Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Ashburn	Analyst:	William Koch	Bill Number:	SB 594
Related Bills:	See Legislative History	Telephone:	845-4372	Introduced Date:	February 27, 2009
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Employer Cafeteria Plan Administrative Costs Credit-FTB Report To Legislature On Or Before January 1, 2013, Regarding Utilization Of Credit

SUMMARY

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

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, 2009, and before January 1, 2014.

POSITION

Pending.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

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.

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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 percent 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]

Except for FICA withholding, 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.

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[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 percent, for a maximum contribution of $6,045. The employee tax rate for Medicare is 1.45 percent. 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.

Under state law, for taxable years beginning on or after January 1, 2008, and before January 1, 2010, the total of all business credits otherwise allowable may not exceed 50 percent of the net tax of the taxpayer for that taxable year. Taxpayers with net business income of less than $500,000 are excluded from this limitation.

In addition, current state Corporation Tax Law allows the assignment of certain credits to taxpayers that are members of a combined reporting group and adds the following provisions:

- Provides that an “eligible credit” may be assigned by a taxpayer to an “eligible assignee.”
  - “Eligible credit” means any credit earned by a taxpayer in a taxable year beginning on or after July 1, 2008, or any credit earned in any taxable year beginning before July 1, 2008, which is eligible to be carried forward to the taxpayer’s first taxable year beginning on or after July 1, 2008.
  - “Eligible assignee” means any “affiliated corporation” that is a member of a combined reporting group at certain specified times.
  - “Affiliated corporation” means a corporation that is a member of a combined reporting group.
- Provides that the election to assign any credit is irrevocable once made and is required to be made on the taxpayer’s original return for the taxable year in which the assignment is made.

THIS BILL

This bill would establish, under both the personal income tax law and the corporation tax law, a credit against income or franchise tax in the amount of 15 percent of administrative costs incurred by a qualified taxpayer in connection with establishing or administering a cafeteria plan that provides for the payment of health insurance premiums of the taxpayer’s employees.

The bill would define the term “qualified taxpayer” as an employer, meaning any individual or entity that is doing business in California, that is deriving income from California sources or is subject to the laws of California. The term “employer” would also mean the State of California and all of its political subdivisions, Regents of the University of California, any other political body or agency of the state, and any person, officer, employee, department, or agency paying wages to employees for services performed within California.

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 income tax or corporation tax law was allowed. The bill would also allow any unused credit to be carried over for seven years.

The bill would require the FTB to provide a report on the utilization of the credit to the chairpersons and vice chairpersons of the Senate and Assembly Health Committees and the Senate and Assembly Revenue and Taxation Committees. The report would be required to be submitted on or before January 1, 2013, and must provide information regarding the effectiveness of the credit, including the amount of the credit claimed, an estimate of the number of IRC section 125 cafeteria plans established, and the number of employees affected, and information regarding the types of benefits offered by these plans.

The credit provided by this bill would be subject to the 50 percent limitation for the 2009 taxable year and could be assigned to other members of a combined reporting group.

The bill would repeal the credit on December 1, 2014.

IMPLEMENTATION CONSIDERATIONS

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

The bill language indicates the credit would be allowed for establishing **or** administering a cafeteria plan as specified. It is unclear if the credit for the initial year could be calculated based on both the costs associated with establishing **and** the costs associated with administering the cafeteria plan. It is recommended that the bill be amended to provide clarity on this issue.

This bill would allow a credit for the costs associated with a cafeteria plan, as defined in section 125 of the IRC, that provides for the payment of health insurance premiums of the taxpayer's employees. A cafeteria plan also includes an FSA, which can be used to pay for certain expenses other than health insurance premiums. Isolating the costs attributable to an FSA within a cafeteria plan may be difficult for a taxpayer and the department. The author may wish to amend the bill to provide guidance on this issue.

The bill does not define the term "administrative costs." The absence of a definition to clarify this term could lead to disputes with taxpayers and would complicate the administration of this credit. It is suggested that the bill be amended to provide a definition for this term.

The bill defines a qualified taxpayer, in part, as an employer "making payments of wages to employees for services performed within this state." The bill lacks a threshold or minimum duration that an employee must provided services within this state. A taxpayer could claim the credit for a nonresident employee that worked briefly in California. If this is not the author's intent, it is recommended that the bill be amended to require an employee to provide services within California for a minimum period.

TECHNICAL CONSIDERATIONS

The bill language applies the "making payments of wages to employees for services performed within this state" element of the definition to government entities in the second sentence of the paragraph, but not to the "person, corporation, association or limited liability company" list in the first sentence. On page 2, lines15 and 16, and on page 3, lines 22 and 23, strikeout "state. "Employer" also includes" and insert "state," to correct this problem.

LEGISLATIVE HISTORY

AB 8 (Nuñez, 2007/2008) would have created the California Cooperative Health Insurance Purchasing Program to serve as a health care purchasing pool for employers and made other changes to health care related provisions of several California Codes. It would have required employers to make health care expenditures or elect to pay an in-lieu fee to a specified fund. It would also have required employers to set up a cafeteria plan under IRC section 125. This bill was vetoed by Governor Schwarzenegger, whose veto message can be found in Appendix A.

SB 48 (Perata, 2007/2008) would have established the California Health Care Coverage and Cost Control Act, which would have required 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 adopt and maintain an IRC section 125 plan. The author amended SB 48 to remove these health care provisions.

SB 820 & SBX1 23 (Ashburn, 2007/2008) contained provisions similar to this bill. SB 820 failed to pass out of the Senate Revenue and Taxation Committee by the constitutional deadline. SBX1 23 failed passage in the Senate Revenue and Taxation Committee.

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. None of these states provides a credit comparable to the credit this bill would allow.

