

Franchise Tax Board

**ANALYSIS OF AMENDED BILL**

Authors: Perea, Blumenfield and Padilla Analyst: Scott McFarlane Bill Number: AB 36  
 Related Bills: AB 1178 (2009/2010) Telephone: 845-6075 Amended Date: January 27, 2011  
 Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Medical Care Expense Exclusion / Deduction for Children Under 27

**SUMMARY**

This bill would conform to the federal law that allows an exclusion or deduction from income for certain medical care expenses of a child under 27.

**SUMMARY OF AMENDMENTS**

The bill as introduced on December 6, 2010, would have amended the Health and Safety Code relating to controlled substances. The January 27, 2011, amendments removed those amendments, and would make the changes discussed in this analysis. This is the department's first analysis of the bill.

**PURPOSE OF THE BILL**

It appears that the purpose of the bill is to prevent individuals from being taxed on certain health-care expenses of their children.

**EFFECTIVE/OPERATIVE DATE**

As a tax levy, this bill would be effective immediately and specifically operative for expenses incurred and benefits provided on or after March 30, 2010.

**POSITION**

Pending.

Board Position:	Department Director	Date
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## **BACKGROUND**

The Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 were enacted in March, 2010, to effectuate fundamental reforms to the United States health care system. Many of the provisions of the health-care acts do not take effect until 2014; however, one provision that became effective in 2010 requires group health plans and health insurance issuers that offer group or individual health insurance coverage, and that provide dependent coverage of children, to continue to make such coverage available for an adult child (who is not married) until the child turns 26 years of age.<sup>1</sup> In conjunction with that requirement, a provision was enacted to add a new category of excludable or deductible medical care expenses for a child who has not attained age 27 as of the end of the taxable year.<sup>2</sup> The new category applies to reimbursements for medical care expenses under excludable employer-provided health coverage, deductible self-employed medical insurance costs, Voluntary Employees' Beneficiary Associations (VEBA) benefits, and qualified retiree health plan benefits.

For purposes of excludable employer-provided health coverage, deductible self-employed medical insurance costs, and VEBAs, California conforms to the federal exclusion and deduction for dependent's medical care expenses that were in effect on January 1, 2009; thus, California does not conform to the new category of excludable or deductible medical care expenses for children under 27.

For purposes of a qualified retiree health plan, California automatically conforms to the new category that allows retiree's children, who have not attained age 27 as of the end of the calendar year, to be included in the plan.

## **ANALYSIS**

### FEDERAL/STATE LAW

#### **Federal Law**

##### Definition of Dependent for Exclusion for Employer-Provided Health Coverage

The IRC generally provides that employees are not taxed on (that is, may "exclude" from gross income) the value of employer-provided health coverage under an accident or health plan.<sup>3</sup> This exclusion applies to coverage for personal injuries or sickness for employees (including retirees), their spouses and their dependents. In addition, any reimbursements under an accident or health plan for medical care expenses for employees (including retirees), their spouses, his or her dependents,<sup>4</sup> and any child of the taxpayer<sup>5</sup> who, as of the end of the taxable year, has not attained age 27 generally are excluded from gross income.<sup>6</sup>

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<sup>1</sup> Section 2714 of the Patient Protection and Affordable Care Act of 2010, Public Law 111-148.

<sup>2</sup> Section 1004 of the Health Care and Education Reconciliation Act of 2010, Public Law 111-152.

<sup>3</sup> IRC section 106.

<sup>4</sup> As defined in IRC section 152, without regard to whether or not a taxpayer is a dependent of another taxpayer (IRC section 152(b)(1)), whether an individual is married (IRC section 152(b)(2)), or whether or not an individual's gross income is less than the federal exemption amount (IRC section 152(d)(1)(B)).

<sup>5</sup> As defined in IRC section 152(f)(1).

Employers may agree to reimburse medical expenses of their employees (and their spouses and dependents), not covered by a health insurance plan, through flexible spending arrangements that allow reimbursement not in excess of a specified dollar amount (either elected by an employee under a cafeteria plan or otherwise specified by the employer). Reimbursements under these arrangements are also excludable from gross income as employer-provided health coverage. The same definition of dependents applies for purposes of flexible spending arrangements.

#### Deduction for Health Insurance Premiums of Self-Employed Individuals

Self-employed individuals may deduct the cost of health insurance for themselves, their spouses and dependents,<sup>7</sup> and any child<sup>8</sup> of the taxpayer who as of the end of the taxable year has not attained age 27. The deduction is not available for any month in which the self-employed individual is eligible to participate in an employer-subsidized health plan. Moreover, the deduction may not exceed the individual's self-employment income. The deduction applies only to the cost of insurance (i.e., it does not apply to out-of-pocket expenses that are not reimbursed by insurance). The deduction does not apply for self-employment tax purposes. For purposes of the deduction, a more than two percent shareholder-employee of an S corporation is treated the same as a self-employed individual. Thus, the exclusion for employer-provided health care coverage does not apply to such individuals, but they are entitled to the deduction for health insurance costs as if they were self-employed.

