

SUMMARY ANALYSIS OF AMENDED BILL

Author: Perata/Kuehl Analyst: Anne Mazur Bill Number: SB 48

May 1, 2007

Related Bills: See Prior Analysis Telephone: 845-5404 Amended Date: April 18, 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/Require Employers Electing To Pay The Health Care Fee To Establish Section 125 Plan

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

AMENDMENTS IMPACT REVENUE. A new revenue discussion is provided.

AMENDMENTS DID NOT RESOLVE ALL OF THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced January 3, 2007.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO _____.

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

OTHER – See comments below.

SUMMARY

This bill would do the following:

- Require every individual with income subject to personal income tax to maintain a minimum policy of health care (individual mandate),
- 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.
- Require employers to elect to make health care expenditures of an unspecified amount or pay an equivalent amount to a specified fund, and require certain employees to make a health care coverage contribution for deposit into a specified fund.
- Require specified employers to adopt an Internal Revenue Code (IRC) section 125 plan (125 plan).

Board Position:	Legislative Director	Date
<input type="checkbox"/> S <input type="checkbox"/> NA <input type="checkbox"/> NP <input type="checkbox"/> SA <input type="checkbox"/> O <input type="checkbox"/> NAR <input type="checkbox"/> N <input type="checkbox"/> OUA <input checked="" type="checkbox"/> PENDING	Brian Putler	5/24/07

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.

SUMMARY OF AMENDMENTS

The April 18, 2007, amendments made the following changes:

- Replaced provisions of the Labor Code that would be added by this bill relating to "Employee Health Care Coverage," including a health care coverage mandate for every individual, as defined, a requirement for employers to elect to make health care expenditures of a certain amount or pay an equivalent amount to a specified fund, and a requirement for certain employees to make a health care coverage contribution for deposit into a specified fund.
- Revised provisions that would be added to the Revenue and Taxation Code (R&TC) relating to enforcement of the individual mandate.
- Added a provision to the R&TC to allow information furnished or secured by FTB to be used to facilitate the administrations of the individual mandate.
- Added a provision that would be added to the R&TC to require specified employers to adopt and maintain a 125 plan.

The May 1, 2007, amendments made the following changes:

- Added a limit based on employee health care coverage contributions.
- Added an exception for the individual mandate based on family income for certain individuals.
- Revised the 125 plan mandate to be limited to those employers that elect to pay the employer health care fee.

The amendments resolved some—relating to implementation timeline, demonstration of coverage, coverage of spouses, and credit adjustments—but not all implementation concerns described in the analysis of the bill as introduced January 3, 2007. Due to the broadened scope of the bill, a full analysis is included below, revised to address the amendments.

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

This bill would become effective January 1, 2008. The bill specifies that the individual mandate and 125 plan mandate would apply beginning January 1, 2011. The bill also specifies that individuals would be required to report health care coverage information on their personal income tax returns for taxable years beginning on or after January 1, 2011.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Personal Exemption Credits

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.

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.

Health Care Expenses

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 an 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.

Health Care Benefits

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.¹

¹ IRC § 106.

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.²

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 called 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 social security and Medicare taxes for both the employee and employer.³ 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.

California generally conforms to federal law in this area.

² IRC § 105(h).

³ 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.

THIS BILL

Starting January 1, 2011, this bill would amend the Labor Code to require employers to elect either to make health care expenditures in an amount equal to an unspecified percentage of social security wages paid to full or part-time employees or both, as defined, or to pay the employer health care fee in an equivalent amount to the Health Insurance Trust Fund (Fund). Employees of employers electing to pay the fee would be required to make a health care coverage contribution to the Employment Development Department (EDD) for deposit in the Health Insurance Trust Fund. The amount of the employee contribution would be determined by the Managed Risk Medical Insurance Board (MRMIB), but would not exceed a threshold ranging from zero to 5% of family income, depending on family income level, after considering the employee's tax savings by making the contributions pre-tax via a 125 plan.

Also starting January 1, 2011, this bill would require every individual in this state who receives income subject to the Personal Income Tax Law (PITL) to maintain a minimum policy of health care coverage⁴ for him or herself and dependents. The individual mandate would not apply to individuals for which any of the following applies:

- Family income is less than 400% of the federal poverty level.
- Sole source of income is qualified retirement income, as defined.
- Cost of the minimum policy of health care coverage exceeds 5% of family income.

The bill would define the term "dependents" with reference to IRC section 152, which generally includes a qualifying relative or qualifying child, as applicable for purposes of the PITL. Certain support, relationship, age, citizenship, and other tests apply.

The bill would permit the use, subject to specified federal limitations, of tax information furnished or secured by FTB to facilitate the administration of the individual mandate.

For taxable years beginning on or after January 1, 2011, the bill would amend the R&TC to require personal income tax return forms to be revised to require taxpayers to indicate the existence of, or exemption from, health care coverage for the taxpayer and their dependents shown on the return during the calendar year ending in the taxable year of the return.

The bill would allow a personal exemption credit only to those individuals having the required health care coverage under the individual mandate. 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 provide that any resulting denial or reduction of a personal exemption credit based on information disclosed on a tax return could be treated as a math error, that is, the balance due would be immediately due and no pre-payment remedy would be provided.

⁴ The minimum policy of health care coverage would be determined by the existing Managed Risk Medical Insurance Board.

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.

The bill also would permit FTB to prescribe regulations if necessary to enforce compliance with the individual mandate and the purposes of the California Health Care Coverage and Cost Control Act.

