Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Oropeza	Analyst:	Norman Catelli	Bill Number:	AB 2065
Related Bills:	See Legislative History	Telephone:	845-5117	Amended Date:	August 31, 2002
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Suspend Teacher Credit & NOL Deduction/Change Withholding on Sale of Real Estate and Stock Options/Bad Debt Conformity/Collections/Delinquent

SUMMARY

Provisions of this bill would:

1. Suspend the Teacher Retention Credit for one year (page 2).
2. Suspend the deduction for net operating losses (NOLs) for two years, then make the NOL deduction 100% (page 4).
3. Extend withholding on real property sales to residents (page 7).
4. Increase withholding on stock options and bonus payments (page 9).
5. Institute special collection procedures to pursue high-risk collections (page 10).
6. Conform to federal bad debt deduction rules for banks (page 13).
7. Provide penalty relief for underpayments caused by tax changes enacted during the 2002 calendar year (page 16).

The provisions of this bill will be discussed separately.

This analysis addresses only those provisions of the bill affecting the FTB.

This is the department's first analysis of this bill.

EFFECTIVE/OPERATIVE DATE

Unless otherwise specified, the effective and operative date of this bill would be January 1, 2002.

POSITION

Pending.

SUMMARY OF FISCAL IMPACT

Department costs to implement this bill are estimated to be approximately $12.4 million for fiscal year 2002-03. Second-year costs are estimated to be $7.3 million. See the discussions of provision Nos. 3 and 5 for additional information.

Board Position:			Department Director	Date
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______ N	______ OUA	__X__ PENDING		

SUMMARY OF ECONOMIC IMPACT

Estimated Revenue Impact			
Years Beginning On or After January 1, 2002			
Fiscal Years			
(In Millions)			
	2002-3	2003-4	2004-5
Teacher Credit	+$170	-	-
NOL Deduction—2 year suspension	+$1,200	+$800	-$400
Expand nonresident withholding on sale of real estate by individuals to residents. For dispositions made on or after 1/1/03.	+$225	+$10	+$10
Increase withholding on stock options and bonus income from 6% to 9.3%, beginning on or after 1/1/02.	+$400	+$20	+$20
FTB Collections	+$125	-	-
Bad Debt Reserve	+$285	+$15	-
Estimate Penalty	No Impact	No Impact	No Impact
Total	+$2,405	+$845	-$370

This estimate does not consider the possible changes in employment, personal income, or gross state product that would result from this bill.

The revenue discussion is included with each provision.

1. SUSPEND THE TEACHER RETENTION CREDIT

EFFECTIVE/OPERATIVE DATE

This provision would apply to taxable years beginning on or after January 1, 2002, and before January 1, 2003.

ANALYSIS

FEDERAL/STATE LAW

Existing federal and state laws provide various tax credits designed to provide tax relief for taxpayers that incur certain expenses (e.g., child adoption) or to influence the taxpayer's 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 might not otherwise undertake.

Current state law allows a tax credit for credentialed teachers based upon the taxpayer's years of service as a credentialed teacher. The credit amount varies as follows:

Years of Service	Credit
At least 4 but less than 6 years	$250
At least 6 but less than 11 years	$500
At least 11 but less than 20 years	$1,000
20 or more years	$1,500

The credit cannot exceed 50% of the amount of tax that would be imposed on a teacher's salary, excluding pensions or other deferred compensation, after application of the standard deduction or itemized deductions.

THIS BILL

This provision of the bill would suspend the Teacher Retention Credit for taxable year 2002. Since there are no carryover provisions for this credit (including the suspended credit), the suspended credit amounts would not be available to reduce tax for any other taxable year.

IMPLEMENTATION CONSIDERATIONS

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

LEGISLATIVE HISTORY

AB 428 (Budget Committee, 2001-2002) contains similar provisions as this bill. This bill failed passage on the Senate floor.

AB 433 (Budget Committee, 2001-2002) contains the same provision as this bill. This bill failed passage because of a lack of concurrence to Senate amendments.

