Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Scott | Analyst: Kristina E. North | Bill Number: SB 219

Related Bills: See Legislative History | Telephone: 845-6978 | Amended Date: August 23, 2002

Attorney: Patrick Kusiak | Sponsor: ______

SUBJECT: Allow All Taxpayers To Be Eligible For Disaster Relief/Conformity To Federal Victims Of Terrorism Relief Act/AB 1122 Federal Conformity Clean-Up

____ 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 ______________________.

____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED ______________________ STILL APPLIES.

X OTHER - See comments below.

SUMMARY

This bill would do the following:

1. conform state law to specified sections of the federal Victims of Terrorism Tax Relief Act of 2001;
2. adopt the federal employer-provided adoption assistance income exclusion;
3. extend the time a "financially disabled" taxpayer has to file a claim for an income tax refund;
4. adopt certain federal scholarship and fellowship income exclusions;
5. correct AB 1122's (Stats. 2002, Ch. 35) inadvertent failure to conform to federal installment sale pledge rules;
6. make several technical non-substantive corrections to provisions added by AB 1122; and
7. permit a 100% shareholder of an S corporation to file a group return.

Each of these provisions will be discussed separately under **ANALYSIS**.

SUMMARY OF AMENDMENTS

The August 23, 2002, amendments added items 2 through 7 listed above and are discussed in this analysis. Each of these provisions will be discussed separately under **ANALYSIS**.

The provisions regarding conformity to sections of the Victims of Terrorism Relief Act were discussed in the department's previous analysis of this bill as amended June 13, 2002.

Board Position:			Department Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR	Gerald H. Goldberg	9/16/02
____ N	____ OUA	X PENDING		

PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to:

- grant financial relief to victims or the families of victims of a Presidentially declared disaster or terrorist attack by conforming to specified federal law relief provisions.
- simplify California income tax law by providing taxpayers income tax treatment comparable to federal law.

EFFECTIVE/OPERATIVE DATE

As an urgency statute, this bill would be effective immediately. Some of the provisions related to the Victims of Terrorism Tax Relief Act specify an operative date that would apply to taxable years ending before, on, or after September 11, 2001.

POSITION

Pending.

At its meeting on March 6, 2002, the Franchise Tax Board voted to take a support position on the language providing specific relief for all taxpayers affected by a Presidentially declared disaster.

At its March 6, 2002, meeting the Franchise Tax Board voted to sponsor legislation for the suspension of the statute of limitations for financially disabled taxpayers as contained in this bill.

FTB has not had an opportunity to consider the recent amendments pertaining to the Federal Victims of Terrorism Tax Relief Act of 2001.

REVENUE TABLE

Estimated Impact As amended on August 23, 2002 ($ In Millions)				
Provision	Foot note	2002/03	2003/04	2004/05
Employer-provided Adoption Assistance		Negligible Loss	Negligible Loss	Negligible Loss
Financially Disabled SOL Extension		**Negligible Loss**	**Negligible Loss**	**Negligible Loss**
Exclusion of Specified Scholarship Awards	(a)	Negligible Loss	Negligible Loss	Negligible Loss
Installment Method Pledge Rules	(b)	-	-	-
Nonsubstantive Technical Corrections		No Impact	No Impact	No Impact
100 % Shareholder of S Corp may file a Group Return	(c)	Negligible Gain	Negligible Gain	Negligible Gain
Terrorism Relief	(d)	Negligible Loss	Negligible Loss	NegligibleLoss
Disaster Relief Deadlines	(e)	-	-	-

Negligible – less than $250,000 annually
Minor – less than $500,000 annually

Footnotes:
(a) Based on federal loss projections of $1 million per year for this provision, state income tax revenue losses are projected to be insignificant.

