

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Portantino Analyst: David Scott Bill Number: AB 1178  
Related Bills: See Legislative History Telephone: 845-5806 Amended Date: August 5, 2010  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Health Care Conformity

### SUMMARY

This bill would conform California law to the following federal tax laws:

- Provisions of the March, 2010, federal health care acts (the "Patient Protection Affordable Care Act" and the "Health Care and Education Reconciliation Act of 2010"); and,
- Federal health savings accounts (HSAs).

### SUMMARY OF AMENDMENTS

The August 5, 2010, amendments removed property tax law provisions of the bill, and added the following health care provisions (plus adds HSA provisions):

- Exclusion of therapeutic discovery project grant income;
- Exclusion of income from certain health-care related student loan repayment programs;
- Increase in the exclusion of employer-provided adoption assistance;
- Exclusion of health benefits provided by Indian tribal governments;
- Exclusion of income for medical benefits for adult children;
- Codification of the economic substance doctrine;
- Revisions to the definition of qualified medicine for certain health plans;
- Increase to the additional tax on non-qualified medical expenses for certain health plans;
- Denial of a deduction of the fee on pharmaceutical manufacturers and importers;
- Nondiscrimination safe harbors for small businesses establishing cafeteria plans;
- Limitation on the dollar amount of flexible spending arrangement (FSA) contributions;
- Increase to the adjusted-gross-income (AGI) threshold for deducting medical expenses;
- Denial of a deduction of the additional hospital insurance tax imposed on employees;
- Allows small businesses to have Exchange options in their cafeteria plans; and,
- Exclusion of the value of Free Choice Vouchers from income.

### PURPOSE OF THE BILL

The general purpose of conforming to numerous changes in federal law is to simplify both the preparation of California income tax returns and the administration of California income tax laws.

Board Position:	Department Director	Date
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**EFFECTIVE/OPERATIVE DATE**

As a tax levy, this bill would be effective immediately. Conformity to HSAs would be operative for taxable years beginning on or after January 1, 2013. The operative dates of the conformity provisions of the March, 2010, federal health care acts would be as follows:

<b>Act / Section</b>	<b>Description</b>	<b>Operative Date</b>
PPACA 9023	Exclusion of grants provided in lieu of therapeutic discovery project credits	Taxable years beginning on or after January 1, 2009
PPACA 10908	Exclusion of student loan forgiveness of certain health professionals	Operative for amounts received on or after January 1, 2010
PPACA 10909	Increase to the adoptions assistance exclusion	Taxable years beginning on or after January 1, 2010
PPACA 9021	Exclusion of tribal government health benefits	Operative for benefits/coverage provided after March 23, 2010
HCERA 1004	Exclusion for adult dependent health care benefits (dependents under 27)	Operative March 30, 2010
HCERA 1409	Codification of economic substance	Operative for transactions entered into after March 30, 2010
PPACA 9003	New limitations on FSA / HRA distributions	FSA and HRA - operative for expenses incurred on or after January 1, 2011.
PPACA 9004	Increase in additional tax on nonqualified MSA distributions	MSA - operative for disbursements made during taxable years beginning on or after January 1, 2011.
PPACA 9008	Denial of deduction of annual fee on branded prescription pharmaceutical manufacturers and importers	Calendar years beginning on or after January 1, 2011
PPACA 9022	Establishment of cafeteria plans for small businesses	Taxable years beginning on or after January 1, 2011
PPACA 9005	New limitations on FSA contributions	Taxable years beginning on or after January 1, 2013
PPACA 9013	Increase to the AGI threshold of the Schedule A medical expense deduction	Taxable years beginning on or after January 1, 2013
PPACA 9015	Denial of deduction for additional hospital insurance tax	Taxable years beginning on or after January 1, 2013
PPACA 1515	Adding Exchanges to cafeteria plans	Taxable years beginning on or after January 1, 2014
PPACA 10108	Exclusion of Free Choice Vouchers	Taxable years beginning on or after January 1, 2014

**POSITION**

Pending.