AB 2879 (Jackson, Stats. 2000, Ch. 75) enacted the Teacher Retention Credit.

OTHER STATES' INFORMATION

Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws do not provide a credit comparable to the credit allowed by this provision. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Suspension of the Teacher Retention Credit would generate additional state revenue of $170 million for the fiscal year 2002-03.

Revenue Discussion

This revenue estimate is based on actual credits claimed in 2000 and 2001, using a 7% growth rate for future years as in the original revenue estimate for the Teacher Retention Credit. The Teacher Retention Credit cannot be carried forward; therefore, the total impact of the suspension is reflected in the 2002-03 fiscal year.

2. SUSPEND AND INCREASE THE DEDUCTION FOR NOLs

EFFECTIVE/OPERATIVE DATE

This provision of the bill would apply to taxable years beginning on or after January 1, 2002.

ANALYSIS

FEDERAL/STATE LAW

Simply stated, NOLs are beneficial tax rules for losses that allow a taxpayer to deduct (offset) those losses in other years when the taxpayer recognizes income.

Federal law provides, in general, that an NOL can be carried back two years and forward 20 years. Special rules are provided for the carryback of NOLs arising from specified liability losses, excess interest losses, casualty or theft losses, disaster losses of a small business, and farming losses. An NOL is defined as the excess of allowable deductions (as specifically modified) over gross income computed under the law in effect for the loss year.

Existing state law conforms to the federal computation of an NOL, except for the following modifications: California does not allow NOL carrybacks. In addition, depending on the type of taxpayer or amount of a taxpayer's income, the percentage of the NOL that is eligible to be carried forward and the number of years it can be carried forward varies.

Existing state law provides for seven different types of NOLs:

Type of NOL	NOL % Allowed to be Carried Over	Carryover Period
General NOL	55% (2000 - 2001) 60% (2002 - 2003) 65% (2004 - on)	10 Years
New Business Year 1 Year 2 Year 3	100% 100% 100%	10 Years
Eligible Small Business	100%	10 Years
Specified Disaster Loss	100% 50%	5 Years 10 Years
Economic Development Areas	100%	15 Years

Special NOL treatment as stated in the above chart is provided for the following taxpayers:

New businesses that are engaged in a trade or business activity that first commenced in California on or after January 1, 1994. "New business" special NOL treatment also applies to taxpayers engaged in certain biopharmaceutical activities for taxable years beginning on or after January 1, 1997, that have not received approval for any product from the U.S. Food and Drug Administration.

For taxable years beginning on or after January 1, 1994, eligible small businesses that are engaged in a trade or business activity with gross receipts, less returns and allowances, of less than $1 million during the taxable year.

Taxpayers that suffer a casualty loss in an area declared a disaster area by the President or Governor may carry over 100% of an NOL for five years and 50% of any NOL remaining after the first five years for an additional 10 years.

Taxpayers that operate a business in an Economic Development Area, including a Local Agency Military Base Recovery Area, a Targeted Tax Area, or an Enterprise Zone may carry over 100% of an NOL for 15 years. However, NOLs generated in these incentive areas may offset only income generated in the incentive areas, and the taxpayer may claim an NOL from only one incentive area in any year.

In the case of corporations doing business both within and outside of this state, most states, including California, tax corporations on a source income basis. Source income is determined using an apportionment formula for business income and an allocation methodology for nonbusiness income.

While a state cannot tax income from sources outside the state, it is similarly not obligated to consider losses from sources outside the state. Thus, the applicable apportionment rule governing NOLs provides that a taxpayer has a California NOL based on the sum (or net) of California-apportioned business income (or loss) and allocated nonbusiness income (or loss).

