**Franchise Tax Board**

# ANALYSIS OF ORIGINAL BILL

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| Author: | Garcia | Analyst: | Raul Guzman | Bill Number: | AB 1573 |
| Related Bills: | See Legislative History | Telephone: | 845-4624 | Introduced Date: | Feb. 22, 2005 |
| | | Attorney: | Patrick Kusiak | Sponsor: | |

**SUBJECT**: Individual Development Accounts/Exclusion of Interest Income and a $5,000 Deduction/Nontaxable Distributions

## SUMMARY

This bill would create an "individual development account" (IDA) that would include certain income tax benefits similar to an individual retirement account (IRA).

## PURPOSE OF THE BILL

The author's office has indicated that the purpose of the bill is to encourage and promote individual home ownership.

## EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and operative for taxable years beginning on or after January 1, 2005.

## POSITION

Pending.

## SUMMARY OF SUGGESTED AMENDMENTS

Department staff is available to assist with amendments to resolve the implementation, technical, and policy concerns discussed in this analysis.

## ANALYSIS

### FEDERAL/STATE LAW

There are two general types of IRAs, traditional IRAs (Internal Revenue Code (IRC) Section 408), to which both deductible and nondeductible contributions may be made and Roth IRAs (IRC Section 408A). Since the provisions of this bill would provide income tax benefits similar to those provided by a traditional IRA, this analysis only provides information on the traditional IRA.

For 2005, an individual may make deductible contributions to a traditional IRA up to the lesser of $4,000 or the individual's compensation if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. The deductible contribution amount is increased starting in 2008 to $5,000 and is adjusted for inflation in $500 increments thereafter.

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In the case of a married couple, deductible IRA contributions of up to $4,000 can be made for each spouse, including a homemaker who does not work outside the home, if the combined compensation of both spouses is at least equal to the contributed amount. If the individual, or the individual's spouse is an active participant in an employer-sponsored retirement plan, the $4,000 deduction limit is phased out for taxpayers with adjusted gross income (AGI) over certain levels for the taxable year. For 2005, the AGI phase-out limits range for single taxpayers, who are active participants in employer-sponsored plans, is between $50,000 and $60,000. For married filing joint taxpayers, the AGI phase-out range is between $70,000and $80,000; for married taxpayers filing a separate return, the AGI phase-out range is $0 to $10,000.

If the individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the $4,000 deduction limit is phased out for taxpayers with AGI between $150,000 and $160,000.

To the extent an individual cannot or does not make deductible contributions to an IRA, the individual may make contributions to a traditional IRA even though the contributions would be includable in income.

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent the withdrawal is a return of nondeductible contributions. Includible amounts withdrawn prior to attainment of age 59 1/2 are subject to an additional 10% early withdrawal tax, unless the withdrawal is:

- due to death or disability,
- made in the form of certain periodic payments,
- used to pay medical expenses in excess of 7.5% of AGI,
- used to purchase health insurance of an unemployed individual,
- used for education expenses, or
- used for first-time homebuyer expenses of up to $10,000.

To qualify for the $10,000 first-time homebuyer exclusion from the 10% early withdrawal tax, the following applies:

- First-time buyer means an individual or individual's spouse has not had an ownership interest in a principal residence in the two-year period ending on the date the new home is acquired,
- The residence qualifies as the individual's principal residence,
- The principal residence may be the principal residence of the taxpayer, taxpayer's spouse, child, grandchild, or ancestor,
- The $10,000 is a lifetime limit cap,
- The distribution must be used within 120 days to purchase the residence. Rules apply to permit the re-contribution of funds under certain circumstances, and
- The distribution is used for qualified acquisition costs of the residence including down payment settlement costs and closing fees.

California conforms to federal law, as it relates to traditional IRAs, with one exception germane to this bill. California substitutes 2.5% for the 10% early withdrawal tax.

## THIS BILL

This bill would create an IDA. The interest earned and the requirements and limitations on the IDA, except as provided in this bill, would receive the same treatment as a traditional IRA. The gross interest income on the account would not be taxable, and a taxpayer, hereafter beneficiary, could deduct up to $5,000 in contributions per year for the maximum of three years to the IDA. Other persons would be allowed make contributions of matching funds to the IDA.

The bill would define an IDA as a “trustee or custodial” account that:

- Is established by an individual whose gross income for the taxable year that the IDA is created is $75,000 or less. In the case of a family, the total household income cannot exceed $120,000 for the taxable year the IDA is created.
- Is designated as an IDA by the trustee or custodian.
- Has a written governing instrument creating the account and provides that: all contributions are required to be in cash, the account exclusively benefits the individual beneficiary establishing the account, and the distributions from the account will be used to pay for “qualified individual development expenses.”
- Is, except as provided in the bill, subject to the same requirements and limitations as a traditional IRA.

