

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Strickland Analyst: Norman Catelli Bill Number: AB 305

Related Bills: See Legislative History Telephone: 845-5117 Introduced Date: 02/16/01

Attorney: Patrick Kusiak Sponsor: California Senior Legislature

SUBJECT: Revise Form 540EZ to Allow Usage by Taxpayers 65 or Older/Flat Tax Rate for These Taxpayers

SUMMARY

This bill would give qualifying seniors a reduced tax rate and the option of using a new modified Form 540EZ.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to make filing income tax returns easier for seniors.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective on the date of enactment. Because the bill would affect the computation of tax, the bill would be operative for taxable years beginning on and after January 1, 2001.

POSITION

Pending.

Summary of Suggested Amendments

A fiscal year 2001/02 appropriation is needed for the department to implement and administer this bill beginning January 1, 2002. Additional amendments are needed to resolve the issues discussed under "Implementation Considerations."

ANALYSIS

FEDERAL/STATE LAW

The state income tax law for all individuals is largely patterned upon the federal income tax law. Current state income tax law requires the department to make the tax forms as simple as possible for taxpayers to prepare. The department is required to design the forms so taxpayers can copy figures from or attach a copy of their federal returns. The following are items that must be taken into consideration in tax form design and tax return preparation:

Board Position:

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 N OUA X PENDING

Department Director

Date

Gerald H. Goldberg

05/29/01

Adjusted gross income (AGI) -- Individuals generally begin their California personal income tax (PIT) return preparation by copying their federal AGI to their California income tax return. Additionally, other federal income tax return numbers are copied to the California income tax return. However, frequently federal and state differences require that the taxpayer modify an income item(s) reflected in the federal AGI for California income tax purposes to determine California AGI. The source of income dictates the complexities of the modifications. The following include some of the income items that may be subject to different treatment under federal and state law and, therefore, are subject to modifications for California tax purposes:

- mutual fund dividends;
- social security benefits;
- capital gains/losses;
- retirement-type distributions;
- constitutionally exempt interest income;
- California lottery winnings;
- depreciation; and
- disaster net operating losses.

Filing requirements -- Federal and state income tax law requires individuals to file a tax return when their AGI reaches certain dollar levels (AGI threshold). For California, the thresholds are increased for senior citizens or individuals with dependents. Generally, married individuals file their state income tax returns with the same filing status as used on their federal income tax returns, either married filing separately or married filing jointly.

Tax rates -- Under current state tax law, an individual's California AGI may be subject to tax at up to six personal income tax rates ranging from 1% to 9.3%, depending upon the level of income (progressive tax rate structure). Income brackets establish the tax rates. The range of the income bracket differs depending upon the filing status of the taxpayer: single, married filing a separate return, married filing a joint return, qualifying widow(er) with dependent child, or head of household. For example, a single individual, under California's progressive tax rate structure, with \$3,650 in taxable income is taxed at 1%. If that single individual, however, has taxable income of \$8,000, the first \$3,650 is taxed at 1% and the remaining \$4,350 is taxed at 2%. The percentage rates increase as the amount of income in the various brackets increases. The top rate for individuals is 9.3%. For single individuals, the top rate is for taxable income over \$23,950, and for heads of household, taxable income over \$32,600.

Credits -- Once the tax amount is computed, the individual may be allowed certain credits to reduce that tax amount. Under state law individuals generally are allowed a personal exemption credit, with an additional exemption credit allowed for senior citizens. The renter's credit is another credit that is claimed by many individuals, and a special head of household credit is available for certain qualifying senior citizens.

Nonresident and part-year residents -- These individuals must make additional calculations to compute their taxes for California income tax purposes.

The income tax is self-assessed. However, the department is required to determine that the correct amount of tax is reflected on the return. Additionally, FTB must capture income tax return data for statistical purposes.

THIS BILL

Under this bill, qualifying seniors could use the Form 540EZ (which no longer exists, see "Program Background") income tax return to compute their tax at a flat tax rate of 2.5% of their total income. To qualify for the flat tax option, the qualifying senior must be:

- 65 years of age or over, and
- either a single person with total income for the taxable year of \$50,000 or less; or a married couple filing a joint return with total income for the taxable year of \$100,000 or less.