**Summary of Suggested Amendments**

Technical amendments are suggested and provided with this analysis.

In addition, amendment number seven is suggested to make the additional tax on the distribution for nonqualified medical expenses from an HSA consistent with the treatment for an MSA.

**(1) Conformity to Fifteen Provisions of the March, 2010, Federal Health Care Acts**

FEDERAL/STATE LAW

See the Franchise Tax Board’s (FTB’s) report titled [“Summary of March, 2010, Federal Health Care Acts”](#) for a detailed discussion of federal and state laws affected by this bill.

THIS BILL

This bill would conform to the following provisions, of the PPACA and the HCERA:

	<b>Act / Section</b>	<b>Description</b>
1	PPACA 9023	Exclusion of grants provided in lieu of therapeutic discovery project credits
2	PPACA 10908	Exclusion of student loan forgiveness of certain health professionals
3	PPACA 10909	Increase to the adoptions assistance exclusion
4	PPACA 9021	Exclusion of Indian tribal government health benefits
5	HCERA 1004	Exclusion for adult dependent health care benefits (dependents under 27)
6	HCERA 1409	Codification of economic substance
7	PPACA 9003	New limitations on FSA / HRA distributions
8	PPACA 9004	Increase in additional tax on nonqualified MSA distributions <i>(California’s additional tax would increase from 10 percent to 12.5 percent)</i>
9	PPACA 9008	Denial of deduction of annual fee on branded prescription pharmaceutical manufacturers and importers
10	PPACA 9022	Establishment of cafeteria plans for small businesses
11	PPACA 9005	New limitations on FSA contributions
12	PPACA 9013	Increase to the AGI threshold of the Schedule A medical expense deduction

13	PPACA 9015	Denial of deduction for additional hospital insurance tax
14	PPACA 1515	Adding Exchanges to cafeteria plans
15	PPACA 10108	Exclusion of Free Choice Vouchers

**(2) - HSAs**

FEDERAL/STATE LAW

Current Federal Law

*HSAs*

Under federal law, individuals with a High Deductible Health Plan (HDHP), and no other health plan other than a plan that provides certain permitted coverage, may establish an HSA.

In general, HSAs provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. In general, HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents.

Within limits, contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual in determining adjusted gross income (AGI).<sup>1</sup> Contributions to an HSA are excludable from income and employment taxes if made by the employer. Earnings on amounts in HSAs are not taxable. Distributions from an HSA for qualified medical expenses are not includible in gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 20 percent. The 20-percent additional tax does not apply if the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100 percent of the annual deductible under the HDHP,<sup>2</sup> or (2) \$3,050 in the case of self-only coverage and \$6,150 in the case of family coverage.<sup>3</sup> Contributions in excess of the maximum contribution amount are generally subject to a six-percent excise tax.

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<sup>1</sup> Adjusted Gross Income (AGI) is defined as gross income reduced by “above-the-line” deductions. Above-the-line deductions include certain trade or business deductions, contributions to an MSA, alimony paid, and contributions to pension and annuity plans.

<sup>2</sup> The limits are indexed for inflation. For 2010, a high deductible plan is a health plan that has a deductible that is at least \$1,200 for self-only coverage or \$2,400 for family coverage and that has an out-of-pocket expense limit that is no more than \$5,950 in the case of self-only coverage and \$11,900 in the case of family coverage.

<sup>3</sup> These amounts are for 2010, and are indexed for inflation.

*Health Flexible Spending Arrangements (FSAs) and Health Reimbursement Arrangements (HRAs)*

Arrangements commonly used by employers to reimburse medical expenses of their employees (and their spouses and dependents) include health FSAs and HRAs. Health FSAs typically are funded on a salary-reduction basis, meaning that employees are given the option to reduce current compensation and instead have the compensation used to reimburse the employee for medical expenses. If the health FSA meets certain requirements, then the compensation that is foregone is not includible in gross income or wages and reimbursements for medical care from the health FSA are excludable from gross income and wages. Health FSAs are subject to the general requirements relating to cafeteria plans, including a requirement that a cafeteria plan generally may not provide deferred compensation. This requirement often is referred to as the "use-it-or-lose-it rule."