FISCAL IMPACT

If the bill is amended to resolve the implementation consideration 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 additional costs have not been determined at this time. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimates:

Based on the data and assumptions discussed below, this bill would result in the following revenue losses:

Estimated Revenue Impact of SB 594 Effective for Taxable Years BOA 1/1/09 [$ In Millions]		
2009-2010	**2010-2011**	**2011-2012**
-$60	-$100	-$120

This analysis does not account for 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 amount of qualified cafeteria plan tax credits that would be applied to reduce tax liabilities of employers.

The average cost of establishing a qualified cafeteria plan is $1,425, which is comprised of a $425 average fee paid to a third party plus $1,000 internal administrative costs. Available information indicates that employers' costs associated with ongoing plan administration are about $100 per employee per year.

Based on California Employment Development Department reports, the number of businesses is estimated to be 1.3 million in 2009. The number of businesses is reduced by 20 percent to account for businesses consisting of multiple establishments. The number of employers is therefore estimated to be 1,040,000 in 2009 (1.3 million businesses x 80% = 1,040,000 employers).

Available information indicates that about 28 percent of employers offered cafeteria plans that provided for the payment of employee health insurance premiums in 2006. For purposes of this estimate, it is assumed that the number of employers offering cafeteria plans will increase by 1 percent in each subsequent year. It is projected that approximately 322,000 employers will offer qualifying cafeteria plans to their employees during 2009 [1,040,000 employers x 31% ≈ 322,000 employers] and that 312,000 employers [1,040,000 employers x 30% = 312,000 employers] offered qualifying cafeteria plans during 2008. New cafeteria plans offered by California employers is estimated to be 10,000 during 2009 [322,000 employers offering plans during 2009 – 312,000 employers offering plans during 2008 = 10,000 new cafeteria plans in 2009]. Using the average cost of $1,425, the cost to employers for establishing qualified cafeteria plans during 2009 is approximately $14 million [10,000 plans x $1,425 = $14 million].

Current employment statistics from the California Employment Development Department indicate that the number of non-governmental California employees is 11.9 million in 2009. Based on various data, it is estimated that 50 percent of these employees have access to a cafeteria plan that provides for the payment of health insurance premiums and 60 percent of these employees participate in the plans. Using the estimated cost of $100 per participating employee, the estimated cost to employers for internal administrative costs during 2009 is $357 million [11.9 million employees x 50% with access to qualified cafeteria plans x 60% participation rate x $100 cost per participating employee = $357 million].

Additional costs to administer a qualified cafeteria plan may include fees charged by banks, investment companies, insurance companies, retirement plan administrators and other providers that may independently provide service to the qualified cafeteria plan. These additional costs are assumed to average approximately $100 per qualified cafeteria plan. Additional qualifying costs are estimated at approximately $32 million for 2009 [322,000 employers offering cafeteria plans x $100 average miscellaneous fees per employer ≈ $32 million].

Total available credits related to establishing and administering qualified cafeteria plans for California employees would be approximately $60 million for 2009 [$14 million + $357 million + $32 million = $403 million, $403 million x 15% credit = $60 million].

This bill would not limit the credit to costs incurred for just California employees. Approximately 25 percent of employees participating in qualified cafeteria plans work for apportioning corporations. Approximately $15 million of the credit calculated above would be generated from costs associated with California employees who work for apportioning corporations [$60 million x 25% = $15 million]. Based on tax return data, the average apportionment factor is about 10 percent. Applying an average apportionment factor of 10 percent to the payroll of these apportioning corporations would generate credits of $150 million [$15 million credit for California employees divided by 10% apportionment]. This results in total credits generated in 2009 of $195 million [$60 million –$15 million + $150 million = $195 million].

Employers may currently deduct the costs of establishing and administering cafeteria plans. This bill would not allow deduction of any costs for which the credit is allowed. Since the average tax rate of 7.5 percent is 50 percent of the 15 percent credit, the value of the credit after taking into account the offsetting loss of deductions is approximately half the amount of the credit, or $23 million, for credits for non-apportioning businesses [$60 million - $15 million (attributed to apportioning corporations) = $45 million, $45 million x 50% ≈ $23 million]. Since only 10 percent of qualifying costs of apportioning corporations would be apportioned to California, the value of the credit to apportioning corporations, after taking into account the offsetting loss of deductions, is approximately 95 percent of the credits, or $143 million [$150 million x 95% ≈ $143 million]. The deduction offset for apportioning corporations is calculated as follows: $150 million credits divided by 15 percent credit = $1 billion qualifying costs, $1 billion qualifying costs x 10% apportionment factor = $100 million, $100 million qualifying costs apportioned to California x 7.5% average tax rate = $7.5 million lost deductions ($150 million - $7.5 million = $142.5 million, which is rounded to $143 million). The total value of the credit for both non-apportioning and apportioning business is $166 million [$23 million + $143 million = $166 million]. It is estimated that 33 percent of the net value of the credit will be applied in 2009 due to the limitation on all business credit use to 50 percent of tax. In addition, it is anticipated that 30 percent of employers entitled to the credit simply neglect to report it for various reasons in the initial tax year of the deduction, resulting in estimated total credits reported in 2009 of $38 million [$166 million x 33% = $55 million, $55 million x 70% = $38 million].

It is assumed that administrative fees actually paid by employees (through payroll deduction) would not qualify for the credit.

Taxable year estimates have been converted to fiscal year cash flow estimates in the table.

POLICY CONCERNS

The bill does not limit eligible costs to those allocable to employees in California. Therefore, employers could claim the credit for costs attributable to non-California employees, which may be inconsistent with the policy objective the author is trying to achieve.

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APPENDIX A

VETO MESSAGE FROM PRIOR LEGISLATIVE BILL, AB 8

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