Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author: Perata | Analyst: John Pavalasky | Bill Number: SB 1017

Related Bills: See Prior Analysis | Telephone: 845-4335 | Amended Date: June 11, 2001

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Taxation of Estates/Trusts Shall Not Apply To Qualified Portfolio Capital Gain If Fiduciary Elects

____	DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ______________________.
X	AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.
____	AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended ______________________.
____	FURTHER AMENDMENTS NECESSARY.
____	DEPARTMENT POSITION CHANGED TO ______________________.
X	REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 23, 2001 STILL APPLIES.
X	OTHER - See comments below.

SUMMARY

This bill would allow an election to limit California's ability to tax the capital gain income of estates and trusts.

SUMMARY OF AMENDMENT

The June 11, 2001, amendment would allow the fiduciary of an estate or trust to elect to have "qualified portfolio capital gain," as defined, excluded from taxation.

ANALYSIS

FEDERAL/STATE LAW

In addition to the discussion contained in the analysis of the bill as introduced February 23, 2001, the following discussion is relevant to the June 11, 2001, amendments.

A tax on an estate or trust is imposed only when the estate or trust does not distribute all of its income or gains in the taxable year. In that case, the estate or trust pays tax on that undistributed income or gain in the taxable year the income is received or the property is sold or exchanged in a transaction in which gain is recognized.

Board Position:			Legislative Director	Date
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When the undistributed income or gain is actually distributed in the future, that distribution is taxable to the beneficiary receiving that distribution in the year of distribution with a tax credit allowed equal to the taxes paid by the trust on that undistributed income or gain in the earlier year. If the distribution is made to a nonresident beneficiary, the portion of the distribution that is derived from intangible personal property such as stocks or bonds will not generally be treated as California-source taxable income.

THIS BILL

This bill would allow the fiduciary of an estate or trust to elect to exempt "qualified portfolio capital gain" income from taxation.

This bill defines "qualified portfolio capital gain" to mean the gain on the sale of all or a portion of the estate's or trust's holdings of a single asset comprising at least 75% of the value of the entire estate or trust. For example, assume that the assets in the estate or trust include 5,000 shares of XY Corporation stock and the total value of those shares is at least 75% of the value of all the assets of the estate or trust. When 100 shares of that stock are sold, this bill would allow the fiduciary to elect to exclude the gain on that sale from California tax, even though the proceeds from the sale were not distributed to the beneficiary.

This election could be exercised only twice with respect to a single estate or trust, and it could be made only on a timely filed return for a sale made during that taxable year. In addition, the sale must have been within five years of holding a qualified portfolio.

IMPLEMENTATION CONSIDERATIONS

The following implementation considerations relate to the June 11, 2001, amendments.

1. This bill would require that to be considered "qualified portfolio capital gain" when all or part of the asset is sold, the asset must comprise at least 75% of the value of the entire estate or trust." Since the test is met on an aggregate basis, it is important to define whether this test is met on an aggregate basis for all stock as the asset being measured, if an estate or trust owns more than one company's stock, or whether the stock in each company owned is to be measured to determine that it comprises at least 75% of the value of the entire estate. In addition, the bill is silent regarding the date on which the 75% test is to be met. Is the 75% test measured before or after the sale or is it to be measured when the estate or trust is created? Without clear definitions, disputes could arise between the estate or trust and the department.

2. This bill allows the election to be made only twice with respect to a single estate or trust. Although this provision of the bill appears restrictive, the ability to create multiple trusts for a single beneficiary would enable numerous trusts to be created with asset holdings designed to meet the 75% of total value requirement. Thus, each trust would enable the trustee to elect tax-free treatment twice. The requisite number of trusts could be created that would essentially enable an unlimited number of elections of tax-free treatment with respect to asset holdings.

ECONOMIC IMPACT

Revenue Estimate

Based on tax liabilities of fiduciaries filing for the 1998 tax year, the following estimates reflect order of magnitude potential revenue losses for the initial three-year period.

Estimated Revenue Impact of SB 1017 As Amended 6/11/01 ($ In Millions)		
2001-2	2002-3	2003-4
-$40	-$190	-$340

The bill would be effective for taxable years beginning on or after January 1, 2001, with enactment assumed after September 2001.

Revenue Discussion

This amended version of the bill would result in rather easily attained tax-avoidance opportunities for creators of trusts to meet the minimum 75% asset test for tax-free treatment for their clients. In cases where the 75% asset test is not currently met, creators of trusts can, for example, separate and assign targeted assets to multiple trusts to satisfy the asset test of 75% and thereby avoid tax on all or any portion of the sale of the asset. Potential revenue losses for this version of the bill would potentially exceed that projected for the proposed residency test of the original bill.

For the 1998 tax year, the total amount of income tax paid by taxable trusts and estates was approximately $380 million with trusts comprising around 95%. For this amended bill, the assumed percentages of revenue at risk used previously (original bill) would be higher (except for 2001 because of the later assumed enactment date), i.e. one-tenth for 2001, increasing to one-half for the second year, and to 90% for 2003. This estimate was further modified to include estates and for certain forms of fiduciary income not constituting capital gains (e.g. interest income, dividends).

ARGUMENTS/POLICY CONCERNS

1. Under this bill, the beneficiary would not be required to be a nonresident of California during the entire taxable year that the sale is made. This would enable a fiduciary of an estate or trust having a resident beneficiary to avoid paying tax in the year of sale and also distribute that gain to that beneficiary upon that beneficiary establishing residency in another state in a later year.

   Thus, the gain would be tax free even though the beneficiary was a resident of California and would have been required to pay tax on the gain had they, rather than the trust, held the asset on the date of sale. This provision has the potential to completely eliminate the California tax on capital gain for sophisticated tax planners.

2. This bill would define the term “qualified portfolio capital gain” to mean the capital gain recognized by an estate or trust upon the sale of all or a portion of its holdings of an asset comprising at least 75% of the value of the entire estate or trust. This definition, however, is not limited to “intangible” assets such as stocks, bonds, or other evidences of indebtedness but

would include real property and tangible personal property located in California. Thus, the gain on real and tangible personal property located in California would be tax free even though the residuary beneficiary would have been required to pay tax on this gain had they, rather than the trust, held the asset. If this is the author's intent, this definition has the potential to completely eliminate the California tax on all capital gain for sophisticated tax planners.

3. The exemption from tax of undistributed portfolio capital gains by estates and trusts proposed by this amended bill could encourage the proliferation of trusts established for tax planning purposes by sophisticated tax planners.

4. Under this amended bill, the California tax on portfolio gain accumulated by an estate or trust would be deferred/eliminated until it is distributed, rather than being paid each year that the income is accumulated. Should California impose a nondeductible interest charge on the estate or trust making the election as a price for the state permitting a current deferral/elimination of that tax.

LEGISLATIVE STAFF CONTACT

John Pavalasky
Franchise Tax Board
845-4335

Brian Putler
Franchise Tax Board
845-6333