#### Voluntary Employees' Beneficiary Associations (VEBAs)

A VEBA is a tax-exempt entity that is a part of a plan for providing life, sick or accident benefits to its members or their dependents<sup>9</sup> or designated beneficiaries.<sup>10</sup> For this purpose, the term "dependents" specifically includes any member's child who has not attained age 27 as of the end of the calendar year. No part of the net earnings of the association inures (other than through the payment of life, sick, accident or other benefits) to the benefit of any private shareholder or individual. A VEBA may be funded with employer contributions or employee contributions or a combination of employer contributions and employee contributions.

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<sup>6</sup> IRC section 105(b).

<sup>7</sup> As defined in IRC section 152, without regard to: (1) whether or not an individual is a dependent of another taxpayer (IRC section 152(b)(1)); (2) whether an individual is married (IRC section 152(b)(2)); or, (3) whether or not an individual's gross income is less than the federal exemption amount (IRC section 152(d)(1)(B)).

<sup>8</sup> As defined in IRC section 152(f)(1).

<sup>9</sup> As defined in IRC section 152.

<sup>10</sup> IRC sections 419(e) and 501(c)(9).

## Qualified Plans Providing Retiree Health Benefits

A qualified pension or annuity plan can establish and maintain a separate account to provide for the payment of sickness, accident, hospitalization, and medical expenses for retired employees, their spouses, and their dependents<sup>11</sup> ("401(h) account"). For this purpose, the term "dependents" specifically includes any retired employee's child who has not attained age 27 as of the end of the calendar year. An employer's contributions to a 401(h) account must be reasonable and ascertainable, and retiree health benefits must be subordinate to the retirement benefits provided by the plan. In addition, it must be impossible, at any time prior to the satisfaction of all retiree health liabilities under the plan, for any part of the corpus or income of the 401(h) account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than providing retiree health benefits and, upon satisfaction of all retiree health liabilities, the plan must provide that any amount remaining in the 401(h) account be returned to the employer.

### California Law

#### Definition of Dependent for Exclusion for Employer-Provided Health Coverage

California conforms to the federal definition of dependent for purposes of the exclusion for employer-provided health coverage as of the "specified date" of January 1, 2009.<sup>12</sup> Thus, California does not conform to the federal change that extends the exclusion to any child of an employee who has not attained age 27 as of the end of the taxable year because it was enacted after January 1, 2009.

Under California law, any reimbursements under an accident or health plan for medical care expenses for employees (including retirees), their spouses, and their dependents are generally excluded from gross income. A dependent means a qualifying child or a qualifying relative.<sup>13</sup>

A child generally is a qualifying child of a taxpayer if the child satisfies each of five tests for the taxable year: (1) the child has the same principal place of abode as the taxpayer for more than one-half of the taxable year; (2) the child is the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individual; (3) the child has not yet attained the age of 19 by the close of the taxable year (or, if a full-time student, has not attained the age of 24 by the close of the taxable year); (4) the child has not provided over one-half of their own support for the calendar year in which the taxable year of the taxpayer begins; and (5) the qualifying child has not filed a joint return (other than for a claim of refund) with their spouse for the taxable year beginning in the calendar year in which the taxable year of the

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<sup>11</sup> As defined in IRC section 152.

<sup>12</sup> For taxable years beginning on or after January 1, 2010, R&TC section 17131 conforms to IRC section 105, as of the "specified date" of January 1, 2009.

<sup>13</sup> As defined in IRC section 152, as of the "specified date" of January 1, 2009, without regard to (1) whether or not an individual is a dependent of another taxpayer (IRC section 152(b)(1)); (2) whether an individual is married (IRC section 152(b)(2)); or, (3) whether or not an individual's gross income is less than the federal exemption amount (IRC section 152(d)(1)(B)).

taxpayer begins. A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child, and there is no age limit with respect to individuals who are totally and permanently disabled<sup>14</sup> at any time during the calendar year.

A qualifying relative means an individual that satisfies three tests for the taxable year: (1) the individual bears a specified relationship to the taxpayer; (2) the taxpayer provides more than one-half the individual's support for the calendar year in which the taxable year begins; and (3) the individual is not a qualifying child of the taxpayer or any other taxpayer for any taxable year beginning in the calendar year in which such taxable year begins. The specified relationship test for qualifying relative is satisfied if that individual is the taxpayer's: (1) child or descendant of a child; (2) brother, sister, stepbrother or stepsister; (3) father, mother or ancestor of either; (4) stepfather or stepmother; (5) niece or nephew; (6) aunt or uncle; (7) in-law; or (8) certain other individuals, who for the taxable year of the taxpayer, have the same principal place of abode as the taxpayer and are members of the taxpayer's household.