THIS BILL

This provision of the bill would:

- Suspend all deductions for NOLs for the 2002 and 2003 taxable years,

- Extend the carryover period for the suspended years, specifically:
    - extend carryover periods for losses incurred before January 1, 2002, by two years,
    - extend carryover periods for losses incurred on or after January 1, 2002, and before January 1, 2003, by one year, and

- Provide that for tax years beginning on or after January 1, 2004, the NOL carryover percentage would be 100% of the loss.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would not significantly impact the department's programs and operations.

OTHER STATES' INFORMATION

The laws of *Florida, Illinois, Massachusetts, Michigan,* and *Minnesota* were reviewed because their tax laws are similar to California's income tax laws.

Florida income tax law, with respect to corporations, provides a 20-year carryover period but no carryback, and otherwise conforms to federal NOL laws. *Florida* has no personal income tax.

Illinois income tax law conforms to federal law regarding NOLs.

Massachusetts income tax law does not allow NOL treatment for personal income taxpayers, but corporations are allowed a 100% NOL that applies to the first five years of the entity's existence.

Michigan income tax law conforms to federal NOL laws, including the allowance of NOL carrybacks for corporations. However, *Michigan's* personal income tax law does not allow NOL carrybacks.

Minnesota personal income tax law conforms to federal NOL laws, while corporate taxpayers determine NOLs pursuant to federal law but have no NOL carrybacks and only a 15-year carryforward period.

LEGISLATIVE HISTORY

SB 169 (Alquist, Stats. 1991, Ch. 117) and AB 31 (Klehs, Stats. 1991, Ch. 474) suspended NOLs for taxable periods beginning in 1991 and 1992. The carryover period for losses incurred in 1991 was extended by one year. The carryover period for losses incurred prior to 1991 was extended by two years.

AB 428 (Budget Committee, 2001-2002) contains similar provisions as this bill. This bill failed passage on the Senate floor.

AB 433 (Budget Committee, 2001-2002) contains similar provisions as this bill. This bill failed passage due to a lack of concurrence to Senate amendments.

AB 511 (Alquist, Stats. 2000, Ch. 107) incrementally increased the general NOL from 50% to 65% and increased the carryover period from five to ten years.

FISCAL IMPACT

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

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Suspension of the NOL deduction would generate additional state revenue of $1.2 billion for fiscal year 2002-03, and $800 million for fiscal year 2003-04; followed by a decrease in state revenue of $400 million during fiscal year 2004-05.

Revenue Discussion

This revenue estimate is based on current projections for NOL usage in affected years adjusted to reflect the proposed two-year suspension and increased deduction percentage beginning in 2004. Current NOL projections are based on actual NOL deductions claimed over the past five years.

3. EXTEND WITHHOLDING ON REAL PROPERTY SALES TO RESIDENTS

EFFECTIVE/OPERATIVE DATE

This provision would apply to dispositions of California real property interests that occur on or after January 1, 2003.

ANALYSIS

FEDERAL/STATE LAW

Under federal law, 10% of the amount realized on the disposition of a U.S. real property interest must be withheld when a foreign investor disposes of that interest in real property. The withholding obligation is generally imposed on the buyer, who must report the amounts withheld and pay them to the Internal Revenue Service.

Under state law, when California real estate is sold by a nonresident of California, buyers are required to withhold 3 ⅓% of the total sales price unless a withholding exemption is met or the Franchise Tax Board (FTB) authorizes a waiver or reduction in the withholding amount.

Generally, the buyer is required to withhold when purchasing California real property if any of the following items are met:

- the seller's last known street address is outside California,
- the disbursement instructions authorize proceeds to be sent to a financial intermediary of the seller, or
- the seller is a corporation with no permanent place of business in California immediately after the sale.