For purposes of the flat tax, "total income" is defined as "taxable capital gains, dividends, interest, and pension income."

IMPLEMENTATION CONSIDERATIONS

The 540EZ could be reinstated and revised for purposes of this bill. However, significant implementation considerations exist, as discussed below. Staff is available to work with the author to resolve these considerations as the bill moves through the legislative process.

Two tax methods -- To administer both the current tax and flat tax methods for taxable year 2001, the department would need to make changes to its computer systems, tax return processes, and eventually, audit procedures. Taxable year 2001 tax returns would be processed beginning on or after January 1, 2002. With an appropriation in the bill, staff indicates the change could be accomplished by January 1, 2002.

Author's intent -- Without amendments, the bill may be inconsistent with or unclear as to the author's intent, as follows:

- Although the author's staff has indicated the intent of the bill is to provide a flat tax option for qualifying seniors, the bill could be interpreted to provide a flat tax for all qualifying seniors and a filing option. Amendments would be needed to clarify that the flat tax rate is an option rather than the tax computation applicable for all eligible seniors.
- Only the following specific income items would be subject to the flat tax rate: taxable capital gains, dividends, interest, and pension income. Other income items (e.g., wages) received by seniors that are taxed under the current tax method would be exempt from tax under the flat tax method. According to the author's office, the intent of this bill is for all income items, including wages and retirement-type income, to be subject to the flat tax rate for qualifying seniors who choose this option. The bill should be amended to define "total income" to achieve this intent.
- The specific components of "total income", i.e., "taxable capital gains, dividends, interest, and pension income" are not further defined.
- It is not clear whether qualifying seniors would continue to make the AGI modifications for state and federal differences, which according to the author's office is the intent of the bill. Under the author's intent, social security benefits, constitutionally tax exempt interest, California lottery winnings, and other tax exempt or excluded income items would continue to be tax exempt or excluded under the flat tax option. However, whether the author intends this treatment to be continued should be clarified in the bill because making these modifications adds complexity to income tax return preparation.

- Unless “total income” is further clarified, qualifying seniors would not be allowed either the current standard deduction or the option of itemizing deductions. According to the author’s office, this is the intent of the bill. Under the author’s intent, neither the standard nor itemized deductions would be allowed for qualifying seniors under the flat tax option.
- It is unclear whether married couples may file a joint return under this flat tax option if both taxpayers are not seniors. According to the author’s staff, if only one spouse is a senior, a joint return could still be filed under this flat tax option. The bill should be amended to clarify this intent.
- As written, qualifying seniors would continue to be allowed the personal exemption credit and other credits, including carryovers, under this flat tax option. It is unclear whether this is consistent with the author’s intent. If qualified seniors can continue to claim credits, the application of credits or carryovers adds complexities to income tax preparation.
- Only single seniors and married couples filing jointly would be allowed to use this flat tax option. The bill makes no provision for those qualifying seniors that are married filing separately or that may be heads of household or qualifying widow(ers). Whether it is the author’s intent to exclude these seniors, is unclear.
- The flat tax option is not limited to qualifying seniors who are California residents. Part-year residents and nonresidents compute their tax as though residents, then multiply the tax amount by the ratio of California AGI to total AGI from all sources outside California. Under this bill, it would appear that part-year residents and nonresidents that are eligible seniors would not compute their tax under the flat tax method multiplied by the ratio of California AGI to total AGI. The author’s intent for taxing qualifying seniors who are not residents should be clarified.

Tax form design -- The revised Form 540EZ may look similar to the existing forms. A Form 540EZ revised for qualified seniors would need:

1. additional lines on the form for nontaxable items such as social security. These lines allow the department to continue to determine readily that taxpayers correctly report income and compute their tax, and to capture all the statistical data currently required.
2. worksheets or schedules in the instructions to accommodate the modifications for the federal and state differences in income and itemized deduction for qualifying seniors on a single income tax return form; and
3. additional special tax tables and instructions to accommodate the additional personal exemption credit allowed for seniors.