"Qualified individual development expenses" would mean expenses incurred, including the down payment, by the beneficiary in connection with the purchase of the beneficiary's first principal residence. "Trustee or custodian" would have the same meaning as under the traditional IRA.

This bill would provide that any amount withdrawn from the IDA is included in income unless the distribution is made to pay for qualified individual development expenses of an individual that established the IDA. Thus, contributions to the IDA made by persons other than the beneficiary and not deducted by the beneficiary or the other persons would be included in the income of the beneficiary if the distribution was made but not to pay for qualified individual development expenses.

The deduction for contributions to the IDA created by this bill would be a miscellaneous itemized deduction subject to the 2% of AGI floor limitation.

## IMPLEMENTATION CONSIDERATIONS

Although the bill limits the amount that may be contributed to the IDA by the taxpayer to $5,000 for not more than three years, the bill does not limit the amount that may be matched and contributed to the IDA by another person. As a result, the other person would have no limit on the amount that he or she may contribute to the IDA and exclude from income. For example, this bill could be interpreted to mean that the taxpayer can contribute $5,000 to his or her IDA and another person can contribute $10,000 to the same taxpayers IDA.

Additionally, it is not clear if the total contribution from the taxpayer and the other person is limited to $5,000 per IDA or if the taxpayer and the other person could each contribute $5,000 to the same taxpayers IDA.

The bill refers to "deposits of matching funds" with respect to another person contributing to the taxpayers IDA. It is not clear if matching funds means the other person's contribution must be limited to the same amount as the taxpayer's contribution. For example, if the taxpayer contributes $4,000 to his or her IDA, the other person would match it by contributing $4,000 for the same IDA. Or, another interpretation could be that the other person can contribute some amount to the taxpayer's IDA even if it is a different dollar amount than what the taxpayer contributed. A definition of "matching funds" would provide clarity for taxpayers and the department.

Further, this bill does not limit the number of IDA's a taxpayer may establish or contribute to concurrently. Limits and rules for the establishment of IDAs and their matching contributions need to be established to eliminate disputes between taxpayers and the department.

It is unclear how the IDA is treated if the monies are not distributed within the three-year period after the IDA is created. Because the bill does not state that the account ceases to be an IDA at the end of the period, the interest would continue to be excluded from income.

It is not clear if the gross income limitations of $75,000 and $120,000 are applicable at the time the IDA is established or at the time the IDA is withdrawn. Clarification is needed from the author.

The bill does not address unqualified distributions. Having the bill explicitly state that unqualified distributions are subject to or not subject to the 2.5% early withdraw tax would provide clarity for taxpayers and the department.

The language on this bill looks to the purpose for which the distribution was made and not how the funds were used. Current law for IRA's place the emphasis on how the funds were used. In the bill on page 3, lines 12 and 13, it states that, "unless a payment or distribution is made to pay for IDA expenses, that payment or distribution is not taxable." To place the emphasis on how the funds were used lines 12 and 13 could be changed to state, "unless the payments or distributions are used for IDA expenses, those payments or distributions are not taxable." If the author's intent is for the distribution from an IDA to be consistent with how distributions are made from IRAs, the author should amend the bill to refer to how the funds are used rather than how the distribution is made to pay.

## TECHNICAL CONSIDERATIONS

This bill is adding Section 17140.5 to the Revenue and Taxation Code, however there is an existing Section 17140.5 (Exclusion of Military Pay) effective January 01, 2004. The author should consider changing the section number.

On page 2, line 6 the bill incorrectly references Section 17204. The proper reference is 17204.6.

On page 2, line 12, the bill describes the monetary amount placed in an IDA as a "deposit." On line 29 of the same page, the bill describes the same monetary amount as a "contribution." For consistency purposes author should use the same word when describing the monetary amount placed in an IDA.

On page 2, line 20, the bill refers to the income of an individual as "gross income." The bill should refer to income as adjusted gross income. Please insert "adjusted" prior to gross income.

On page 2, line 23, the bill refers to income as “total household income.” The bill should refer to this income as adjusted gross income instead. Please strikeout “total household income” and insert “adjusted gross income.”

On page 2, line 23, the bill uses the expression “in the case of a family” referring to a filing status such as “married.” The language should be more specific for clarity. Please strikeout “in the case of a family” and insert “if married filing jointly.”

On page 2, lines 20 to 23, there are income limits placed on the individual who established the IDA. It is unclear if the author wants to place the income limit on the establishment year or the deduction year. Clarification from the author is needed.

On page 2, line 24, the bill states the IDA means a trustee or custodial account. The proper designation of an IRA-type account, such as the IDA, is a trust. An IRA is not a trustee account or a custodial account. An IRA is a trust where the trustee is a bank with limitations on investments. A custodial account can be treated as a trust if the assets of the account are held by a bank. If IDA’s are to be treated consistent with traditional IRAs, the bill should be amended to only refer to trusts.