HRAs operate in a manner similar to health FSAs, in that they are an employer-maintained arrangement that reimburses employees for medical expenses. Some of the rules applicable to HRAs and health FSAs are similar, e.g., the amounts in the arrangements can only be used to reimburse medical expenses and not for other purposes. Some of the rules are different. For example, HRAs cannot be funded on a salary-reduction basis, and the use-it-or-lose-it rule does not apply. Thus, amounts remaining at the end of the year may be carried forward to be used to reimburse medical expenses in the next year. Reimbursements for insurance covering medical care expenses are allowable reimbursements under an HRA, but not under a health FSA. Subject to certain limited exceptions, health FSAs and HRAs constitute other coverage under the HSA rules.

*Tax Relief and Health Care Act (TRHCA) of 2006 (Public Law 109-432), enacted December 20, 2006*

Starting in 2007, the TRHCA made the following six changes to HSAs:

1. FSA and HRA Terminations to Fund HSAs

Certain amounts in a health FSA or HRA are allowed to be distributed from the health FSA or HRA and contributed through a direct transfer to an HSA without violating the otherwise applicable requirements for such arrangements. The amount that can be distributed from a health FSA or HRA and contributed to an HSA may not exceed an amount equal to the lesser of (1) the balance in the health FSA or HRA as of September 21, 2006, or (2) the balance in the health FSA or HRA as of the date of the distribution.

2. Repeal of Annual Deductible Limitation on HSA Contributions

Limits on the annual deductible contributions that can be made to an HSA are modified so that the maximum deductible contribution is not limited to the annual deductible under the HDHP.

3. Modification of Cost-of-Living Adjustment

In the case of adjustments made for any taxable year beginning after 2007, the Consumer Price Index for a calendar year is determined as of the close of the 12-month period ending on March 31 of the calendar year (rather than August 31 as under present law) for the purpose of making cost-of-living adjustments for the HSA dollar amounts that are indexed for inflation (i.e., the contribution limits and the HDHP requirements).

4. Contribution Limitation Not Reduced for Part-Year Coverage

In general, starting in 2007, individuals who become covered under an HDHP in a month other than January are allowed to make the full deductible HSA contribution for the year rather than, as under prior law, being required to prorate the deduction based on the number of months the individual was enrolled in an HDHP.

5. Exception to Requirement for Employers to Make Comparable HSA Contributions

An exception to the comparable contribution requirements is enacted to allow employers to make larger HSA contributions for non-highly-compensated employees than for highly-compensated employees. For example, an employer is permitted to make a \$1,000 contribution to the HSA of each non-highly-compensated employee for a year without making contributions to the HSA of each highly-compensated employee.

6. One-Time Distribution from Individual Retirement Arrangements (IRAs) to Fund HSAs

A one-time contribution to an HSA of amounts distributed from an individual IRA is allowed. The contribution must be made in a direct trustee-to-trustee transfer. Amounts distributed from an IRA under these rules are not includible in income to the extent that the distribution would otherwise be includible in income. In addition, such distributions are not subject to the 10-percent additional tax on early distributions.

*PPACA (Public Law 111-148), enacted March 23, 2010*

Starting in 2011, the PPACA made the following changes to HSAs:

1. Increase in Additional Tax on Nonqualified Distributions

The additional tax on nonqualified HSA distributions was increased from 10 percent to 20 percent.

2. Distributions for Medicine Qualified Only if for Prescribed Drug or Insulin

With respect to medicines, the definition of medical expense for purposes of an HSA conformed to the definition for purposes of the itemized deduction for medical expenses, except that prescribed drug is determined without regard to whether the drug is available without a prescription. Thus, under the provision, the cost of over-the-counter medicines may not be reimbursed with excludible income through an HSA unless the medicine is prescribed by a physician.