Withholding is not required if any of the following are met:

- the total sales price of the California real property is $100,000 or less,
- the buyer did not receive written notification of the withholding requirements,
- the sellers certify that they are residents of California,
- the seller is a corporation that certifies it has a permanent place of business in California immediately after the transfer,
- the sellers certify that the property conveyed was their principal residence,
- the seller is a bank or a bank acting as a fiduciary for a trust,
- a corporate mortgagee is acquiring the property in foreclosure,
- the seller is a partnership and title to the property is recorded in the name of the partnership,
- the seller is a limited liability company classified as a partnership for California tax purposes, and title to the property is recorded in the name of the limited liability company,
- the seller is exempt from tax under either California or federal law,
- the seller is an estate that certifies the decedent was a California resident at the time of death,
- the seller is an irrevocable trust that certifies at least one trustee is a California resident, or
- the seller is an insurance company, an IRA, or a qualified pension/profit-sharing plan.

Requests for waivers or reduced withholding can be submitted to FTB. All waiver requests are handled on a case-by-case basis. Generally, requests will be granted when:

- there is little or no gain on the transaction,
- the amount otherwise required to be withheld (3 1/3 % of the sale price) exceeds the tax on the recognized gain,
- the transaction involves a like-kind exchange,
- the sale will be reported on the installment sale basis,
- the transfer is the result of a foreclosure byby an individual,
- the transfer is the result of an involuntary conversion and the transferor intends to replace it with qualified property,
- the transaction involves multiple sellers and some, but not all, are California residents, or
- the transaction involves property that was recently acquired by inheritance or through an estate distribution.

THIS BILL

This provision of the bill would extend the 3⅓% withholding requirement to transfers of California real property by California residents. Individuals, whether residents or nonresidents, would be treated the same.

In addition, this provision would create exemptions instead of waivers from the withholding requirements for transactions involving like-kind exchanges, involuntary conversions, and loss on the sale of the property. Waivers or reduced withholding in other circumstances are not allowed.

For installment sales, this provision would allow individuals to elect to compute and remit the withholding as installment payments are received, rather than on the total sales price.

IMPLEMENTATION CONSIDERATIONS

The department would need additional staff to process the additional withholding forms, payments, and exemption requests.

LEGISLATIVE HISTORY

None.

OTHER STATES' INFORMATION

The laws of *Illinois, Massachusetts, Michigan, Minnesota*, and *New York* were reviewed because their tax laws are similar to California's income tax laws. No statutes were found for these states where a withholding requirement is imposed on the sale of real property similar to this provision of the bill.

FISCAL IMPACT

The departmental implementation costs for this provision for additional staff, office space, and equipment to process withholding forms and payments for fiscal year 2002/2003 are estimated to be $9.1 million, with approximately 103 personnel years. Second year costs are estimated to be $ 7.3 million, with approximately 103 personnel years. The current real estate withholding workload would increase twenty-fold. It is expected that staff would process 250,000 additional sales transactions, including a substantial increase in related pre-withholding contacts from taxpayers and escrow companies, related payments, and fallout from return processing.

ECONOMIC IMPACT

Revenue Estimate

This provision would increase state revenue by $225 million for fiscal year 2002-03, $10 million for fiscal year 2003-04, and $10 million for fiscal year 2004-05.

Revenue Discussion

The estimate for real estate withholding was based on the latest tax return data comprising the Department's annual capital gain study (tax year 2000). This aggregate data includes types of capital assets sold and respective gains reported. The estimate reflects the net cash flow impact of projected increased withholding netted against projected decreased final payments and increased refunds associated with this proposal.

4. INCREASE WITHHOLDING ON STOCK OPTIONS AND BONUS PAYMENTS

EFFECTIVE/OPERATIVE DATE

This provision of the bill would apply to stock options granted and bonus payments made on or after January 1, 2002.

ANALYSIS

STATE LAW

The Administration of Franchise and Income Tax Law (AFITL) provides that the Franchise Tax Board shall prescribe the income tax withholding rate (in table form) on wages. The AFITL also provides that an employer may withhold on supplemental wages at an optional rate of 6% in lieu of the withholding amount specified in the withholding tables. Supplemental wages are defined in the AFITL to include, but not limited to, bonus payments, commissions, sales awards, and back pay including retroactive wage increases. Stock options that are granted to employees are considered supplemental wages. Employers are required to add the value of the stock option to the employee's normal wages and either withhold at the rate specified in the withholding tables or at a rate of 6% on the value of the stock option.

