Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Assembly R&T Comm.	Analyst:	Roger Lackey	Bill Number:	AB 2980
Related Bills:	See Legislative History	Telephone:	845-3627	Introduced Date:	02-27-2002
		Attorney:	Patrick Kusiak	Sponsor:	Franchise Tax Board

SUBJECT: Other State Tax Credit Source Rules/Nonresident Alimony Deduction

SUMMARY

This Franchise Tax Board sponsored bill would:

1. allow alimony to be a deduction for nonresident taxpayers, and
2. provide specific sourcing rules for the other state tax credit.

These provisions will be discussed separately.

PURPOSE OF THE BILL

Allowing the alimony deduction to nonresidents would resolve a potential federal constitutional issue.

This bill would codify the detailed rules regarding sourcing of out of state income that are presently in both case law and regulations.

EFFECTIVE/OPERATIVE DATE

This bill, as a tax levy, would be effective immediately and would be operative for taxable years beginning on or after January 1, 2002.

POSITION

Support.

At its December 18, 2000, (alimony provision) and March 6, 2002, (other state tax credit provision) meetings, the Franchise Tax Board voted to sponsor the language introduced in this legislation.

FISCAL IMPACT

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

Board Position:			Department Director	Date
X S	NA	NP	Alan Hunter for GHG	03/29/02
SA	O	NAR		
N	OUA	PENDING		

ECONOMIC IMPACT

Revenue Estimate

Alimony deduction allowed to nonresidents.

This provision is estimated to impact personal income tax revenue as shown in the following table.

Fiscal Year Cash Flow Impact Effective For Taxable Years Beginning After 1/1/02			
	2002-3	2003-04	2004-05
Nonresident Alimony Deduction	Negligible Loss	Negligible Loss	Negligible Loss

Negligible – Less than $250,000 annually.

These estimates reflect various factors including the amount of alimony paid by California nonresidents and part-year residents based on the department’s PIT samples. These estimates reflect various factors including both the amount of alimony paid by and the average apportionment factor of California nonresidents and part-year residents based on the department’s PIT samples. Revenue losses would increase to approximately $2 million annually beginning in 2005-6. This increase results from the elimination of audit enforcement that would otherwise occur due to taxpayer noncompliance under current law. Audit enforcement usually occurs approximately three years after returns are filed.

Other State Tax Credit Source Rules

Any revenue impact associated with this provision would be insignificant. The provision is declaratory of case law and departmental policy.

IMPLEMENTATION CONSIDERATIONS

This bill would improve the department’s administration of state tax law by eliminating a significant area of ambiguity.

1. *Alimony deduction allowed to nonresidents.*

ANALYSIS

FEDERAL/STATE LAW

Federal law contains rules for the taxation of persons who are not citizens of the United States that have income from sources within the United States. Those rules relating to "aliens" (whether resident or nonresident) are specifically made not applicable to California law. California rules are not based upon whether a person is a "citizen" of the United States or California, but instead are based upon the concept of "residency." In general, any person who is in this state for other than a temporary or transitory purpose is a "resident" of this state regardless of whether that person is a United States citizen. Once a person becomes a "resident" of California, they do not lose this status when temporarily absent from California. A "nonresident" is any person who is not a "resident."

A "resident" of California is taxable upon all their income, regardless of the source of that income. However, it is a fundamental principle of California income taxation that "nonresidents" of the state are subject to tax only upon their income from sources within California. Thus, California lacks jurisdiction to tax nonresidents on income from sources outside this state.

Beginning in 1982, California (and several other states, including New York) adopted a method whereby the amount of tax imposed on a nonresident or part-year resident of the taxing state is computed upon the total income of the individual, as if that individual were a resident of the taxing state for the entire year. The resulting amount of tax is prorated based upon the ratio of adjusted gross income (AGI) with a source in the taxing state over AGI from all sources. This method imposes a tax only upon income having a source in the taxing state and at the same tax rates that would apply to a resident of that taxing state.

California law currently provides that the deduction relating to alimony payments is not subtracted from California gross income by a nonresident or by a part-year resident during any portion of the year he or she was not a resident of this state.

THIS BILL

This bill would allow the alimony deduction to nonresidents. This change would make California law consistent with case law from the U.S. Supreme Court, thus resolving a potential federal constitutional issue.

LEGISLATIVE HISTORY

AB 1115 (Assembly Revenue and Taxation Committee, Stats. 2001, Ch. 920) among other changes made a number of changes to the manner that nonresidents and part-year residents are taxed. Earlier versions of AB 1115 included the alimony deduction provision in this bill, however, that provision was deleted prior to the bill becoming law.