### Current California Law

California has not conformed to any of the federal HSA provisions. The California personal income tax return starts with federal AGI and requires adjustments to be made for differences between federal and California law. Adjustments relating to HSAs are required under current law, as follows:

- A taxpayer taking a deduction on the federal personal income tax return is required to increase AGI on the taxpayer's California personal income tax return by the amount of the federal deduction.
- Any interest earned on the account is added to AGI on the taxpayer's California return.
- Contributions to an HSA made on the employee's behalf by their employer are added to AGI on the employee's California return. These include salary-reduction contributions made through a cafeteria plan.

Although California has not conformed to HSAs, California law is conformed to the federal rules for Archer Medical Savings Accounts (MSAs), and allows a deduction equal to the amount deducted on the federal return for the same taxable year. California imposes a 10 percent additional tax rather than the federal 20-percent additional tax on distributions from an MSA not used for qualified medical expenses.

Because a tax-free rollover from an MSA to an HSA is not allowed under California law, any distribution from an MSA that is rolled into an HSA must be added to AGI on the taxpayer's California return; and, as that MSA distribution is not treated as being made for qualified medical expenses, it would be subject to the MSA 10-percent additional tax.

Additionally, a federal tax-free qualified HSA funding distribution is not allowed under California law because California specifically does not conform to IRC section 223, relating to HSAs, even though California conforms to IRC section 408, relating to IRAs.

Under California law, any distribution from an IRA to an HSA must be added to AGI on the taxpayer's California return and would be subject to a two and one-half percent additional tax under the rules for premature distributions.

### THIS BILL

Starting with taxable years beginning on or after January 1, 2013, this bill would conform to the federal HSA provisions. Specifically, the bill would:

1. Allow the same above-the-line deduction for contributions to an HSA by or on behalf of an individual and adopt the rules applicable to the trust itself in order for the trust to be exempt from tax. In addition, the additional tax on nonqualified HSA distributions would be modified for California purposes to be two and one-half percent instead of the federal rate of 20 percent. Consistent with general conformity policy in other areas, the federal six percent excise tax on excess contributions and the federal estate tax provisions would not be conformed to by this bill.

2. Allow the same exclusion from an employee's gross income for the amount of any contributions to an HSA (including salary-reduction contributions made through a cafeteria plan) made on the employee's behalf by their employer.
3. Allow tax-free rollovers from MSAs to be made to HSAs, as well as tax-free rollovers between HSAs, without penalty.
4. Adopt the same \$50 penalty for failure to make required reports.

### IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

### **LEGISLATIVE HISTORY**

Appendix A contains a comprehensive listing of prior legislation regarding conformity to HSAs; however, recent HSA legislation is listed below.

AB 326 (Garrick, 2009/2010) was nearly identical to the HSA provisions of this bill. That bill failed to pass the Assembly Revenue and Taxation Committee.

AB 2041 (Villines, 2009/2010), would provide for conformity to the federal HSA provisions starting in taxable year 2010. AB 2041 is currently in Assembly Rules.

SB 353 (Dutton 2009/2010) was nearly identical to the HSA provisions of this bill, except that conformity to the federal HSA provisions would have applied starting in taxable year 2009. That bill was returned to the Secretary of the Senate pursuant to Joint Rule 56.

SB 1262 (Aanestad, 2009/2010), would provide for conformity to the federal HSA provisions starting in taxable year 2010. SB 1262 is currently in Senate Rules

SBX6 13 (Dutton, 2009/2010) is nearly identical to the HSA provisions of this bill. It would provide for conformity to the federal HSA provisions and would apply starting in taxable year 2010. SBX6 13 is currently in Senate Revenue and Taxation Committee.

SB X8 47 (Dutton, 2009/2010) is nearly identical to the HSA provisions of this bill. It would provide for conformity to the federal HSA provisions and would apply starting in taxable year 2010. SBX8 47 passed from the Senate Rules committee without further action.