(b) Baseline revenue gains are projected to be $1 million annually. Estimate was originally included in AB 1122, 2002.
(c) No specific data is available to determine the revenue effect of allowing one nonresident shareholder to file a composite return. Group return income is taxed at the highest marginal tax rate, cannot include deductions except those necessary to determine each shareholder's pro rata share, and no credits are allowed other than those directly attributable to the S Corporation. The revenue gain from this election is expected to be negligible (not exceeding $250,000 annually) beginning in 2002/03.
(d) Negligible revenue losses of under $250,000 are expected for fiscal year 2002/03, under $200,000 for 2003/04, and under $100,000 for 2004/05.
(e) Revenue losses included in (d).

The revenue estimate for SB 219 is being revised from previous revenue estimates on related bills. Specifically, the revenue analysis of the provision that would toll the SOL for taxpayers while they are financially disabled has been revisited. The previous analyses of this provision inadvertently ignored the impact of California Revenue and Taxation Code Section 19311. That statute allows any taxpayer two years subsequent to the filing of a federal claim for refund to file a California claim for refund. Thus, most of the revenue loss that was associated with the tolling of the statute provision in SB 219 is actually attributed to Section 19311, and, as such, is part of the baseline revenue forecast. Therefore, the revised revenue estimate for the provision to extend the SOL for financially disabled taxpayers in SB 219 is a negligible loss, less than $250,000, annually.

OTHER STATES' INFORMATION

Due to the similarity in income tax laws, the department reviewed the income tax laws of the states of *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York*. (NOTE: *Florida* imposes a corporation income tax, however it does not impose a personal income tax.)

Item 1. For taxpayers and businesses affected by a Presidentially declared disaster, the majority of states conform to the current federal provisions for a Presidentially declared disaster. Individual state information on conformity with the Victims of Terrorism Tax Relief Act of 2001 was not available.

Items 2 and 3. The review of these states' tax laws indicates that they do not permit employer adoption expenses, or allow a suspension of the statute of limitations (SOL) based on a taxpayer being "financially disabled."

Item 4*.* *Illinois, Michigan*, and *New York* tax laws conform to this federal change. *Massachusetts* and *Minnesota* have not conformed to this change.

Items 5, 6, and 7*.* *Illinois, Massachusetts, Minnesota,* and *New York* permit the filing of a group or a composite (similar to a group) return. It could not be ascertained if these states would allow a 100% shareholder or a single shareholder of an S corporation to file a group or composite return. *Florida* does not have a personal income tax and *Michigan* has a "single business tax." Consequently, this provision does not apply to these two states.

ANALYSIS

2. Exclusion of Employer Adoption Expenses

<u>FEDERAL/STATE LAW</u>

The federal Economic Growth and Tax Relief Reconciliation Act of 2001 allows a maximum $10,000 exclusion from the gross income of an employee for qualified adoption expenses paid or reimbursed by an employer under an adoption assistance program, including special needs adoptions.

The special need adoption provisions do not become operative until January 1, 2003. The 2001 Act also repealed the termination date of December 31, 2001, making the exclusion permanent.

A special needs child is an eligible child who is a citizen or resident of the United States who a state has determined: (1) cannot or should not be returned to the home of the birth parents; and (2) has a specific factor or condition (such as the child's ethnic background, age, or membership in a minority or sibling group, or the presence of factors such as medical conditions, or physical, mental, or emotional handicaps) because of which the child cannot be placed with adoptive parents without adoption assistance.

The exclusion for qualified adoption expenses, including special needs adoptions, is phased out ratably for taxpayers with modified adjusted gross income in excess of $150,000. Therefore, the exclusion is not available to taxpayers with modified adjusted gross income of $190,000 or more. Modified adjusted gross income is the taxpayer's adjusted gross income plus certain amounts otherwise excluded, such as the income of U.S. citizens or residents living abroad and employer payments and reimbursements for adoption expenses.

Federal and state laws also provide an adoption credit for unreimbursed adoption expenses. Adoption expenses paid or reimbursed by the employer under an adoption assistance program are not eligible for the adoption credit. A taxpayer may be eligible for the adoption credit for qualified unreimbursed adoption expenses and also for the exclusion with respect to different qualified adoption expenses paid or reimbursed by his or her employer.