PROGRAM BACKGROUND

In determining California-source income, current law does not allow a deduction for alimony payments made by either nonresidents or part-year residents during the time they are nonresidents, even if paid to California residents. This provision denying a deduction was first introduced in 1957. The justification for this rule appears to have been that because California does not tax nonresident taxpayers on alimony income, nonresidents should not be allowed an alimony deduction. Because alimony cannot be deducted while a nonresident, it would appear that this constitutes, under *Lunding*[1], an impermissible categorical denial of deductions to nonresidents. The effect of the current

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[1] *Lunding Et Ux. v. New York Appeals Tribunal et al.* (1998) 118 S.Ct. 766 (citations and internal quotation marks omitted). Although New York's nonresident alimony statute, New York Tax Law Section 631(b)(6), is worded differently than California's Revenue and Taxation Code Section 17302, the effect is identical. It is unclear whether in *Lunding* the petitioner computed his deduction by applying the ratio of New York to total business income or AGI, or if, in his situation, the ratio was the same. From a constitutional standpoint, however, it makes little difference exactly how the deduction is prorated so long as the method can be substantially justified and does not result in a categorical denial of the deduction to nonresidents.

California law is identical to the New York statute that was at issue in *Lunding.* It appears that all viable arguments that could have been reasonably advanced to support the calculation required by this California statute were already presented to and rejected by the U.S. Supreme Court in *Lunding*. Thus, the existing California law that denies the alimony deduction to nonresidents may be facially discriminatory in violation of the U.S. Constitution.

OTHER STATES' INFORMATION

Illinois, Massachusetts, Michigan, Minnesota, and *New York* have income tax laws similar to California. For nonresident taxpayers these states use a method whereby the amount of tax imposed on a nonresident or part-year resident is computed upon the total income of the individual, as if that individual were a resident of the state for the entire year. The resulting amount of tax is prorated based upon the ratio of AGI sourced from the taxing state over AGI from all sources. This method imposes a tax only upon income having a source in the taxing state and at the same tax rates that would apply to a resident of the taxing state having the same total income.

Based on the information available Illinois, Massachusetts, Minnesota and New York allow nonresidents to deduct alimony. Michigan is silent in regard to alimony.

2. Other State Tax Credit Source Rules

ANALYSIS

<u>FEDERAL/STATE LAW</u>

There is no federal credit comparable to the other state tax credit discussed in this bill.

Existing state law imposes tax on the income earned by individuals, partnerships, estates, and trusts. Tax is imposed on the entire taxable income of residents of California and upon the taxable income of nonresidents derived from sources within California.

Existing **California law** allows a tax credit for net income taxes paid to a state other than California. The credit is based on taxes paid to the other state on income that is also taxable under California law. The income must be from sources within the other state.

California regulations and case law are used to determine the source of income, regardless of any provision or interpretation of the law of the other state.

State law also provides specific rules to determine the source of income for California gross income for nonresident taxpayers. For nonresident taxpayers, California gross income includes only gross income derived from sources within this state.

<u>THIS BILL</u>

This bill would codify the nonresident sourcing rules for determining the appropriate other state tax credit that are presently found in case law and regulations.

LEGISLATIVE HISTORY

SB 1229 (Senate Revenue and Taxation Committee Stats. 1999, Ch. 987) made several changes to the state's income tax laws, including technical changes, filing date changes, and other income tax related items. An earlier version of SB 1229 included a provision similar to the other state tax credit sourcing rule provision proposed by this bill.

OTHER STATES' INFORMATION

The income tax laws of *Illinois, Massachusetts, Michigan, Minnesota,* and *New York* were reviewed because of their similarities to California's income tax laws.

Illinois allows a credit equal to the lesser of the tax on items of income included in both states, or the amount of the Illinois tax multiplied by the gross income taxable in the other state divided by the total gross income for Illinois.

Massachusetts allows a credit equal to the lesser of tax due to the other state reduced by interest, penalties, and any federal credit allowable on the federal return, or the amount of the Massachusetts tax multiplied by the gross income taxable in the other state divided by the total gross income for Massachusetts.

New York allows a credit for taxes paid to other states. The credit cannot reduce the tax below the amount of tax that would have been due had the income from the other state not been included.

Michigan and *Minnesota* do not have a credit similar to California's other-state-tax credit.

ARGUMENTS/POLICY CONCERNS

This bill would provide certainty for both the taxpayer and the department in administering the other state tax credit. Also, it would provide effective guidance for taxpayers with complex sourcing issues.

Case law and regulations currently implicate the use of nonresident sourcing rules in determining the credit. This bill would affirm such use and would provide, without question, that the nonresident sourcing rules shall be used in determining the other state tax credit.

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