**ECONOMIC IMPACT**

Revenue Estimate

AB 1178 AS AMENDED August 5, 2010 CONFORMITY TO: HEALTH SAVINGS ACCOUNTS PATIENT PROTECTION AND AFFORDABLE CARE ACT Public Law 111-148, March 23, 2010 HEALTH CARE AND EDUCATION RECONCILIATION ACT OF 2010 Public Law 111-152, March 30, 2010 Assumed Enactment Date By September 30, 2010							
Year	Section #	Title	2010-11	2011-12	2012-13	2013-14	2014-15
2013		Health Savings Accounts	\$0	\$0	-\$40,000,000	-\$80,000,000	-\$100,000,000
2009	PPACA 9023	Exclusion of grants provided in lieu of therapeutic discovery project credits	-\$1,100,000	-\$1,400,000	-\$800,000	-\$500,000	-\$200,000
	PPACA 10908	Exclusion for assistance provided to participants in state student loan repayment programs for certain health professionals	-\$600,000	-\$350,000	-\$350,000	-\$350,000	-\$350,000
2010	PPACA 10909	Expansion of adoption assistance programs	-\$2,700,000	-\$2,200,000	-\$800,000	-\$200,000	-\$200,000
	PPACA 9021	Exclusion of health benefits provided by Indian tribal governments	\$0	\$0	\$0	\$0	\$0
	HCERA 1004	Benefits for children under age of 27	-\$15,000,000	\$16,000,000	-\$19,000,000	-\$20,000,000	-\$22,000,000
	HCERA 1409	Codification of economic substance	Baseline	Baseline	Baseline	Baseline	Baseline
2011	PPACA 9003	Distributions for medicine qualified only if for prescribed drug or insulin	Baseline	Baseline	Baseline	Baseline	Baseline
	PPACA 9004	Increase in additional tax on distributions from Archer MSAs not used for qualified medical expenses (to 12.5%)	\$150,000	\$300,000	\$400,000	\$500,000	\$500,000
	PPACA 9008	Denial of deduction of annual fee on branded prescription pharmaceutical manufacturers and importers	\$3,800,000	\$12,000,000	\$14,000,000	\$13,000,000	\$14,000,000
	PPACA 9022	Establishment of simple cafeteria plans for small businesses (safe harbor)	\$0	\$0	\$0	\$0	\$0
2013	PPACA 9005, 10902 & HCERA 1403	Limitation on health flexible spending arrangements under cafeteria plans	Baseline	Baseline	Baseline	Baseline	Baseline
	PPACA 9013	Increased AGI Threshold to Itemize Deductions for Medical Expenses	\$0	\$0	\$4,600,000	\$46,000,000	\$48,000,000

	PPACA 9015	Exclusion of additional hospital insurance tax	\$0	\$0	\$2,400,000	\$4,400,000	\$4,900,000
2014	PPACA 1515	Small Business Health Options program	Included in estimate of section 9022 (see above)				
	PPACA 10108	Exclusion of free choice vouchers	\$0	\$0	\$0	-\$9,000,000	-\$16,000,000
Total			-\$15,450,000	-\$7,650,000	-\$39,550,000	-\$46,150,000	-\$71,350,000

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO AB 1178  
As Amended on August 5, 2010

AMENDMENT 1

On page 3, line 21, strikeout "2013", and insert:

2018

AMENDMENT 2

On page 3, line 30, strikeout "2013", and insert:

2018

AMENDMENT 3

On page 5, strikeout lines 14 and 15, and insert:

(c) Nothing in enactment of this section shall be construed to create an inference with respect to the exclusion of gross

AMENDMENT 4

On page 6, line 11, strikeout "health savings accounts" and insert:

contributions by employer to accident and health plans

AMENDMENT 5

On page 7, line 10, after "(c)" insert:

For taxable years beginning before January 1, 2011,

AMENDMENT 6

On page 8, line 1, strikeout "as amended by", strikeout lines 2 and 3, inclusive, and on line 4 strikeout "Care Act of 2006 (Public Law 109-432)" and insert:

as amended by the Health Care and Education Reconciliation Act of 2010 (Public Law 111-152,

