimates should be made.

It is recommended that the bill be amended to include appropriation language that would provide funding to implement this provision. Lack of an appropriation will require the department to secure the funding through the normal budgetary process, which may further delay implementation of this provision.

ECONOMIC IMPACT

The provision that would require the FTB to collect on health care premium debts would have no impact on general fund revenues with the assumption that tax debts would be given higher priority in collection over health care premium debts. However, to the extent that health care premium debts are given priority in collection, there could be a significant impact on general fund revenues collected by the FTB.

REFUNDABLE INCOME TAX CREDIT

EFFECTIVE/OPERATIVE DATE

If enacted during the special session, this provision would be effective on the 91st day after adjournment of this special session. The bill indicates that this provision would be specifically operative for taxable years beginning on or after January 1, 2010, and before January 1, 2015.

ANALYSIS

FEDERAL/STATE LAW

Current federal law allows a refundable credit for health insurance costs of a narrow class of individuals—i.e., trade-displaced workers and certain pension recipients, as described in IRC section 35. An “eligible individual” may claim a refundable health coverage tax credit (HCTC) equal to 65% of his qualifying health insurance costs. Eligibility for the credit is determined on a monthly basis. A month is an eligible coverage month, but not before December, 2002, if as of the first day of that month the taxpayer is an “eligible individual,” is covered by qualified health insurance, does not have other specified—generally subsidized—coverage, and is not imprisoned under federal, state, or local authority. The credit cannot be claimed by an individual who may be claimed as a dependent on another person's tax return. IRS must pay the refundable health insurance costs credit in advance. California does not conform to this federal provision.

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Current federal law allows self-employed persons to deduct from gross income 100% of amounts paid for health insurance for themselves, spouses, and dependents, under certain circumstances. Individual taxpayers who itemize deductions may use medical expenses that exceed 7.5% of their federal AGI to reduce their taxable income. Unreimbursed insurance premiums paid for health care coverage are included as medical expenses for purposes of this deduction. California law conforms to these provisions.

THIS PROVISION

This provision would establish an income tax credit for individuals and families not eligible for government-subsidized coverage. The credit would be operative for taxable years beginning January 1, 2010, and before January 1, 2015, and would be structured as follows:

- The credit would equal the amount of qualified health coverage premiums paid by the taxpayer in excess of 5.5% of California AGI, but could not exceed specified maximums based on age and family status.⁶
- The credit would be gradually phased-out by 50% for California AGI that is from 300% to 400% of the federal poverty level (FPL).
- Qualified taxpayers would have a California AGI between 250% and 400% of the FPL, as defined, and could not be eligible to receive employer-subsidized coverage. However, a taxpayer could still be qualified to the extent of premiums paid for dependents⁷ if the employer plan excludes such dependents.
- Taxpayers eligible for coverage under the Cal-CHIP Healthy Families Plan or Medi-Cal program would not be eligible for the credit.
- Married couples could only claim the credit on a joint return.
- The amount of qualified health care plan premium costs would be 75% of the lesser of the amount of actual qualified premiums paid during the taxable year or the cost of a premium for “a plan from coverage choice category 3,” as determined by the MRMIB.
- The amount of credit in excess of a taxpayer’s personal income tax liability would be refundable only if appropriated by the Legislature.
- No credit could be claimed for two taxable years following a final determination that a disallowed credit was claimed due to fraud or reckless or intentional disregard of rules and regulations.
- Tax return preparers would be subject to a \$1,000 penalty for each failure to be diligent in determining eligibility for the credit. This penalty would generally be consistent with the penalty regime for the federal refundable earned income tax credit.

The bill authorizes MRMIB to provide a report to FTB that would include taxpayer and health care premium information to facilitate the administration of the credit by FTB. The bill would also authorize FTB to provide tax return information to MRMIB to administer advances of the credit, if authorized by the Legislature.

The bill provides that, only upon appropriation, amounts in the California Health Trust Fund (which would be established in this bill) would be transferred to FTB in an amount equal to the total amount of credits allowed.