THIS BILL

This bill would increase the rate of withholding to 9.3% for stock options and bonus payments that constitute wages.

IMPLEMENTATION CONSIDERATIONS

Although the withholding is specified in the AFITL under a part of the Revenue and Taxation Code administered by the Franchise Tax Board (FTB), the actual collection of wage withholding is the responsibility of the Employment Development Department (EDD). This provision of the bill would not significantly impact FTB's programs and operations. However, it appears the provision may impact EDD because of the effective date and operative date of January 1, 2002.

LEGISLATIVE HISTORY

SB 1849 (Budget Committee, 2001-2002) contained a provision similar to this one. SB 1849 was held in the Senate.

OTHER STATES' INFORMATION

The laws of *Illinois, Massachusetts, Michigan, Minnesota*, and *New York* were reviewed because the tax laws of those states are similar to California's income tax laws. No statutes were found for these states where a withholding requirement is imposed, in excess of normal withholding requirements on supplemental wages, on stock options granted to employees similar to this provision of the bill.

FISCAL IMPACT

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

ECONOMIC IMPACT

<u>Revenue Estimate</u>

This provision would increase state revenue by $400 million for fiscal year 2002-03, $20 million for fiscal year 2003-04, and $20 million for fiscal year 2004-05.

<u>Revenue Discussion</u>

These estimates reflect an acceleration of revenue received rather than an increase in tax liabilities. The $400 million impact associated with the increased withholding on stock options and bonus income is based on the current Department of Finance (DOF) forecasts for stock options and bonus income. The first year revenue acceleration is significantly less than the prior estimate due to the reduction in DOF forecasts for this income type.

5. PURSUE HIGH-RISK COLLECTIONS

EFFECTIVE/OPERATIVE DATE

This provision of the bill would be operative for the period from October 1, 2002, through June 30, 2003.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

Existing federal and state laws impose tax on the income earned by individuals, estates, trusts, and certain business entities. In addition, penalties and fees can be imposed on those taxpayers that fail to file their tax returns or pay their taxes in full.

For state purposes, tax is imposed on the entire taxable income of residents of California and upon the taxable income of nonresidents derived from sources within California. The tax for individuals is computed on a graduated scale at rates ranging from 1% to 9.3%. If the taxpayer fails to report or pay their state taxes in full, FTB notifies the taxpayer that collection action may commence, which may include wage garnishments, liens, or other forms of levies.

Existing state law imposes interest on any payment of tax that is not paid on or before the last date prescribed for payment and establishes the applicable rate of interest.

The following are the more commonly imposed penalties under current state income tax laws against taxpayers that do not report or underreport their income, or do not pay deficiency assessments:

- Late filing – income tax returns that are filed late are subject to two types of late filing penalties: (1) a basic penalty of 5% of the tax per month that the return is late, up to a maximum of 25% of the tax, or (2) a minimum penalty of the lesser of $100 or 100% of the tax liability, if the return is filed 60 days or more late and the basic penalty is less than $100. If the failure to file is due to fraud, the basic penalty is 1% per month, up to a maximum of 75%.

- Underpayment – income taxes that are not paid by the original due date of the income tax return are subject to a penalty of 5% of the unpaid tax PLUS 1/2 of 1% per month, up to a maximum of 40 months (20%).

- Demand – income tax returns that are not filed upon notice and demand from the FTB are subject to a penalty of 25% of the amount of the tax required to be shown on the return.

- Frivolous return – income tax returns that are not sufficiently completed to substantially determine the correct self-assessed tax are subject to a penalty of $500.

- Accuracy-related – substantial understating income tax, overstating values of items, or overstating pension liabilities are subject to a penalty of 20% of the additional tax that is accuracy related. If the misstatements are due to fraud, the penalty is 75% of that resulting tax.