California conformed to the federal law with regard to the exclusion for employer-provided adoption expenses prior to the Economic Growth and Tax Relief Reconciliation Act of 2001, which allowed an exclusion of a maximum of $5,000 for employer-provided adoption assistance. By conformity to prior federal law, this exclusion from income ceased to apply to amounts paid or expenses incurred after December 31, 2001.

<u>THIS PROVISION</u>

This provision would conform state law to federal law, permanently allowing a maximum $10,000 exclusion from the gross income of an employee for qualified adoption expenses paid or reimbursed by an employer under an adoption assistance program, including special need adoptions.

3. Suspension of SOL for Financially Disabled Taxpayers.

<u>FEDERAL/STATE LAW</u>

Current federal law requires a taxpayer to file a claim for refund for an over payment of tax within the later of:

- three years from the date the return was required to be filed, or
- two years from the date of payment of the tax, or
- seven years after the due date of the return in the case of bad debts or worthless securities.

A refund claim that is filed after these periods is considered untimely and is disallowed.

Also, **federal law** (IRS Reform Act) suspends the SOL for certain refund claims for a period where the taxpayer is “financially disabled.” Individuals are “financially disabled” if they are unable to manage their financial affairs because of a medically determinable physical or mental impairment that is expected to result in death or to last for a continuous period of at least one year.

An individual would not be considered financially disabled for any period that the individual's spouse or any other person is legally authorized to act on that individual's behalf in financial matters. The law does not specify a time limit on the suspension.

Current state law allows a taxpayer to file a claim for refund of tax within the later of:

- four years from the date the return was required to be filed (without regard to extensions), or
- one year from the date of payment of tax; or
- two years from the date of a final federal determination; or
- seven years after the due date of the return in the case of bad debts, worthless securities, or erroneous inclusion of recoveries.

The California Sales and Use Tax Law, like federal law, suspends the SOL for certain refund claims for any period where the taxpayer is "financially disabled." However, the **California Personal Income Tax Law** does not have a "financially disabled" suspension of the SOL for income tax purposes.

<u>THIS PROVISION</u>

This provision would allow the SOL for filing claims for refund for income tax purposes to be suspended during periods where the taxpayer is "financially disabled."

LEGISLATIVE HISTORY

AB 1208 (Chesbro, 1999/2000) included the suspension of the SOL for financially disabled claimants along with numerous other items of proposed legislation. However, AB 1208 failed to move out of the Senate Appropriations Committee and, as a result, died.

AB 1633 (Ortiz, 1997/1998) also contained the suspension of the SOL for financially disabled claimants with other provisions of the IRS Restructuring and Reform Act of 1997. AB 1633 failed to pass the Assembly Appropriations Committee and subsequently died.

AB 1469 (Ortiz, 1997/1998) included suspension of the SOL for financially disabled claimants and other provisions of the IRS Restructuring and Reform Act of 1997. Governor Wilson vetoed AB 1469 because of other provisions contained in the bill.

4. Provide Exclusion from Income for Scholarship Awards

<u>FEDERAL/STATE LAW</u>

The Internal Revenue Code excludes from gross income amounts received as a qualified scholarship for qualified tuition and related expenses. The tax-free treatment does not extend to scholarship amounts covering regular living expenses, such as room and board. The exclusion for qualified scholarships and tuition reductions does not apply to any amount received that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction.

The National Health Service Corps Scholarship Program (the "NHSC Scholarship Program") and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the "Armed Forces Scholarship Program") provide education awards to participants on the condition that the participants provide certain services. In the case of the NHSC Program, the recipient of the scholarship is obligated to provide medical services in a geographic area identified by the Public Health Service as having a shortage of health care professionals.

In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility.

Prior to the Economic Growth & Tax Relief Act of 2001 (EGTRRA), because the NHSC Scholarship and Armed Forces Scholarship Programs required the recipients to perform services in exchange for the amounts received under the program, the amounts used to pay higher education expenses were taxable income to the recipient. EGTRRA provided that amounts received by an individual under the NHSC Scholarship Program or the Armed Forces Scholarship Program are eligible for tax-free treatment as qualified scholarships.