The bill would state the intent of the Legislature to authorize this credit to be advanceable. If advances were authorized, MRMIB would administer the advance process and would apply such advances to pay health coverage premiums on behalf of an individual, spouse, and dependents.

⁶ FTB would be required to recompute the maximums annually based on the California Consumer Price Index, U Medical Care.

⁷ “Dependents” would be defined with reference to the individual mandate, meaning “spouse, registered domestic partner, minor child of the subscriber, or a child 18 years of age and over who is dependent on the subscriber, as defined by [MRMIB].”

In addition, the bill would state the intent of the Legislature to authorize a health care coverage credit for taxpayers who are 50 to 64 who do not qualify for the credit described above. This credit would be allowed only to the extent fiscal resources are available and subject to an appropriation, but could not exceed \$50 million annually.

IMPLEMENTATION CONSIDERATIONS

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

1. The bill would allow FTB to be reimbursed from the Health Care Trust Fund or General Fund for the aggregate amount of premium credits allowed only if appropriated. It appears that the bill intends that no premium credits be allowed unless an amount has first been appropriated for such credits. If there is no appropriation by the Legislature or in the annual Budget Act for the fiscal year in which the credit would be granted, FTB could not allow credits claimed. Lack of appropriation could result in a delay in processing all returns that claim the credit. Such delays may require payment of interest on any refunds due. It is also unclear how the credit would be administered if credits claimed exceeded the appropriated amount.
2. It is unclear whether departmental processes and systems would be subject to federal HIPAA requirements as a result of receipt of insurance premium data from MRMIB. An affirmative determination could significantly impact the department and, as noted below, substantially increase the department's costs to implement this proposal.
3. If it is intended that the credit be verified during initial personal income tax return processing, FTB would need premium data from MRMIB annually and as close to taxable year end as possible to minimize delay in issuing personal income tax refunds. In the alternative, returns claiming the credit prior to receiving data from MRMIB would be held, pending receipt of that information, until FTB has the historical experience to establish a reasonable threshold for allowing refunds during that period.
4. Refundable credits are susceptible to fraud. Resources would be necessary to detect and prevent fraud. Unlike the existing refundable child and dependent care credit, reliable third party information—from MRMIB—would presumably reduce fraud by increasing both detection and prevention. The risk of fraud would substantially increase if MRMIB is unable to provide the data necessary to verify upon initial processing the credits claimed.
5. At least two new lines would need to be added to individual tax returns to allow taxpayers to claim the credit and report any advances received, if authorized. Instructions would be added and a schedule or worksheet would be created to compute the credit. The addition of two lines may result in a 3-page return, which would increase annual costs as discussed, below, under Fiscal Impact.

6. Consistent with the law as it applies for refundable credits, any corrections to the credit in processing would be treated as a math error adjustment⁸ and billed to the taxpayer. Taxpayers wishing to dispute the adjustment would be required to pay the amount owing and file a claim for refund.
7. Unless it is modified, fewer taxpayers would be able to use the user-friendly Form 540 2EZ, California Resident Income Tax Return, because it does not require AGI or other information necessary to process the credit.
8. Individuals included on an income tax return may not match the individuals included in a family for health care coverage purposes. For example, a taxpayer may be required to purchase insurance pursuant to divorce agreement for a family member that is appropriately not included on his or her income tax return, such as a child reported as a dependent on another taxpayer's return. Because FTB would administer this credit based on the individuals included on the return, it is unclear how these issues would be reconciled.
9. The bill provides that only health care premiums purchased through MRMIB — presumably for enrollment in Cal-CHIPP — would be treated as a qualified premium. However, the bill also requires, as an option in a list, an individual to be eligible for the credit in order to be eligible to enroll in Cal-CHIPP. This would result in a circular, thus unadministrable, requirement.
10. The bill would authorize MRMIB to provide a report to FTB with specified health care information for each individual that purchases a health care plan through MRMIB. However, it does not authorize such information to be provided with respect to the dependents of the taxpayer for which health care was also purchased. In addition, FTB would need the age of each subscriber in order to apply the credit maximums. Such information would be necessary for the administration of the credit.
11. The language of the provision appears to require all funds deposited in the California Health Care Trust Fund to be transferred to FTB or MRMIB for purposes of the credit or advances of the credit, if authorized. However, other provisions of the bill authorize the Fund to be used for numerous purposes relating to this health care proposal. It is suggested this conflict in the use of the Fund be resolved.
12. The bill would permit a penalty on tax return preparers for failure to be diligent in determining eligibility for the credit. The bill authorizes FTB to modify a federal due diligence penalty as needed through instructions or notices. It is suggested that the bill be amended to provide an Administrative Procedures Act (APA) waiver to prevent a likely APA challenge on grounds that such modifications constitute an underground regulation.