In addition, taxpayers that fail to file returns or pay their income tax liabilities may be liable for the following fees relating to the enforcement of the income tax return or liability:

- Filing enforcement cost recovery fee -- for individuals that fail to file income tax returns within 25 days after FTB mails its formal legal demand for the returns.

- Collection cost recovery fee -- for individuals that fail to pay their income taxes after FTB mails a notice for payment that advises that continued nonpayment may result in collection action.

<u>THIS BILL</u>

For the period from October 1, 2002, through June 30, 2003, this provision of the bill would allow FTB to identify eligible taxpayers with high-risk collection accounts and offer those taxpayers the opportunity to satisfy an unpaid tax liability by paying the tax in full and receiving a waiver of interest, penalties, and fees. For purposes of this provision, the following terms are defined:

- Eligible taxpayer – any taxpayer notified by FTB that their unpaid tax liabilities may be satisfied with the payment of an “eligible amount.”

- Eligible amount – an amount equal to the “unpaid tax liability” less interest, penalties, and fees. The amount must be paid in one or more installments, as determined by FTB, before the due date established by FTB, which would be no later than June 30, 2004.
- High-risk collection account – any “unpaid tax liability” where satisfaction is in the best interest of the state. These accounts include any unpaid tax liability where FTB determines:
    - efforts to collect the unpaid tax would be uneconomical, or
    - the unpaid tax liability would not be fully paid within a reasonable period of time.
- Unpaid tax liability – any liability under the Personal Income Tax Law (PITL) including tax, penalties, interest, and fees that are owed by an individual and are unpaid.

In addition, this provision would clarify that:

- No refund or credit will be granted for any penalty or interest paid prior to October 1, 2002.
- The determinations made by FTB under this provision are final and conclusive.
- FTB will not be required to disclose standards used in making the determinations under this bill or the information used for determining those standards if it is determined that the disclosure will seriously impair assessment, collection, or enforcement of the income tax laws.
- FTB is not authorized under this provision to compromise any final tax liability, and the laws regarding administrative regulations and rulemaking are not applicable for purposes of implementing and administering this provision.
- A public record must be made of each high-risk collection account that receives a waiver of penalties, interest, or fees. The public record must include the taxpayer’s name, amount of fees, penalties, and interest waived, and a summary of the reason the waiver is in the best interest of the state.

This provision of the bill would be repealed as of December 31, 2004.

IMPLEMENTATION CONSIDERATIONS

Although this provision would significantly impact the department, as stated below under “Fiscal Impact,” implementation of this provision could be accomplished by the operative date of October 1, 2002.

LEGISLATIVE HISTORY

AB 3230 (Hannigan; Stats. 1984, Ch. 1490) provided for an amnesty program for individual taxpayers relating to the nonpayment and underreporting of tax or the nonpayment of any previously assessed tax.

ABX 8 and AB 2635 (Martinez; 1997-1998) both would have provided an income tax amnesty program. The revenue generated from the program would have been transferred to special funds to provide disaster loss assistance and provide relief from damages caused by uninsured motorists, respectively. Neither bill passed its first policy committee.

SB 1439 (Oller, 2001-2002) would have created an amnesty program for certain taxpayers that have failed to file income tax returns. This bill failed passage out of the Assembly Appropriations Committee.

OTHER STATES' INFORMATION

No similar program was found in other states. However, according to information furnished by the Federation of Tax Administrators, many states have offered or are currently offering tax amnesty programs.

FISCAL IMPACT

The costs to implement this provision have been estimated at $3.3 million for 41 limited-term positions (32.5 personnel years) effective for the period of September 1, 2002, through August 31, 2003.

This bill would require the department to make programming changes to various systems and implement quality control procedures, train staff, develop and maintain a database, respond to inquiries from both eligible and non-eligible taxpayers, and manually process 500,000 accounts and the related correspondence.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

This provision would increase state revenue by $125 million during fiscal year 2002-03.