California law was in conformity with federal law, as it relates to the income exclusion for amounts received as a qualified scholarship, prior to the changes made by EGTRRA.

THIS PROVISION

This provision would conform California law to the changes made by EGTRRA excluding from income amounts received as a scholarship for qualified tuition and related expenses from the NHSC Scholarship Program or the Armed Forces Scholarship Program.

5. Conform to the Modification of the Installment Method Pledge Rules.

FEDERAL/STATE LAW

The Conformity Act of 2002 (Corbett, AB 1122, Stats. 2002, Ch. 35) conformed California law to numerous federal changes occurring after January 1, 1998. The federal Ticket to Work Act (PL 106-170) modified the installment method pledge rules making the rules more restrictive (IRC 453A(d)(4)). AB 1122 inadvertently failed to conform to this federal change.

Prior to the Ticket to Work Act, if a taxpayer on the installment method of accounting “directly” pledged the installment promissory note as collateral for a loan, recognition of the gain from the sale generating the promissory note would be accelerated up to the amount of the pledge. This is done because, in effect, the taxpayer is treated as having received money from the sale of property at the time the loan proceeds are received.

The Ticket to Work Act expanded the pledge rule to installment promissory notes “indirectly” used as collateral for a loan.

THIS PROVISION

This provision would conform state law to the pledge rule contained in the federal Ticket to Work Act.

6. Technical and Non-Substantive Corrections to AB 1122

This provision would make eight non-substantive technical changes to related to the enactment of AB 1122. Five of the corrections affect pension conformity provisions in AB 1122, two of the corrections affect S corporations, and the last technical change renumbers a Revenue and Taxation Code section added by AB 1122.

7. Permit a 100% Shareholder of an S Corporation to File a Group Return

STATE LAW

The existing Personal Income Tax Law (PITL) imposes a tax on the income of a nonresident taxpayer that is derived from or attributable to sources within this state. Generally, a nonresident taxpayer will file a Form 540NR, California Nonresident or Part-Year Resident Income Tax Return. Form 540NR requires a nonresident to report their income on a world basis (total taxable income or total TI) in one column and California sourced income in another column. A ratio is determined based on the "tax on total TI" over "total TI". This ratio is applied against California-sourced taxable income to determine the nonresident's tax liability.

The Administration of Franchise and Income Tax Law (AFITL) permits nonresident shareholders of an S corporation with income sourced in this state to elect to file a "540NR group return" (group return). The group return reports the California-sourced pro rata share of the electing shareholders' S corporation net income and applies the highest PITL tax rate (currently 9.3%) to that income. Only credits generated by the S corporation may be applied against the tax of the nonresident shareholder as reflected in the group return. Exemption credits and net operating losses are not permitted on a group return. A requirement for a shareholder to participate in a group return is that the shareholder cannot have any other California-sourced income (unless being reported on another group return).

A group return can ease the filing burden of a sometimes cumbersome and lengthy Form 540NR for nonresidents with very little connection to California. In virtually all cases, the tax computed on Form 540NR will never be more than the tax computed on a group return. Due to the disallowance of the exemption credits on the group return, the group return will generally result in slightly more tax than a Form 540NR. The tax of a nonresident on a group return can be much greater than the nonresident's tax as computed on a Form 540NR tax. Nonresidents who would pay less tax by filing a Form 540NR normally do not elect to participate in a group return and file their individual Form 540NR.

Similar rules to the above apply to nonresident partners of partnerships.

THIS PROVISION

This provision would permit a single 100% shareholder of an S corporation to file a group return. Present law uses the term "shareholders," thus, prohibiting a single shareholder from filing a group return. This provision also reiterates the authority of FTB to adjust the income of a nonresident included in a group return to properly reflect income.

LEGISLATIVE STAFF CONTACT

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