⁸ An adjustment to a tax return balance due that is treated as a math error adjustment pursuant to applicable statutes is due upon notice and demand. A taxpayer may protest or appeal such an adjustment only after the adjustment amount is paid, at which point the taxpayer may file a claim for refund.

FISCAL IMPACT

Assuming this provision is amended to resolve implementation concerns described above, it is estimated that the department would incur costs of approximately \$1.6 million for first-year implementation and \$1 million in ongoing annual operational costs for FTB to implement and administer the refundable credit proposed in this bill.

The proposal would establish a refundable credit—that could be advanced, if authorized—for payment of premiums. These features would require the following:

- System changes requiring new programming and testing.
- Processing changes and additional keying requirements, which would include an interface with MRMIB for data to establish the amounts of premiums paid and premiums advanced, if authorized.
- Limited education and outreach efforts—it is assumed that there would be substantial education and outreach efforts with respect to the broader health care reform program handled by MRMIB or other health care organizations.
- Modifications to forms and instructions.
- Increased customer service inquiries through the call centers in the department.

In addition, the department could incur costs to collect increased accounts receivable as a result of this proposal (such as for advances made in excess of the credit allowed, if authorized), but such costs cannot be estimated because such an increase cannot be quantified. The present forms have limited space available for additional lines. If these changes, along with other pending legislation, increase the forms from two to three pages, the department would incur additional costs for revising the forms and instructions, printing, systems changes, processing, and storage.

Any change to the credit proposal could result in substantial changes in cost estimates. In addition, it is unclear whether departmental processes and systems would be subject to federal HIPAA requirements as a result of receipt of insurance premium data from MRMIB. Such requirements could substantially increase the department's costs to implement this proposal.

It is recommended that the bill be amended to include appropriation language that would provide funding to implement this provision. Lack of an appropriation will require the department to secure the funding through the normal budgetary process, which will delay implementation of this provision.

ECONOMIC IMPACT

As noted at the beginning of this analysis, staff understands that the revenue estimates, as well as the other fiscal analyses, for the different aspects of this bill are being developed by Jon Gruber. As such, even though FTB would typically be responsible for developing revenue estimates for changes to personal income and corporation tax law, department staff will not perform these analyses for the premium credit provision in this bill.

LEGAL IMPACT

It appears the intended credit would apply only to California residents, but not nonresidents, as those terms are defined for California income tax purposes. However, some nonresident individuals may nevertheless be subject to the individual mandate. This is because the concept of residency is defined differently for California income tax purposes than it would be for purposes of the individual mandate. The U.S. Supreme Court in *Lunding Et Ux. v. New York Appeals Tribunal et al.* (1998) 522 U.S. 287, found that New York's denial of an alimony deduction to nonresident taxpayers, while allowing such a deduction to resident taxpayers, was discriminatory and thus unconstitutional. Thus, if the intended health coverage premium credit in this provision is conditioned on residency in California, it may be subject to constitutional challenge.