AMENDMENT 7

On page 8, line 11, strikeout "2 1/2 percent" for "10 percent", and insert:

"12 ½ percent" for "20 percent"

AMENDMENT 8

On page 9, line 22 to 30, inclusive, and insert:

(b) Any individual who is required to furnish information under Section 17508 as to the amount of designated nondeductible contributions made for any taxable year, and overstates the amount of those contributions made for that taxable year, shall pay a penalty of one hundred dollars (\$100) for each overstatement, unless it is shown that the overstatement is due to reasonable cause.

AMENDMENT 9

On page 11, line 33, after "(e)" insert:

(1)

AMENDMENT 10

On page 11, line 36, strikeout "(a)".

AMENDMENT 11

On page 12, ~~strikeout~~ lines 1 to 5, inclusive and insert:

of an understatement attributable to that transaction.

(2) No court or administrative agency shall abate a penalty imposed pursuant to paragraph (1) of this subdivision unless the taxpayer establishes, by clear and convincing evidence, that the imposition of the federal penalty under Section 6662 of the Internal Revenue Code for an underpayment attributable to that transaction was clearly erroneous.

(3) Any penalty imposed under this subdivision shall also remain eligible for relief under subdivision (d).

## Appendix A

### Legislative History

Bill Number	Description	Status
AB 84 (Nakanishi/Smyth, 2007/2008)	Conformity to the federal HSA provisions starting in taxable year 2008.	This bill was held in the Assembly Revenue and Taxation Committee.
AB 142 (Plescia, 2007/2008)	Conformity to the federal HSA provisions would apply starting in taxable year 2008.	This bill was held in the Assembly Revenue and Taxation Committee.
AB 245 (DeVore, 2007/2008)	Conformity to the federal HSA provisions would apply starting in taxable year 2008.	This bill was held in the Assembly Revenue and Taxation Committee.
AB 2292 (Garrick, 2007/2008)	Conformity to the federal HSA provisions would apply starting with taxable year 2008.	This bill failed to pass the Assembly Revenue and Taxation Committee.
ABX1 4 (Nakanishi, 2007/2008)	Conformity to the federal HSA provisions would apply starting with taxable year 2008.	This bill was held at the Assembly desk.
SBX1 10 (Maldonado, 2007/2008)	Conformity to the federal HSA provisions would have applied retroactively starting with taxable year 2006 and would have allowed amended returns to be filed.	This bill failed to pass the Senate Health Committee.
SB 25 (Maldonado and Runner, 2007/2008)	Retroactively conform to the federal HSA provisions starting with taxable year 2006 and would have allowed amended returns to be filed.	This bill was held in the Senate Revenue and Taxation Committee.
AB 661 (Plescia, 2005/2006)	Conformity to the federal HSA provisions would apply starting with taxable year 2006.	This bill was held in the Assembly Revenue and Taxation Committee.
AB 2010 (Plescia, 2005/2006)	Conformity to the federal HSA provisions would apply starting with taxable year 2007.	This bill was held in the Assembly Revenue and Taxation Committee.
SB 173 (Maldonado, 2005/2006)	Conformity to the federal HSA provisions would apply starting with taxable year 2006.	This bill was held in the Senate Revenue and Taxation Committee.
SB 1584 (Runner and Ackerman, 2005/2006)	Conformity to the federal HSA provisions would apply starting with taxable year 2006	This bill was held in the Senate Revenue and Taxation Committee.
SB 1787 (Ackerman, 2005/2006)	Retroactively conformed to the federal HSA provisions starting with taxable year 2004 and would have allowed amended returns to be filed.	This bill was held in the Senate Revenue and Taxation Committee.
AB 2315 (Maldonado/ Nakanishi, 2003/2004)	Conformity to the federal HSA provisions would apply starting with taxable year 2006.	This bill was held in the Assembly Appropriations Committee.