This bill would add provisions to the R&TC that would require employers that elect to pay the employer health care fee during a taxable year to adopt and maintain a 125 plan, also known as a cafeteria plan, to provide accident or health plan coverage to the employee. The bill states that, at a minimum, the plan must include premium-only products for health insurance purposes.

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 bill would provide exceptions to the individual mandate based on the term "family income." This term is undefined and it is not clear when or how it would be measured. Further, FTB would need to know the dollar amount of the minimum policy as it applies to individuals or families, as applicable, and would need to develop a method of obtaining that information and family income data in order to enforce the mandate and determine compliance.
2. 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.
3. The bill's individual mandate refers to the "individuals in this state." It is recommended the bill be clarified to specify whether it is intended to implicate all individuals with California source income or a narrower class of individuals.
4. Although the bill defines the term "dependent" with reference to IRC section 152 as it applies for California purposes, such definition may not be consistent with the definition of "dependent" for purposes of health coverage; it is unclear how such differences would be reconciled. The intended result is also unclear for situations where some, but not all, dependents are covered under the taxpayer's policy.

5. The bill provides “Unless federal law or the law of this state provides otherwise, each employer in this state” must adopt and maintain a cafeteria plan. It is not clear what certain terms in the preceding phrase are intended to mean. Presumably, the limitations with respect to “federal law” are intended to reflect that California cannot enact laws to compel action by the federal government, unless the federal government has a law to require such action. In this case, California could not compel a federal employer to adopt and maintain a cafeteria plan for its employees. The same problem would probably exist for a federally recognized Indian Tribe. The phrase “employer in this state” also lacks clarity. The absence of a definition to clarify this term could lead to disputes with employers and would complicate the administration of this mandate. Another provision of the bill (on page 37, beginning on line 34) defines “employer” for purposes of that section—relating to the administration of employer and employee contributions to the Fund. The author may wish to consider referencing that same definition for purposes of the 125 mandate.
6. Although the bill would place the 125 mandate language in the parts of the Revenue and Taxation Code administered by FTB, it is unclear which state department would be responsible for enforcing this mandate. FTB does not have administrative authority over taxpayers in their capacity as employers. Generally, the Employment Development Department administers employer-related laws and has an existing reporting and enforcement relationship with businesses in the businesses’ capacity as employers.
7. The bill would not provide a consequence for failure to comply with the mandate. The author may wish to consider an appropriate enforcement tool to encourage compliance with the mandate.
8. The bill provides a limit of the amount of the health care coverage contribution that employees would be required to make to the fund. The limit would be a percentage of “family income” after taking into account tax savings from making such contributions on a pre-tax basis through a 125 plan. This calculation appears to be circular. The contribution limit could not be determined until family income with 125 plan tax savings is determined, but the 125 plan tax savings could not be determined until the amount of the contribution is known.

TECHNICAL CONSIDERATIONS

Because the 125 plan mandate in this bill would place a requirement on employers to provide a vehicle for employees to purchase health care benefits with pre-tax dollars, this provision might more appropriately reside in another code, such as the Labor Code, where it would have statutory proximity to the employer health care fee election.

LEGISLATIVE HISTORY

AB 8 (Nuñez, 2007/2008) would create the California Cooperative Health Insurance Purchasing Program 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. This bill is currently in the Senate 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 is currently in the Senate Appropriations Committee.

SB 1014 (Kuehl, 2007/2008) would establish a single-payer health care coverage tax consisting of personal income and payroll taxes of certain specified and unspecified rates and the resulting revenue received by FTB would be deposited in the Health Insurance Fund. The bill is currently in the Senate Revenue and Taxation 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.

SB 1784 (Kuehl, 2005/2006) would have imposed on individuals an additional tax on taxable income, self-employment income, and nonwage income in the same manner as in SB 1014. This bill was held in Senate policy committees.

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

This bill would require new lines on personal income tax return forms and a disallowance or increase of the exemption credit that, at a minimum, would require changes to accounting systems and revisions to tax forms and instructions. As a result, this bill would impact the department's systems programming, printing, processing, and storage costs for tax returns.

However, the department's costs to administer this bill cannot be determined until implementation concerns have been fully identified and resolved, but are anticipated to be significant. Costs could be substantially greater depending on whether, and to what extent, FTB would be responsible for administering and enforcing the 125 plan mandate, in addition to enforcing the individual mandate. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested.

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 would impact tax revenues. In addition, the bill could impact revenues to the extent 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.

The revenue impact of the 125 plan mandate would depend on the number of employers who elect to pay the fee to the Health Insurance Trust Fund. This number would in turn depend on the percentage of the social security wages that employers are required to spend on employee health care coverage. If this percentage is less than what an employer already spends on employee health care coverage, then the employer would probably continue its current practice. The proposal, therefore, would not have any revenue impact as far as that employer is concerned. If this percentage is higher, then the 125 plan mandate could have a revenue impact. This is because the employer in the latter case would be confronted by a choice of whether to spend the required amount to provide health care coverage directly to employees or indirectly through the Health Insurance Trust Fund. Because this percentage has not yet been specified, the revenue impact cannot be quantified.

This bill would also disallow exemption credits for individuals 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 ERISA⁵ 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. The Maryland Attorney General did not appeal this decision. Although the effects of this decision on the applicable laws of other states, including California, is unknown, similar mandates involving covered ERISA plans may also be preempted by ERISA.

⁵ Federal Employee Retirement Income Security Act of 1974.

ARGUMENTS/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 do not have a 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.

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