ARGUMENTS/POLICY CONCERNS

1. Employees with employer-subsidized health plans would be ineligible for the credit and, therefore, would not be able to receive the same benefit that similarly-situated taxpayers would receive by purchasing health care coverage through MRMIB.
2. The credit would give a preference for MRMIB plans versus employer-subsidized plans by excluding individuals participating in employer plans from the credit.
3. California AGI may be an inadequate measure of need for assistance to pay for health care coverage. For example, AGI excludes deferred compensation. Also, significant income may be offset by large capital or partnership losses, resulting in a low AGI.
4. Conflicting tax policies come into play when a credit is provided for an item that is already deductible. In this case, unreimbursed or unsubsidized expenditures may be deductible by a taxpayer as an itemized deduction to the extent total medical expenses are in excess of 7.5% of AGI. Such expenses are fully deductible "above-the-line" by self-employed individuals. Providing both a credit and allowing the deduction would have the effect of providing a double benefit for that item or cost. On the other hand, making an adjustment to deny the deduction in order to eliminate the double benefit creates a difference between state and federal taxable income, which is contrary to the state's general federal conformity policy.
5. The bill provides for the same penalty—i.e., no credit could be claimed for two taxable years—if there is a final determination that a claimed credit was due to fraud or due to reckless or intentional disregard for rules and regulations. Because fraud is a more serious offense than reckless or intentional disregard of rules and regulations, the penalty for fraud should be stronger.

125 PLAN MANDATE

EFFECTIVE/OPERATIVE DATE

If enacted during the special session, this bill would be effective on the 91st day after adjournment of this special session, and specifically operative January 1, 2010.

ANALYSIS

FEDERAL/STATE LAW

Current federal law allows employers to extend certain benefits, including health care benefits, to employees without requiring inclusion of such benefits in the gross income of employees. For example, employees can exclude from gross income amounts received from an employer, directly or indirectly, as reimbursement for expenses for the medical care of the employee, the employee's spouse, and the employee's dependents. An employee also excludes from gross income the cost—that is, premiums paid—of employer-provided coverage under an accident or health plan.⁹ Insurance premiums paid for partners and more-than-2% S corporation shareholders are not excludable. Highly compensated individuals who benefit from an employer's "self-insured" medical reimbursement plan that discriminates in favor of "highly compensated employees," as those terms are defined, must include in income benefits not available to other participants in the plan.¹⁰

Under IRC section 125, current federal law allows employers to offer a choice of benefits—assuming such benefits are otherwise excluded from gross income under a specific provision of the IRC—or cash to employees. A plan under IRC section 125 is also known as a "cafeteria plan." It is a written plan under which employee-participants may choose their own "menu" of benefits consisting of cash and "qualified benefits." No amount is included in the gross income of the employee-participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan. Employer contributions to a cafeteria plan can be made under a salary reduction agreement with the employee-participant if it relates to compensation that hasn't been received by, and does not become currently available to, the participant.

A cafeteria plan can also include "flexible spending accounts" (FSAs) that are funded by employee contributions on a pre-tax salary reduction basis to provide coverage for specified expenses—such as qualified medical expenses or dependent care assistance—that are incurred during the coverage period and may be reimbursed.

IRC section 125 provides special rules with respect to plans that discriminate based on eligibility and benefits in favor of "highly compensated participants" and "key employees."

The practical benefit of cafeteria plans is that employees may make contributions in payment of benefits, such as insurance premiums, on a pre-tax basis. Such contributions reduce the amount of wages that would otherwise be subject to income, social security, and Medicare taxes for both the employee and employer.¹¹ Federal law does not require employers to establish cafeteria plans and does not mandate the type of benefit choices offered in the plan as long as the benefits are otherwise "qualified" under applicable provisions of the IRC.

⁹ IRC § 106.

¹⁰ IRC § 105(h).

