# DEPARTMENT OF TAXATION
# 2013 Fiscal Impact Statement

**1. Patron** Robert G. Marshall

**2. Bill Number** HB 1313

**House of Origin:**
X **Introduced**
_____ **Substitute**
_____ **Engrossed**

**Second House:**
_____ **In Committee**
_____ **Substitute**
_____ **Enrolled**

**3. Committee** House Finance

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

**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 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 arrangement for Virginia income tax purposes.

This bill would be effective for taxable years beginning on or after January 1, 2013.

**6. Budget amendment necessary:** Yes.
ITEM(S): Page 1, Revenue Estimates

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

| ***Fiscal Year*** | ***Dollars*** | ***Fund*** |
|---|---|---|
| 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 |
| 2018-19 | ($33.88 million) | GF |

**8. Fiscal implications:**

Administrative Costs

The Department has not assigned any administrative costs to this bill because the changes required by a single bill such as this can be implemented as part of the annual changes to our systems and forms. As stand-alone legislation, the Department considers implementation of this bill as "routine," and does not require additional funding.

The Department will provide specific administrative costs on any legislation that is not "routine." Additionally, the Department will review all state tax legislation likely to be enacted prior to the passage by each house. If the aggregate number of routine bills likely to pass either house is unusually large, it is possible that additional resources will be required. If so, the Department will identify the costs at that time.

Revenue Impact

This bill would have a negative impact on General Fund revenues 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, $29.92 million in FY 2018, and $33.88 million in FY 2019. These estimates are 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 arrangements is not expected to have any revenue impact.

**9. Specific agency or political subdivisions affected:**

Department of Taxation

**10. Technical amendment necessary:** Yes.

Line 51, after spending
Strike: account
Insert: arrangement

**11. Other comments:**

Background

Since 2003, the General Assembly has advanced the date as of which Virginia conforms to the Internal Revenue Code ("IRC"). 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 activities deduction allowed under IRC § 199 for taxable years beginning on or after January 1, 2010, but before January 1, 2013. Virginia allows a deduction equal to two-thirds of the federal deduction, which effectively deconforms from a scheduled increase in the federal deduction. Virginia will conform to the full deduction beginning in Taxable Year 2013.

- The temporary increase in the federal earned income tax credit (EITC). Virginia has advanced conformity to this provision one taxable year at a time. During the 2012 session, conformity was advanced for Taxable Year 2011.

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 on or after 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, effective for taxable years beginning after December 31, 2012. 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 Taxable 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 alternative minimum tax (AMT) treatment of the itemized deduction for medical expenses.

Another provision limits the health flexible spending arrangements in cafeteria plans to $2,500, which is then 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 such an arrangement. 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.

<u>Proposal</u>

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

This bill is effective for taxable years beginning on or after January 1, 2013.

Impact of Proposal

In order to deduct unreimbursed medical expenses for federal income tax purposes, an individual must itemize his deductions, rather than claiming 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 his Virginia tax return the same way that he files his federal return with respect to using either itemized deductions or the standard deduction. For itemizing taxpayers with unreimbursed expenses above the 7.5 percent threshold, this bill would allow a Virginia itemized deduction for the difference between 7.5 percent of their AGI and their actual expenses, or 10 percent of AGI, whichever is less. However, under this bill, itemizing taxpayers would have to compute medical expenses using both the 10 percent federal threshold and the 7.5 percent 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 arrangement 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 arrangement 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 arrangement 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: 1/12/2013 MTH
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