In some cases, under existing California law and former federal law to which California conforms, an adult child can be a dependent for exclusion of health care purposes, but not a dependent for income tax exemption purposes, notably where the adult child is supported by the employee, but earns more than the standard deduction amount for the tax year.

#### Deduction for Health Insurance Premiums of Self-Employed Individuals

California conforms to the federal deduction for health insurance costs of self-employed individuals that was in effect on the "specified date" of January 1, 2009.<sup>15</sup> Thus, California does not conform to the self-employment medical care insurance deduction for any child who has not attained the age of 27 by the end of the taxable year because it was enacted after January 1, 2009. Instead, self-employed individuals may deduct health insurance costs of themselves, their spouse, and their dependents.<sup>16</sup>

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<sup>14</sup> Within the meaning of IRC section 22(e)(3).

<sup>15</sup> For taxable years beginning on or after January 1, 2010, R&TC sections 17201 and 24343 conform, with modifications, to IRC section 162, as of the "specified date" of January 1, 2009.

<sup>16</sup> For purposes of the self-employment health coverage deduction, the term "dependent" means a dependent as defined in IRC section 152, as of the "specified date" of January 1, 2009.

## Voluntary Employees' Beneficiary Associations (VEBAs)

For taxable years beginning on or after January 1, 2010, California law provides that an organization operating as a nonprofit VEBA within the provisions of IRC section 501(c)(9), as of January 1, 2009, may apply for tax-exempt status.<sup>17</sup> Similar to federal law, California VEBAs may provide for the payment of health benefits to its members, their spouse, and their dependents; however, under California law, the term “dependents” means dependents as defined in IRC section 152, as of the “specified date” of January 1, 2009. In other words, California does not conform to the federal change to the definition of VEBA dependents to include any child of a member who has not attained the age of 27 by the end of the calendar year.

## Qualified Plans Providing Retiree Health Benefits

California conforms by reference to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC (IRC sections 401 through 420), relating to pension, profit-sharing, and stock-bonus plans, etc., without regard to taxable year.<sup>18</sup> Thus, California automatically conforms to the federal change that allows plans providing retiree health benefits to retired employees, their spouses, and their dependents, to include within the meaning of “dependent” any child of a retired employee who has not attained age 27 as of the end of the calendar year.

## THIS BILL

This bill would conform to the new federal category of excludable or deductible medical care expenses for a child who has not attained age 27 as of the end of the taxable year. The new category would apply to reimbursements for medical care expenses under an employer-provided accident or health plan, benefits provided under a VEBA, and deductible medical care insurance expenses of self-employed individuals, and would apply as of the same date the new category applies for federal purpose—to expenses incurred and benefits provided on or after March 30, 2010.

## **LEGISLATIVE HISTORY**

AB 1178 (2009/10, Portantino) would have conformed to the tax provisions of the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010, including the exclusion/deduction of medical care expenses of any child under 27. That bill failed to pass the Senate Appropriations Committee.

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<sup>17</sup> For taxable years beginning on or after January 1, 2009, R&TC section and 23701i conforms to IRC section 501(c)(9), as of the “specified date” of January 1, 2009.

<sup>18</sup> R&TC sections 17501 and 24601.

## 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. *Illinois, Michigan, and New York* automatically conform each taxable year to the IRC; thus, these states automatically adopt the new category of excludable or deductible medical care expenses for a child under 27.

*Minnesota, Massachusetts, and Florida* conform to the IRC as of a specified date, similar to California. *Minnesota* conforms to the IRC as amended through March 18, 2010, and does not conform to the new category of excludable or deductible medical care expenses for a child under 27.<sup>19</sup> *Massachusetts* conforms to the IRC as amended through January 1, 2005, and does not conform to the new category of excludable or deductible medical care expenses for a child under 27. *Florida* imposes corporate income tax, but does not impose personal income tax; thus, this provision is not applicable to *Florida*.

## FISCAL IMPACT

This bill would not significantly impact the department's costs.

## ECONOMIC IMPACT

### Revenue Estimate

Estimated Revenue Impact of AB 36 For Taxable Years Beginning On or After January 1, 2010 Enactment Assumed After June 30, 2011 (\$ in Millions)				
2010-11	2011-12	2012-13	2013-14	2014-15
-\$4.8	-\$38	-\$35	-\$40	-\$44

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<sup>19</sup> See "Federal Changes" at:

[http://taxes.state.mn.us/individ/Pages/other\\_supporting\\_content\\_whats\\_new\\_10.aspx#P64\\_4818](http://taxes.state.mn.us/individ/Pages/other_supporting_content_whats_new_10.aspx#P64_4818).