¹¹ For federal purposes, under the Federal Insurance Contributions Act (FICA), in addition to withholding for personal income tax, wages are subject to withholding for both social security (also known as OASDI for Old Age, Survivors, and Disability Insurance) and Medicare. For 2007, the social security tax wage base limit is \$97,500. The employee tax rate is 6.2%, for a maximum contribution of \$6,045. The employee tax rate for Medicare is 1.45%. There is no wage base limit for Medicare tax. Employers are required to pay social security and Medicare tax on wages paid in the same amount of the employee contribution.

Except for the social security and Medicare deductions, California generally conforms to federal law in this area.

THIS PROVISION

This provision would add a new division to the Unemployment Insurance Code (UIC) to require employers with one or more employees in this state to adopt and maintain a cafeteria plan pursuant to IRC section 125 for the purpose of allowing employees to pay premiums for health care coverage. Penalties in an amount per employee would apply to any employer that failed to meet this requirement. The provision would provide definitions of key terms, such as employer and full-time equivalent employee. EDD would be required to establish rules and regulations to implement this provision.

IMPLEMENTATION CONSIDERATIONS

It appears EDD would be required to administer and enforce the 125 plan mandate because this provision would reside in the UIC and would require EDD to establish rules and regulations to implement this provision. Generally, EDD administers employer-related laws and has an existing reporting and enforcement relationship with businesses in the businesses' capacity as employers. As such, this provision would not impact the department's programs or operations.

FISCAL IMPACT

This bill would not impact the department's costs.

ECONOMIC IMPACT

As noted at the beginning of this analysis, this bill would cause an increase in the number of employees making contributions for health insurance premiums through section 125 plans. The amount of tax reduction resulting from increased section 125 use depends crucially on the estimated behavioral responses to the provisions of this bill. In fact, the tax reduction amounts are truly secondary to the overall expenditure impacts of this bill. Because the impacts that staff would be estimating are secondary and because the estimate of behavioral responses to the various provisions in this bill are being made elsewhere, it does not seem appropriate or helpful to generate revenue estimates that may or may not be aligned with the assumptions and estimates used to determine the primary impacts of this bill.

Furthermore, staff understands that Jon Gruber, who has developed the model to simulate the primary impacts of these proposals, will be developing estimates of these secondary impacts.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO ABX1 2
As Amended December 17, 2007

AMENDMENT 1

On page 150, line 3, ~~strikeout "dependent"~~ and insert:

dependent,

AMENDMENT 2

On page 152, line 6, ~~strikeout "credit"~~ insert:

credit, as may be authorized in accordance with the intent reflected in
Section 17052.31,

AMENDMENT 3

On page 152, lines 25 and 26, ~~strikeout "December 31, 2015,"~~ and insert:

December 1, 2016,

AMENDMENT 4

On page 156, line 24, ~~strikeout "Section 12699.215"~~ and insert:

Section 12699.212

Appendix I

BILL NUMBER: AB 8
VETOED DATE: 10/12/2007

To the Members of the California State Assembly:

I am returning Assembly Bill 8 without my signature.

While I appreciate the Legislature's efforts to reform our broken health care system and applaud the hard work that has gone into AB 8, I cannot sign this bill. AB 8 would put more pressure on an already broken system.

AB 8 does not achieve coverage for all, a critical step needed to reduce health care costs for everyone. Comprehensive reform cannot leave Californians vulnerable to loss or denial of coverage when they need it most. Finally, to be sustainable, comprehensive reform cannot place the majority of the financial burden on any one segment of our economy. Unfortunately, AB 8 falls short on all three accounts.

California needs a financially sustainable health care reform plan that shares responsibility, covers all Californians and keeps our emergency rooms open and operating. I cannot support reform efforts that fall short of these goals and threaten to weaken our already broken system.

