**Franchise Tax Board**

# ANALYSIS OF ORIGINAL BILL

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| Author: | Perata/Kuehl | Analyst: | Anne Mazur | Bill Number: | SB 48 |
| Related Bills: | See Legislative History | Telephone: | 845-5404 | Introduced Date: | January 3, 2007 |
| | | Attorney: | Tommy Leung | Sponsor: | |

**SUBJECT**: California Health Care Coverage And Cost Control Act/Mandatory Employee Health Care Coverage/Disallowance Of Adjusted Personal Exemption Credit If Failure To Comply


## SUMMARY

This bill would do the following:

- Require every employed person or self-employed person to maintain a minimum policy of health care,
- Require the Franchise Tax Board (FTB) to increase or deny the amount of personal exemption credits permitted against tax based on a taxpayer's compliance or failure to comply with the health insurance mandate under this act.

The bill contains additional provisions related to proposed and existing health care coverage programs that do not impact the department's operations or programs, and therefore are not discussed in this analysis.


## PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to ensure that California's working adults and their families have access to affordable health insurance.

## EFFECTIVE/OPERATIVE DATE

As an appropriations bill, this bill would be effective immediately upon enactment. This bill does not specify a date upon which its provisions would become operative.

## POSITION

Pending.

## ANALYSIS

STATE LAW

State law provides various exemption credits, including a personal exemption credit and exemption credits for dependents, blind persons, and individuals 65 or older. Unlike federal law, these exemptions are not deductions from adjusted gross income (AGI), but instead are credits against tax. The exemption credit amounts for the 2006 taxable year are equal to $285 per dependent and $91 per all other exemptions.

| Board Position: | | | Department Director | Date |
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The exemption credit amounts are indexed annually for inflation. The exemption credits are not refundable and may not be carried over to future years. Exemption credits begin to phase out at federal AGI levels in excess of the amounts listed below:

| Filing Status | AGI (2006) |
|---|---|
| Single/Married Filing Separate | $150,743 |
| Married Filing Joint/Qualifying widow(er) | $301,491 |
| Head of Household | $226,119 |

The exemption credit amount is reduced by six dollars for every $2,500 ($1,250 for married filing a separate return) that the taxpayer's federal AGI exceeds the above threshold amounts, not to exceed the full amount of the credit. Taxpayers that file a joint return or a return as a surviving spouse must reduce their credit by $12 for every $2,500 that the taxpayer's federal AGI exceeds the above threshold amounts.

Under current federal and state law, an employer's payment of health insurance premiums for employees and their families is generally deductible if it is ordinary and necessary business expense. Individual taxpayers who itemize deductions may use medical expenses that exceed 7.5% of their federal AGI to reduce their taxable income. Insurance premiums paid for health care coverage are included as medical expenses for purposes of this deduction.

THIS BILL

This bill would require every employed or self-employed person in this state to maintain a minimum policy of health care coverage[1] for the person and dependents. The bill would amend the Revenue and Taxation Code to disallow a personal exemption credit for the taxpayer and the taxpayer's dependents for any tax year for which the taxpayer fails to comply with the requirement to maintain a minimum health care policy. In the case of joint returns, if one spouse was in compliance and the other was not, the personal exemption credit would be reduced by half.

The bill would require FTB to estimate the revenue gain from the aggregate disallowance of personal exemption credits for each tax year and, based on this amount, proportionately increase the personal exemption credits for that same tax year for all taxpayers that demonstrate compliance with the health care coverage requirement. The bill specifies that the estimate of revenue lost from increasing personal exemption credits should equal the estimate of revenue gain from disallowing personal exemption credits.

In addition, this bill would require employers to provide health care coverage to employees and dependents that results in the expenditure of an unspecified percentage of social security wages paid by the employer or allow employers to elect to have that coverage provided through a purchasing pool upon payment of an equivalent amount by the employer into a specified fund. Employers who elect the latter would be required to collect and transmit to the state an employee contribution in an amount equal to an unspecified percent of an employee's social security wages.

[1] The minimum policy of health care coverage would be determined by the existing Managed Risk Medical Insurance Board.

IMPLEMENTATION CONSIDERATIONS

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

1. The timeline in which the author intends for the provisions of this bill—in particular, the worker mandate and associated tax enforcement—to be completed is not specified. It appears that the majority of the bill's provisions would need to be implemented before the department would be able to perform any verification or adjustment of exemption credits. It is recommended that the expected implementation timeline be clarified to ensure consistent implementation among all departments.

