

ANALYSIS OF AMENDED BILL

Author: Ashburn Analyst: Anne Mazur Bill Number: SB 820
 Related Bills: See Legislative History Telephone: 845-5404 Amended Date: April 9, 2007
 Attorney: Tommy Leung Sponsor: _____

SUBJECT: Employer Cafeteria Plan Administrative Costs Credit

SUMMARY

This bill would permit a credit against franchise and income tax for administrative costs associated with establishing a "cafeteria plan."

SUMMARY OF AMENDMENTS

The April 9, 2007, amendments deleted health care related legislative intent language and added provisions to the Revenue and Taxation Code (R&TC) that would establish a credit in both the personal income tax and corporation income tax laws.

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

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to create an economic incentive for employers to establish cafeteria plans for their employees to purchase health care benefits.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and would apply to taxable years beginning on or after January 1, 2007.

POSITION

Pending.

Board Position:

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Department Director

Lynette Iwafuchi
for Selvi Stanislaus

Date

6/5/07

ANALYSIS

FEDERAL/STATE LAW

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 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 Internal Revenue Code (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 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.

¹ IRC § 106.

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.

California generally conforms to federal law in this area.

Credits Generally

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.

THIS BILL

This bill would establish, under both the personal income and the corporation tax laws, a credit against franchise or income tax in the amount of 15% of administrative costs incurred by a qualified taxpayer in connection with establishing a cafeteria plan that provides health benefits to the taxpayers' employees. The bill would define the term "qualified taxpayer" as an employer.

The bill would define the term "cafeteria plan" as a qualified cafeteria plan as defined in IRC section 125, which is described in the Federal/State Law section of this analysis. It should be noted, however, that IRC section 125 does not use the term "*qualified* cafeteria plan." A technical consideration is included below to correct this error.

The bill would deny a deduction for any portion of expenses for which the credit is allowed and would not allow this credit for expenses for which any other credit under the personal or corporation income tax law was allowed. The bill would also allow any unused credit to be carried over for seven years.

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.

The bill would define the term "qualified taxpayer" as an employer. To assure clarity and to avoid disputes, the author may wish to further define the term "employer," possibly with reference to existing definitions in the California Unemployment Insurance Code.

The bill would allow the credit for administrative costs incurred in connection with "establishing" a cafeteria plan. It is unclear whether the term "establishing" includes expenses of both start-up and on-going costs to maintain the plan. The term "administrative costs" also lacks clarity. Staff suggests the bill be amended to provide a definition for these terms.

TECHNICAL CONSIDERATION

As described in the This Bill section of this analysis, this bill would define "cafeteria plan" as a qualified cafeteria plan within the meaning of IRC section 125. IRC section 125 does not use the term "*qualified* cafeteria plan." This suggested amendment would correct this error:

On page 2, lines 11 and 33, strikeout "qualified."

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 Assembly Appropriations Committee.

SB 48 (Perata, 2007/2008) would establish 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 also permit employers to elect to pay a fee in lieu of making health care expenditures and mandate certain employers adopt and maintain an IRC section 125 plan. The bill is currently in the Senate Appropriations Committee.

FISCAL IMPACT

If the bill is amended to resolve the implementation considerations addressed in this analysis, the department's costs are expected to be minor. The credit created by this bill would require a new form or worksheet to be developed to calculate the credit. As a result, this bill would impact the department's printing, processing, and storage costs for tax returns, the costs of which could be absorbed by the department.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, the Personal Income Tax and Corporation Tax revenue impact from this bill would be as follows:

Estimated Revenue Impact of SB 820 Effective 1/1/07 with Enactment After 6/30/07 (\$ in Millions)		
2007-08	2008-09	2009-10
- \$1.0	- \$1.0	- \$1.1

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

Revenue Discussion

The revenue impact of this bill depends on the number of new employers establishing a cafeteria or section 125 plan and the amount of tax credits that can be applied to reduce tax liabilities. There were 1,231,532 California employers in the third quarter of 2005, according to the Employment Development Department (EDD). National participation in section 125 plans in 2005 was 26%,⁴ according to a, suggesting that in California there were about 320,200 firms offering these section 125 plans (1,231,532 x .26 = 320,200). After applying a growth rate to the number of California employers in 2005 and the applicable percentage of employers projected to offer section 125 plans, the number of offering employers is projected to be 354,400 and 387,300, for 2006 and 2007, respectively.

⁴ National participation data was compiled by *Mercer National Survey of Employer-Sponsored Health Plans*.

Because it is assumed for purposes of this estimate that only expenses incurred in connection with the start-up of a plan would be eligible for the credit, the number of employers that would benefit from this credit would be equal to the incremental change in the number of offering employers from year to year. In the 2007 base year, the number of newly-offering employers that would be eligible for the credit would be 32,900 (387,300 offering employers in 2007 minus 354,400 in 2006 = 32,900). It is assumed that for 2007, the aggregate cost for California employers to set up a traditional section 125 plan, including fairness testing,⁵ would be approximately \$14 million (32,900 employers x \$425 cost per employer⁶ = \$14 million).

In 2007, credits generated would be \$2 million per year (\$14 million x .15 = \$2 million). The proposed credit would be \$64 per employer (\$425 x .15 = \$64). However, because employers can already deduct the \$425 as a business expense (worth a tax reduction of \$34 after applying an 8% tax rate), the net new value of the credit is \$30 per employer (\$64 - \$34). This reduces the cost of the credit to \$1 million per year (32,900 x \$30). Of credits generated, it is assumed that 50% would be applied in the tax year generated. Unapplied credits would be carried over and applied in the next year.

Should section 125 plans be made mandatory, potentially 904,000 additional employers would be eligible for the credit. The credits associated with plan set-up alone would be approximately \$60 million in the first year and then decrease to less than \$2 million per year thereafter.

ARGUMENTS/POLICY CONCERNS

This bill lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of the credit by the Legislature.

The bill defines "qualified taxpayer" as an "employer." Because the term "employer" lacks qualification, any employer with a California franchise or income tax liability could claim this credit, including an employer with no California employees, which may be inconsistent with the policy objective the author is trying to achieve.

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⁵ IRC section 125 contains provisions that prohibit eligibility or benefits discrimination favoring certain highly compensated or key employees.

⁶ Per interview with David Turner, Vice President of Business Plans, Inc., which has operated as a third party administrator of 125 plans for over 14 years, and anecdotal information.