Sincerely,

Arnold Schwarzenegger

Appendix II

BILL NUMBER: SB 840
VETOED DATE: 09/22/2006

To the Members of the California State Senate: While I commend Sen. Sheila Kuehl's commitment and dedication to providing health care coverage for all Californians, I must return SB 840 without my signature because I cannot support a government-run health care system. Socialized medicine is not the solution to our state's health care problems. This bill would require an extraordinary redirection of public and private funding by creating a vast new bureaucracy to take over health insurance and medical care for Californians - a serious and expensive mistake. Such a program would cost the state billions and lead to significant new taxes on individuals and businesses, without solving the critical issue of affordability. I won't jeopardize the economy of our state for such a purpose. SB 840 relies on the failed old paradigm of using one source - this time the government - to solve the complex problem of providing medical care for our people. It uses the same one-sided approach tried in SB 2, the employer-mandated coverage measure signed into law before I became governor. I opposed SB 2 because it placed nearly the entire burden on employers, and voters repealed it in 2004. I want to see a new paradigm that addresses affordability, shared responsibility and the promotion of healthy living. Single payer, government-run health care does none of this. Yet it would reduce a person's ability to choose his or her own physician, make people wait longer for treatment and raise the cost of that treatment. With my partners in the Legislature, I look forward in 2007 to working to develop a comprehensive and systemic approach to health care that not only provides affordable medical treatment to people when they are ill, but that strives to make sure people don't get sick in the first place. An approach that supports cost containment and recognizes the shared responsibility of individuals, employers and government. That promotes personal responsibility and builds on existing private and public systems. As part of this comprehensive approach, my administration already has worked hard on the fight against obesity, a leading cause of disease in this country. I signed the landmark Healthy Schools Now Act, which bans junk food and sugar-laden drinks in public schools. Our budget included \$18 million to replace that junk food with fresh fruits and vegetables so we can start promoting healthy living choices for our youngsters. Recently I signed AB 2384 (Leno) to make fruits and vegetables more affordable and accessible in low-income communities and AB 2226 (Garcia) to help inform 7th grade students and their parents or guardian(s) of the risk of Type 2 Diabetes. Our efforts to effectively prevent and detect diseases extend far beyond obesity prevention. I recently signed legislation to ensure early detection of hearing loss through newborn hearing screenings (AB 2651- Jones). Since I've taken office we have expanded newborn health screenings from 33 to 85, dramatically increasing the ability to prevent or detect disease early to keep our children as healthy as possible from the beginning. On the question of access, I've made children's coverage a priority, resulting in nearly a quarter million additional

children covered by our Medi-Cal and Healthy Families programs. Building on an \$80 million budget investment to target uninsured children who are eligible, but not enrolled in state health care programs, I signed legislation to eliminate roadblocks to coverage, streamline enrollment for Medi-Cal and Healthy Families and reduce the number of kids that lose coverage due to administrative barriers. (SB 437 Escutia, AB 1948 Montanez, and AB 1851 Coto) And on the question of affordability, I reached agreement with the Legislature to provide discounts on prescription drugs of up to 40 - 60 percent off brand name and generic drugs for our neediest citizens.

But we're not stopping there. I convened a California Health Care Summit in July that for the first time brought together experts on all sides of this issue. At the table with us were representatives from academia, government, business, health care and labor. From that summit and follow-up meetings, there emerged a strong sense of how to proceed on health care reform. Affordability is the key to making our system work for everyone, and affordability is exactly what we are dedicating ourselves to. By implementing a statewide plan advancing health information technology that I called for in a recent executive order, we can shave billions of dollars off healthcare costs in California. By creating the 500 elementary school-based health centers I called for in our Health Summit, medical treatment will be more accessible to our children who need it most and they can avoid costly emergency care. We have made progress toward this goal by enacting legislation (AB 2561 Ridley-Thomas) to support Californias school health centers by increasing cross-agency collaboration, gathering data about services delivered in school health centers throughout the state and providing technical assistance to aid in the development of new and existing school health centers. With the same willingness to compromise that we showed this past legislative session on issues like global warming, I know we can reach our goals. I look forward to working with Sen. Kuehl and other members of the Legislature, as well as the experts who participated in our summit and other stakeholders, to create a healthier California. For these reasons, I am returning SB 840 without my signature.

Sincerely,

Arnold Schwarzenegger