<u>Revenue Discussion</u>

The projected revenue increase is based on a universe of 500,000 high-risk accounts with an average unpaid tax of $2,500 at a projected recovery rate of 10% resulting in $125 million of revenue gain. Due to the type of accounts involved in this proposal, it is expected that any of this accelerated revenue that may have been collected in subsequent years would be insignificant in amount. Therefore, no revenue offset is projected for subsequent years.

POLICY CONCERNS

This provision could be construed to be unfair since many taxpayers with unpaid tax liabilities would not be eligible for or offered relief under this provision since the department may not consider those accounts to be high-risk.

This provision could improve compliance with state tax laws and accelerate the collection of accounts that are determined to be at high risk for collection.

<u>6. CONFORM TO FEDERAL BAD DEBT DEDUCTION RULES FOR BANKS</u>

EFFECTIVE/OPERATIVE DATE

This provision of the bill would apply to taxable years beginning on or after January 1, 2002.

ANALYSIS

FEDERAL/STATE LAW

Under federal law, for taxable years after 1986, bad debts are deducted in the year they become worthless unless the taxpayer is allowed to use the reserve for bad debt method under IRC Section 585. Under this method, the additions to the reserve that may be deducted cannot bring the reserve above the loans outstanding at year-end, multiplied by a six-year moving average percentage (the experience method). Under current federal law, the term "bank" includes a domestic building and loan association (a thrift institution)(IRC Section 581).

Banks (including a thrift institution) are the only taxpayers allowed to use the reserve method and only if they are not "large banks" (including thrift institutions). A large bank (including a thrift institution) is one where the average of all its assets is greater than $500 million during any taxable year beginning after December 31, 1986.

Under current California law, all banks, mutual savings banks, co-operative banks, building and loan associations, and other savings institutions are allowed to use the reserve for bad debt method regardless of the amount of its assets. In addition, the experience method calculations under the California regulations are based on the greater of a three- or six-year moving average rather than the federal six-year moving average. California law also provides that an additional amount may be deducted if the taxpayer is able to establish that additions to the reserve under the normal California computation are insufficient to absorb anticipated losses. In no event may loss charged to reserve for any loan be greater than that charged or reported to regulatory agencies, or reported in financial statements (R&TC Section 24348).

Federal law provides a corporate AMT rate of 20%. Existing state law provides a corporate AMT rate of 6.65%. A taxpayer with substantial income can use preferential tax benefits, such as exclusions, deductions, and credits, to reduce their income tax liability. AMT was established to ensure that a taxpayer who can use preferential tax benefits does not completely escape taxation.

THIS BILL

As described below, this provision of the bill would conform to federal law (IRC Section 585) with respect to the bad debt deduction rules. Thus, for taxable years beginning on or after January 1, 2002:

- Bad debts would be deducted in the year they become worthless, unless the taxpayer is allowed to use the reserve for bad debt method under IRC Section 585.
- Banks (including a thrift institution) are the only taxpayers allowed to use that method and only if they are not "large banks (including thrift institutions)." A large bank (including a thrift institution) is one where the average of all its assets is greater than $500 million during any taxable year beginning after December 31, 1986.
- This provision does not provide any carryback rules, any election options contained in federal 1986 or 1995 transitional rules under IRC Section 585 or IRC Section 593, or any changes to the net operating loss rules. Instead, it goes directly to the rules contained in IRC Section 585.
- However, for purposes of adjustment of income under Article 6 of Chapter 13, this provision would allow the bad debt reserves of large banks, large savings and loan associations, as well as all financial corporations at the beginning of 2002 to be taken into account at an amount of 50% of the applicable excess reserve (as defined) at the end of the first tax year beginning on or after January 1, 2002. A small bank would not have to bring any excess reserves into income.

Additionally, this provision eliminates the AMT tax preference item that was generated by the excess of the deduction allowed by the reserve method over the actual method.

IMPLEMENTATION CONSIDERATIONS

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

LEGISLATIVE HISTORY

AB 428 (Budget Committee, 2001-2002) contained a similar provision conforming to federal bad debt deduction rules for banks and modifying related AMT items. This bill failed passage in the Senate.