However, if the author does not wish to be consistent with traditional IRA’s and refer only to trusts, the terms “trustee” and “custodian” should be individually defined in the bill.

## LEGISLATIVE HISTORY

AB 1164 (Bogh, 2005) contains provisions similar to this bill. AB 1164 has been referred to the Assembly Revenue and Taxation Committee.

SB 553 (Dutton, 2005) contains provisions similar to this bill. SB 553 has been referred to the Senate Revenue and Taxation Committee.

## OTHER STATES’ INFORMATION

Review of *Illinois, Massachusetts, Michigan*, *Minnesota*, and *New York* laws found no comparable tax provisions as proposed in this bill. These states were reviewed because of the similarities between California income tax laws and their tax laws.

*Florida* only has a corporation income tax therefore this personal income tax provision is not applicable.

## FISCAL IMPACT

If the bill is amended to resolve the implementation considerations addressed in this analysis, the department’s costs are expected to be minor.

**ECONOMIC IMPACT**

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses annually beginning in 2005-06.

| Estimated Revenue Impact of AB 1573<br>As Introduced 2/22/05<br>[$ In Thousands] | | |
|---|---|---|
| 2005-06 | 2006-07 | 2007-08 |
| a/ | a/ | a/ |
| a/ Insignificant loss of less than $150,000. | | |

Revenue Discussion

The revenue impact of the bill would be determined by the amount of deductible deposits, the amount of earnings on all deposits that is excluded from gross income, and marginal tax rates of taxpayers reporting such deductions and/or the exclusion of interest.

Although the bill is effective with taxable years beginning on or after January 1, 2005, it is unlikely financial institutions would begin offering IDAs before the last quarter of 2006. The first full-year's impact would be 2007. For the revenue estimate, it is assumed that the initial accounts established in the last quarter of 2006 are limited to about one-eighth of a full year's number.

The number of first-time homebuyers as defined in the bill is projected at approximately 148,000 in 2007. If one in 50 first-time buyers establish an IDA, then roughly 3,700 accounts would be established each year [148,000 x 2.5% = 7,400]. It is assumed that one in eight accounts would have matching deposits equal to one-half of the average annual deposit.

As the bill is currently drafted, taxpayers could deposit up to $5,000 annually per account and taxpayers could potentially establish multiple accounts for purposes of depositing substantial sums. Also, there is no limitation on the amount of matching deposits. For the revenue estimate, average annual deposits of $4,000 and average annual matching deposits of $2,000 are assumed.

For the 2007 taxable year, earnings of nearly $320,000 would be excluded from income. Applying a marginal tax rate of 6% derives a revenue loss of $20,000 [$320,000 x 6% = $19,000]. To derive the amount of excluded earnings, the following assumptions apply: (1) average rate of return of 3.25%, (2) annual deposits and matching deposits are made mid-year, and (3) funds in existing accounts would earn the projected rate of return for the full year.

Deposits are projected at nearly $18 million in 2007. As the proposed deduction is subject to the 2% of AGI threshold, it is estimated that only about 2.5% of deposits would derive a deduction benefit for taxpayers. Applying a marginal tax rate of 6% derives a revenue loss of $27,000 [$18 million x 2.5% x 6% = $27,000].

**LEGAL IMPACT**

The deduction and exclusion provided by this bill would not be limited to taxpayers purchasing homes in California. However, restrictions based on property located within the state have been the subject of constitutional challenges as explained bellow.

The U.S. Court of Appeals for the 6th Circuit ruled in *Cuno v. DaimlerChrysler, Inc.* (2004) 386 F. 3d 738 that Ohio's Investment Tax Credit is unconstitutional because it gives improper preferential treatment to companies to locate or expand in Ohio rather than in other states and, therefore, violates the Commerce Clause of the U.S. Constitution. Ohio is seeking review by the U.S. Supreme Court. Although the outcome of this decision and its affects on the income tax credits of other states, including California, is unknown, targeted tax incentives that are conditioned on activities in California may be subject to constitutional challenge.

**POLICY CONCERNS**

The definition of "first principal residence" is not explicitly provided in the bill; therefore, a literal interpretation of the term would apply. The author may desire to adopt the provisions of IRC Section 72 relating to first home purchases, described above.

This bill would create a state and federal difference, which adds complexity to the tax return as the income excluded or deferred by this bill is still subject to federal income tax. The absence of similar federal treatment may dissuade banks from embarking on the California-only IDA, since they will need to keep separate accounting of the deposits and withdrawals for state and federal tax purposes.

**LEGISLATIVE STAFF CONTACT**

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