2. The bill does not specify how, when, and to what department taxpayers would demonstrate compliance. This requirement is necessary to determine how and when FTB would implement the provisions of this bill, i.e., whether verification of compliance with the mandate would be an automated or manual process and whether verification would occur during initial tax return processing or at some point after initial processing.

3. The bill does not specify how and when the disallowance or increase of exemption credits would be applied. For example, it is unclear whether taxpayers would voluntarily disallow or increase the credit on their returns or if such adjustments would be made to applicable returns as they are processed.

4. The bill's health coverage mandate refers to the "employed or self-employed in this state." It is recommended the bill be clarified to specify whether it is intended to implicate all workers earning California wages. It is also recommended that the bill clarify the intended result for taxpayers that fail to comply during a portion of the year due, for example, to change in employment status.

5. It is unclear from the bill what definition of "dependent" would be used to determine compliance and the corresponding tax treatment. A dependent for purposes of health coverage may not be the same as a dependent for purposes of the exemption credit; it is unclear how such differences would be reconciled.

6. The bill specifies that the credit would be increased "proportionately" for taxpayers that are in compliance. It is recommended that the bill clarify in relation to what the proportionate calculation would be made. The tax forms and instructions list the dollar amount of exemption credit a taxpayer can use. Any revisions to the credit amount must be known before the forms and instructions are printed.

7. It is unclear from the bill whether an employee would be required to obtain insurance through their employer or whether coverage under a spouse's or parent's plan would be considered compliance with the mandate. The intended result is also unclear for situations where some, but not all, dependents are covered under the working taxpayer's policy.

8. The bill states that if on a joint return one spouse is in compliance and one spouse is not, the exemption will be reduced by half. It is recommended the bill clarify whether working spouses must be covered separately through their respective employers or if one working spouse can be covered by the other spouse's insurance and still be in compliance.

## LEGISLATIVE HISTORY

SB 1014 (Kuehl, 2007/2008) would establish a single-payer health care coverage tax consisting of personal income and payroll taxes of unspecified rates and the resulting revenue received by FTB would be deposited in the Health Insurance Fund. The bill is currently in the Senate Rules 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 the Governor stating in part, "…I cannot support a government-run health care system."

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.

## FISCAL IMPACT

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved, but could be significant.

This bill would require a disallowance or increase of the exemption credit that, at a minimum, would require changes to accounting systems and revisions to tax form instructions. As a result, this bill would impact the department's systems programming, printing, processing and storage costs for tax returns. These changes could be processed through normal annual updates.

## ECONOMIC IMPACT

This bill would require a minimum employer contribution for employee health care. Because an employer's payment of health insurance premiums for employees is generally deductible as a business expense, any changes in the amount of employer expenditures in response to this bill impact tax revenues. In addition, the bill could impact revenues if it causes changes in tax-deductible employee contributions to health care plans. Because the minimum contribution levels for this bill have not been established, these revenue impacts are unable to be quantified.

This bill would also disallow exemptions for employees who fail to carry health care insurance. The bill would redistribute the revenues raised from this disallowance to taxpayers who are compliant. Because this bill is designed so that the redistribution will offset the denied exemptions, it is estimated that this portion of the bill would have no revenue impact.

## LEGAL IMPACT

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[2] because the Act directly regulates employers' provision of healthcare benefits, and therefore has a "connection with" covered employers' ERISA plans. The Act required every employer of 10,000 or more Maryland employees to pay to Maryland an amount that equals the difference between what the employer spends on "health insurance costs" and 8% of its payroll. The court invalidated the Act, concluding that the effect of the Act is to mandate health care spending increases and leaves employers no reasonable choices except to change how they structure their employee benefit plans. Although the outcome of this decision and its effects on the applicable laws of other states, including California, is unknown, similar mandates involving covered ERISA plans may also be preempted by ERISA.

## POLICY CONCERNS

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

Not all taxpayers may claim the nonrefundable personal exemption credit and therefore the enforcement method would have no effect on those taxpayers, either for noncompliance or demonstrated compliance. For example, some taxpayers have no filing requirement because their taxable income is below specified thresholds. Also, for some taxpayers, the exemption credit is phased-out because their federal AGI is above specified thresholds.

## LEGISLATIVE STAFF CONTACT

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[2] Federal Employee Retirement Income Security Act of 1974.