

DEPARTMENT OF TAXATION

2012 Fiscal Impact Statement

1. **Patron** Richard H. Black

2. **Bill Number** SB 673

3. **Committee** Senate Finance

House of Origin:

 X **Introduced**

 Substitute

 Engrossed

4. **Title** Income Tax: Deconforms Virginia from Provisions of the Patient Protection and Affordable Care Act

Second House:

 In Committee

 Substitute

 Enrolled

5. **Summary/Purpose:**

This bill would deconform from two provisions of the Patient Protection and Affordable Care Act that was enacted by Congress in 2010, and to which Virginia conformed to in 2011. The two provisions are: (i) the federal increase in the threshold for unreimbursed medical expenses, and (ii) the decrease in the maximum amount in a flexible spending account for Virginia income tax purposes.

The effective date of this bill is not specified.

6. **Budget amendment necessary:**

7. **Fiscal Impact Estimates are:** Preliminary. (See Line 8.)

7b. **Revenue Impact:**

<i>Fiscal Year</i>	<i>Dollars</i>	<i>Fund</i>
2011-12	\$0	GF
2012-13	(\$2.35 Million)	GF
2013-14	(\$11.07 Million)	GF
2014-15	(\$13.86 Million)	GF
2015-16	(\$14.74 Million)	GF
2016-17	(\$20.24 Million)	GF
2017-18	(\$29.92 Million)	GF

8. **Fiscal implications:**

Administrative Costs

The Department of Taxation (the "Department") considers implementation of this bill as routine, and does not require additional funding.

Revenue Impact

This bill would have a negative revenue impact on General Fund revenue in the amount of \$2.35 million in FY 2013, \$11.07 million in FY 2014, \$13.86 million in FY 2015, \$14.74

million in FY 2016, \$20.24 million in FY 2017 and \$29.92 million in FY 2018. This estimate is based on the estimated federal revenue impact of raising the threshold for itemized deductions of unreimbursed medical expenses. The provision deconforming from the reduced contribution limit for flexible spending accounts is not expected to have any revenue impact.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Background

Since 2003 the General Assembly has advanced the date as of which Virginia conforms to the Internal Revenue Code ("IRC"). This procedure allows the General Assembly to deconform from new federal tax policies that are incompatible with Virginia's policy or revenue objectives. Currently, Virginia income tax law conforms to the IRC as of December 31, 2011, which already includes conformity to certain federal legislation.

In 2010, Virginia deconformed from four provisions that Congress enacted in 2010:

- Tax exclusions under IRC § 108(i) related to cancellation of debt income (but taxpayers may elect to phase-in the modification required for transactions made in 2009 or transactions made on or after January 1, 2010, but before April 21, 2010).
- Tax deductions under IRC § 163(e)(5)(F) related to the application of the applicable high yield debt obligation (AHYDO) rules.
- The domestic production deduction allowed under IRC § 199 for taxable years 2010 and thereafter. Virginia allows a deduction equal to two-thirds of the federal deduction, which effectively deconforms from a scheduled increase in the federal deduction.
- The temporary increase in the federal earned income tax credit (EITC). Virginia has advanced conformity to this provision one taxable year at a time. In the 2011 session conformity was advanced for taxable year 2010.

In 2010, there were five major tax measures that were enacted by Congress, including the Patient Protection and Affordable Care Act (H.R. 3590), which expanded healthcare coverage and provided several tax-related requirements and incentives. Virginia fully conformed to these tax measures for taxable years beginning January 1, 2011, except as noted above.

One of the provisions contained in the Act increases the threshold for the itemized deduction for unreimbursed medical expenses from 7.5 percent of adjusted gross income

("AGI") to 10 percent of AGI for income tax purposes. Under federal law, individuals are allowed an itemized deduction for unreimbursed medical expenses, but only to the extent that such expenses exceed 7.5 percent of AGI. However, for years 2013 through 2016, if either the taxpayer or the taxpayer's spouse turns 65 before the end of the taxable year, the increased threshold does not apply and the threshold remains at 7.5 percent of AGI. The provision does not change the AMT treatment of the itemized deduction for medical expenses.

Another provision limits the health flexible spending arrangements in cafeteria plans to \$2,500; indexed to CPI-U after 2013. A flexible spending arrangement for medical expenses under a cafeteria plan is a form of health coverage in which employees commit in advance to contribute a certain amount of their wages over the next 12 months into an account. Any amount that is not disbursed for qualifying medical expenses is lost. Under this provision, in order for a health flexible spending arrangement to be a qualified benefit under a cafeteria plan, the maximum amount available for reimbursement of incurred medical expenses of an employee, the employee's dependents, and any other eligible beneficiaries with respect to the employee, must not exceed \$2,500.

Proposal

This bill would deconform Virginia from the federal increase in the threshold for unreimbursed medical expenses and the decrease in the maximum amount in a flexible spending account for Virginia income tax purposes.

The effective date of this bill is not specified.

Impact of Proposal

In order to deduct unreimbursed medical expenses for federal income tax purposes, an individual must itemize their deductions and not use the standard deduction. Approximately one third of all taxpayers itemize their deductions, with the majority choosing to use the standard deduction. For Virginia income tax purposes, an individual is required to file their Virginia tax return the same way that they file their federal return with respect to using either itemized deduction or the standard deduction. For itemizing taxpayers with unreimbursed expenses above the 7.5% threshold, this bill would allow a Virginia itemized deduction for the difference between 7.5% of their AGI and their actual expenses, or 10% of AGI, whichever is less. However, under this bill itemizing taxpayers would have to compute medical expenses using both the 10% federal threshold and the 7.5% Virginia threshold.

Health flexible spending arrangements are subject to the general requirements for cafeteria plans, including a requirement that amounts remaining under a health flexible spending arrangement at the end of a year must be forfeited by the employee (referred to as the "use-it-or-lose-it rule"). Because contributions to a flexible spending account cannot exceed \$2,500 pursuant to federal law, there would be no additional amount to exclude from wages for Virginia income tax purposes. In order to implement this bill, Virginia employers would have to set up a similar flexible spending account program solely for Virginia purposes, and then account for different federal and Virginia wages for withholding and W-2 reporting. However, because the federal program would be more

beneficial to the taxpayer, a Virginia flexible spending account program would have fewer participants and the administrative fees would be more costly for those who do participate. The Department does not anticipate that any employers would offer an additional Virginia flexible spending plan for contributions over \$2,500, so no employees would be able to take advantage of the provision in this bill that would deconform from the reduced contribution limit.

cc : Secretary of Finance

Date: 2/3/2012 tlg
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