Additionally, the department does not capture date of birth information on taxpayers for income tax purposes. Under this bill, the department may need this information on the income tax return, and verification thereof, to ensure that only seniors are choosing the flat tax method.

LEGISLATIVE HISTORY

AB 2347 (Bates; 1999/2000) was generally the same as this bill. *AB 2347* was not heard in its first policy committee (Assembly Revenue and Taxation Committee).

AB 1370 (Wiggins; 2001/2002) and *SB 831 (Poochigian/Johnson; 2001/2002)* in general, have only one component of this bill. Both bills intend to allow seniors to file a simpler income tax form. Neither provides a flat tax rate.

PROGRAM BACKGROUND

The department received approximately 13.5 million PIT returns in 2000. Income tax returns must be processed quickly to get payments deposited into the bank and overpayments refunded to the taxpayers.

Individuals generally start their income tax preparation by completing the federal income tax return. They first determine their federal gross income, which includes the items listed in this bill as "total income," plus many other income items. Adjustments (subtractions and additions) are then made to gross income to compute federal AGI.

The department provides a variety of tax forms (including instructions and schedules) for personal income tax (PIT) taxpayers. Tax forms are designed to enable taxpayers to self-assess their correct tax liability. The instruction booklets generally include worksheets and tax tables to aid the taxpayer in making the calculations necessary to compute the correct tax liability. The tax forms generally reflect any income that is taxable under federal law but not California law, so the department can capture that data for statistical purposes. Information on the various income tax return forms is provided below.

The form that a taxpayer should use is determined by several factors, including filing status, dependents, amount and sources of income and deductions. The department has created forms to fit general demographic categories of taxpayers based on the income and deductions they are most likely to have. The forms range from the most complex, which accommodate any combination of income and deductions, to the simplest, which accommodate uncomplicated income profiles made up of only wages, small amounts of interest income, and no deductions. Each of these categories serves a large group of taxpayers, and the differences between each form is easy to communicate to taxpayers.

Form 540 -- The longest income tax return form. All taxpayers may file this form. This form is designed to recognize all income items and modifications that a taxpayer may be required to include in computing the correct tax liability. Ultimately, the department is responsible for determining that the correct tax liability is shown on the taxpayer's income tax return. For this purpose, the department requires taxpayers with certain income items to attach a copy of the federal return or federal schedules to the California income tax return. Through the copy of the federal income tax return and schedules, the department can verify the correctness of the taxpayer's income items and calculations. The Form 540 is two pages long with 70 lines of data.

Form 540A -- A less complex income tax return form. The Form 540A is two pages with 40 data lines. In general, taxpayers with the most common income items and deductions can use this form. These taxpayers may have limited modifications to federal AGI and deductions to reflect state and federal differences and may claim limited credits. The income limitations were removed from this form for 2000 to allow more taxpayers, specifically seniors, to use the form.

Form 540A Senior -- A newly published special edition for seniors and a less complex form (tax year 2000). Instructions are in larger print and focus on those items commonly of interest to seniors. The instructions highlight the higher senior income thresholds and the senior exemption credit. The income tax return form itself is the same as the other Form 540A.

Form 540 2EZ -- The least complex form. It is a newly designed two-page post-card size income tax return (tax year 1999). This income tax return was designed separate and apart from the federal income tax return; the taxpayer does not copy figures from the federal return. Previously, the least complex form was the Form 540EZ, but with the creation of the Form 540 2EZ and revisions to the Form 540A, the Form 540EZ was discontinued in 2000. The Form 540 2EZ was designed based on the 540EZ. It is restricted to those taxpayers with the least complex income items, who use the standard deduction, who have no more than three personal exemption credits, and whose only tax payments are in the form of wage withholding. The Form 540 2EZ taxpayers must use a special tax table. Built into this table is the standard deduction and up to three personal exemption credits. Approximately 3 million taxpayers are eligible to use this form.

Form 540NR -- A form designed especially for part-year residents and nonresidents. This form recognizes the unique tax calculations required of these taxpayers.