OTHER STATES' INFORMATION

Based on available information regarding other states, 15 states, including *North Carolina* and *Texas*, do not impose an income tax or franchise tax on banks. For those states the bad debt reserve is not part of the tax base and not an issue. There are 27 states, including *Massachusetts*, *Michigan*, and *Illinois*, that conform to federal treatment of bad debts and have not allowed large banks to use the reserve method of accounting for bad debts since 1986, and have not allowed large thrifts to use the reserve method of accounting for bad debts since 1995. Of the remaining seven states, four allow a reserve method of accounting more restrictive than the federal method. Three states, including *Alabama, New York*, and *South Carolina* (as well as *California*), allow a less restrictive reserve method of accounting for bad debts.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

This provision would increase state revenue by $285 million during fiscal year 2002-03, and by $15 million during fiscal year 2003-04.

Revenue Discussion

Estimates above reflect revenue gains from taking into account 50% of the excess reserve balances when an entity changes to the specific charge-off method, a method based on writing off actual account balances rather than an estimate of total losses. Remaining reserve balances would not be subject to recapture.

Additional revenue effects would result in a repeal scenario due to the net difference in annual additions to reserves and specific charge-offs against income. The bad debt reserve method is generally considered more favorable to the taxpayer than the specific charge-off method. Assuming lender loan bases (the total amount of loans that may be subject to loss) continue to increase, this favorable relationship would continue. Therefore, we would expect additional revenue gains attributed to the difference in deductions. The revenue gains are expected to be very small relative to the impact of the recapture of bad debts.

7. PENALTY RELIEF FOR UNDERPAYMENTS

EFFECTIVE/OPERATIVE DATE

This provision of the bill would apply to taxable years beginning on or after January 1, 2002.

ANALYSIS

FEDERAL/STATE LAW

Generally, federal and state law requires taxpayers to make estimated tax payments. Payments are generally made quarterly on a "pay as you go" basis. The payments of calendar year taxpayers are generally due on April 15, June 15, September 15, and December 15. Payments that do not meet prescribed rules, and are not covered by the many exceptions, are subject to an underpayment penalty. For federal purposes, an individual taxpayer does not have an underpayment of estimated taxes if the required estimated tax for the year is less than $1,000, known as the *de minimis* safe harbor, and,

- The individual makes timely estimated payments equal to 90% of the tax shown on the return, or

- 100% of the tax shown on the return of the individual for the preceding year. A special rule affecting high-income taxpayers with adjusted gross income (AGI) over $150,000 ($75,000 if married filing a separate return) applies. Effective for 2002, federal law requires high-income taxpayers with AGI in excess of $150,000 to make payments of 112% of the individual's tax for the preceding year. For 2003 and years thereafter, the percentage is 110%.

California law generally conforms to these rules with the exception that California maintains a $200 *de minimis* safe harbor.

Federal and state law generally requires a corporate taxpayer to make timely estimate payments equaling 100% on the tax shown on the return for the current year.

THIS BILL

This provision of the bill would exempt from the underpayment penalty, for any period before April 15, 2003, any additional tax resulting from any tax change enacted in the 2002 calendar year.

IMPLEMENTATION CONSIDERATIONS

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

LEGISLATIVE HISTORY

SB 657 (Scott, Stats. 2002, Ch. 34), and AB 1122 (Corbett, Stat, 2002, Ch. 35) conformed to federal estimated payment requirements for individuals and provided a waiver of the estimated tax penalty for items contained in these acts.

OTHER STATES' INFORMATION

Illinois, Massachusetts, Michigan, Minnesota, and *New York* all provide some procedure to provide relief from penalties for reasonable cause. The laws of these states were reviewed because of similarities to California's income tax laws.

FISCAL IMPACT

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

ECONOMIC IMPACT

This provision would not impact the state's income tax revenue.

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