

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: SR&T Committee Analyst: Jeff Garnier Bill Number: SB 1065

Related Bills: See Legislative History Telephone: 845-5322 Introduced Date: February 27, 2003

Attorney: Patrick Kusiak Sponsor: Franchise Tax Board

SUBJECT: Effect of Federal Elections Made Prior to Becoming a California Taxpayer

SUMMARY

This Franchise Tax Board sponsored bill would mandate that federal tax elections¹ made by a person prior to becoming a California taxpayer apply for California purposes.

PURPOSE OF THE BILL

This bill is intended to clarify tax law and provide certainty regarding income tax elections for persons prior to becoming a California taxpayer.

EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative January 1, 2004.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Current federal law provides taxpayers with a variety of elections for determining how to treat certain transactions for income tax purposes. Generally, elections must be made on an original, timely filed tax return. Federal case law has developed the "doctrine of elections," which, among other things, prohibits a taxpayer that makes an election from revoking or amending that election unless permission is granted by the taxing authority. The purpose of the doctrine is to prevent retroactive tax planning and an undue burden on the administration of the tax laws.

Under current state law, the term "taxpayer" includes any individual, estate, or trust subject to the taxes imposed under the Personal Income Tax Law (PITL) or any person subject to the taxes imposed under the Corporation Tax Law (CTL). The term "person" includes an individual, fiduciary, partnership, limited liability company, corporation, or certain organizations exempt from tax. An "individual" is defined as a natural person.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
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<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director
Gerald H. Goldberg

Date
04/07/03

1. For purposes of this analysis, this bill applies equally to situations where a taxpayer makes no federal election where one is available, and seeks to make such an election for state purposes only. Examples would include an S corporation election and a Section 338 election

Current state law generally conforms to the various elections provided under federal law. Current state law provides "taxpayers" with three general rules regarding elections made when California law conforms to federal law by reference. These general rules also apply when federal law requires a taxpayer to file an application or seek consent regarding how to treat a transaction for tax purposes. These three election rules are:

1. A proper election filed with the Internal Revenue Service (IRS) in accordance with federal law or regulation is deemed to be a proper election for California income tax purposes, unless otherwise provided in another California law or regulation (examples of elections include the depreciation method and rate elections).
2. A copy of the federal election must be furnished to the Franchise Tax Board (FTB) upon request.
3. A separate California election can be made to obtain treatment other than the treatment elected for federal purposes unless another California law or regulation specifies how a transaction must be treated. Separate elections must be filed with FTB at the time and in the manner required by FTB. Generally, separate state elections, like most elections for federal purposes, must be made on an original, timely filed state tax return.

The general rules regarding elections apply only to "taxpayers." FTB's legal staff has interpreted this to mean that a California taxpayer is not allowed to make a separate state election for tax years or transactions that occurred prior to becoming a California taxpayer. Staff has informed such taxpayers that they are bound by their federal elections for state purposes.

Generally, a nonresident or a part-year resident individual taxpayer will file a Form 540NR, California Nonresident or Part-Year Resident Income Tax Return. Form 540NR requires the individual to report their income on a world-wide basis (total taxable income or total TI) in one column and California-sourced income in another column. An average tax rate is determined based on the "tax on total TI" over "total TI." This average tax rate is applied against California-sourced income to determine the nonresident's or part-year resident's tax liability.

California law does not explicitly state how to treat federal elections made prior to the time a person becomes a California taxpayer, which could be interpreted to allow new California taxpayers to change their federal elections for California purposes, thereby providing an opportunity for retroactive tax planning.

THIS BILL

This bill would amend the general rules for elections and applications for consent to which California conforms to by reference to clarify that federal elections (including applications for consent) made before becoming a California taxpayer are binding for California purposes. This general rule would apply to all elections unless otherwise provided in another California law or regulation.

LEGISLATIVE HISTORY

AB 1122 (Corbett, Stats. 2002, Ch. 35) bound the federal S corporation election for state purposes.

AB 1115 (Assembly Revenue & Taxation Committee, Stats. 2001, Ch. 920) changed the method that non-resident and part-year resident individuals compute their California tax liability.

OTHER STATES' INFORMATION

The laws of *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* were reviewed to determine how those states treat federal elections. The laws of these states were reviewed because their tax laws are similar to California's income tax laws. These states generally bind all federal elections where applicable.

FISCAL IMPACT

Because this bill would codify a current department practice, implementing this proposal would not impact the department's programs and operations.

ECONOMIC IMPACT

Revenue Estimate

Since this bill would codify existing practice, it would not impact the state's income tax revenue.

POLICY CONCERNS

This bill would require taxpayers to treat transactions that occurred and elections that were made prior to becoming a California taxpayer consistent with how the transaction or election was treated for federal income tax purposes. This is consistent with California's general income tax policy of conforming to federal laws and treating transactions and elections in the same manner as they were treated for federal income tax purposes. Requiring the federal election made by persons prior to becoming a California taxpayer to apply for California purposes also follows the federal doctrine of elections.

This bill would codify existing department practice. It would clarify the legal effect for California tax purposes of a federal income tax election made prior to a taxpayer becoming a California taxpayer. This bill would add certainty for taxpayers and department staff regarding how to treat prior transactions. This bill would also reduce potential conflicts between taxpayers and the department regarding how to treat prior elections.

LEGISLATIVE STAFF CONTACT

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