Tax return filing -- Paper forms must be mailed to FTB. However, technology allows California taxpayers many alternatives to paper filing that allow faster, easier, and more accurate filing. For example, Internet filing, electronic filing, Telefile, and a variety of scanning options.

OTHER STATES' INFORMATION

Of the 44 states that have a personal income tax law, nine have a flat tax. However, none impose the flat tax on only certain classes of taxpayers.

A review of *Michigan* and *New York* tax forms found that those states do provide a short and long personal income tax form. However, individuals with pension or social security income are required to file the long form. *Illinois*, *Massachusetts*, and *Minnesota* provide only one personal income tax form, which appears to be the equivalent of a California Form 540. The forms of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

Departmental Costs

Preliminary data indicates the department would require approximately \$285,000 in fiscal year 2001/02 for computer programming and testing to implement and administer the provisions of this bill. Any other costs that may be needed will be identified as the bill moves through the legislative process. The suggested language for the appropriation (total amount yet to be determined) is attached.

ECONOMIC IMPACT

Tax Revenue

Based on data and assumptions discussed below, this bill would result in the following revenue losses under the PIT Law.

Estimated Revenue Impact of AB 305 As Introduced 2/16/01 [\$ In Millions]		
2001-02	2002-03	2003-04
-\$150	-\$125	-\$130

This analysis assumes the bill would be amended to achieve the author's intent as discussed under "Implementation Considerations." The bill would be effective for taxable years beginning on or after January 1, 2001, with enactment assumed after June 30.

Revenue Estimate Discussion

The revenue impact of this bill would depend upon the number of qualifying seniors who would choose the flat tax method for computing their tax, and thereby, reduce their tax liability. This analysis further assumes qualifying seniors who could choose this flat tax method, but decide not to because they would experience a tax increase, would continue to compute their tax under the current law. Therefore, under this analysis, approximately 220,000 qualifying seniors would file their income tax returns under the flat tax method.

In accordance with the intention of the author, the flat tax method consists of multiplying the California AGI (modified for federal and state differences) by the flat tax rate of 2.5%, and reducing that tax amount by any credits that could be applied.

Tax return information (1998 as the base year) was used for this revenue estimate. For each qualifying senior, the tax was computed under current tax law and compared to the amount that would be computed under the flat tax method.

Although this bill would reduce State income taxes for many qualifying seniors, the reduction would potentially increase their federal tax liability (to some extent), because the amount of State taxes paid is a federal itemized deduction would decrease. Therefore, for every dollar of reduced State tax liability, their federal itemized deductions would be reduced and, hence, their federal income tax liability would increase by approximately 20 cents, on average.

ARGUMENTS/POLICY CONCERNS

- Having two tax rate methods for computing California income tax would add to the complexities of the state's tax laws and could cause additional confusion.
- Qualifying seniors would likely compute their taxes under both current law and the flat tax method to determine which method would result in the least amount of tax. This would increase the time these seniors spend on income tax preparation.
- Other taxpayers may feel discriminated against since they wouldn't have the option of paying a flat tax rate. This could be perceived as being unfair to other taxpayers.
- Legislation is not needed to require the department to create simple tax forms. Current State law allows the department to design forms that ease taxpayer compliance. Further, the Franchise Tax Board is committed to simplifying the ways Californians file and pay their taxes. The department has an ongoing history of attempting to ease the administrative filing burdens on taxpayers and helping individuals file their tax returns faster and better. The department is constantly improving the filing systems. For example, adding programs like Internet filing, electronic filing, Telefile, offering simpler paper returns like the Form 540 2EZ and Form 540A Senior, and providing a variety of scanning options. Department staff is available to explore ideas for simpler forms, new forms and methods of filing.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 305
As Introduced February 16, 2001

AMENDMENT 1

On page 2, line 8, after "SEC. 2." insert:

The sum of _____dollars (\$_____) is hereby appropriated to the Franchise Tax Board in augmentation of its support budget (Item 1730-001-0001 of the Budget Act.

SEC. 3.