ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Assembly Rev & Tax Committee	Analyst:	Norman Catelli	Bill Number:	AB 3072
Related Bills:	See Legislative History	Telephone:	845-5117	Introduced Date:	03/11/2004
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Claim of Right Deduction/Clarify Application of 2% Floor

SUMMARY

This bill would conform California law to the federal claim of right provisions.

PURPOSE OF THE BILL

This bill is intended to clarify tax law and ease taxpayer compliance and administrative burdens regarding claim of right provisions.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2004.

POSITION

On March 6, 2002, the Franchise Tax Board voted to sponsor conformity to the federal claim of right deduction discussed in this analysis.

ANALYSIS

BACKGROUND

The United States Supreme Court first enunciated the claim of right doctrine in *North American Oil v. Burnet (1932) 286 U.S. 417*. Generally, under the claim of right doctrine a taxpayer must include in gross income any income to which the taxpayer has an apparent unrestricted right at the time of receipt or accrual. Examples of an individual's income that may be subject to the claim of right doctrine are: incorrectly computed wages or commissions, excess social security payments, and excess unemployment compensation payments. Under federal law, a taxpayer who repays that amount in a subsequent year may claim either a deduction or a refundable credit for the amount of tax paid on the repaid income in the previous year, as explained below.

FEDERAL/STATE LAW

Internal Revenue Code (IRC) Section 1341 provides a special relief provision intended to compensate the taxpayer in the year of repayment for taxes paid on amounts included in income under the claim of right doctrine. Taxpayers are allowed to deduct the amount of claim of right income repaid in the year of repayment or claim a credit equal to the decrease in tax for the year of the receipt if the repaid item is excluded from gross income in that year, whichever results in the least tax.

Board Position:			Department Director	Date
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_______ N	_______ OUA	___X___ PENDING		

IRC Section 1341 may be applied if all three of the following requirements are met:

- An item of income was properly included in income for a prior year because it appeared that the taxpayer had an unrestricted right to the income,
- It is established that the taxpayer did not have an unrestricted right to all or a portion of the item of income, and
- The amount of the deduction exceeds $3,000.

While California applies the claim of right doctrine, California law does not conform to Section 1341 nor does California tax law contain provisions comparable to that section.

California law conforms to federal law allowing miscellaneous itemized deductions, subject to the 2% floor on itemized deductions. The 2% floor rule allows miscellaneous itemized deductions to be claimed only when the aggregate amount is more than 2% of the taxpayer's adjusted gross income (AGI). The result is that the entire amount of the repayment is subject to the 2% limitation when claimed as an itemized deduction. A taxpayer that does not itemize deductions receives no benefit for the repayment of the previously taxed income. Federal law does not apply the 2% limitation on repayments. This difference requires an adjustment on California schedule CA.

<u>THIS BILL</u>

This bill would conform California law to the special relief provisions of IRC Section 1341. A taxpayer repaying an amount over $3,000 held under claim of right would be permitted to deduct the amount repaid in the year of repayment or claim a credit equal to the decrease in tax for the year of receipt if the repaid item is excluded from gross income in that year, whichever results in the least tax.

The bill also would exempt amounts restored under a claim of right from the 2% floor on miscellaneous itemized deductions.

<u>IMPLEMENTATION CONSIDERATIONS</u>

Implementation of this bill would occur during the department's normal annual system update.

LEGISLATIVE HISTORY

SB 1061 (Ch. 633, Stats. 2003), as introduced February 27, 2003, contained this provision, which was subsequently amended out of the bill.

OTHER STATES' INFORMATION

The federal government provided permanent statutory relief in claim of right situations to taxpayers in 1954, and many other states have followed that example and provided relief to their taxpayers.

Arizona, Connecticut, Michigan, Minnesota, New York, Oregon, and *Wisconsin* have statutes that generally conform to federal law. *Illinois* does not allow itemized deductions, but allows a subtraction from AGI if the taxpayer uses the federal credit method. *Pennsylvania* does not recognize the claim of right doctrine, allowing an amended return to be filed to adjust the overpayment year.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Revenue Impact ($ Millions)			
Fiscal Year	2004-05	2005-06	2006-07
Revenue loss	Insignificant loss	Insignificant loss	Insignificant loss

An insignificant loss does not exceed $150,000.

Revenue Discussion

The Franchise Tax Board receives only a few questions a year involving Claim of Right. While no compiled data is available regarding actual cases settled in any given year, the impact is projected to be rather insignificant.

ARGUMENTS/POLICY CONCERNS

This bill would provide equitable treatment to taxpayers by attempting to return the same amount of tax paid on the claim of right income.

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