Franchise Tax Board

ANALYSIS OF AMENDED BILL

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Related Bills:	See Legislative History	Telephone:	845-7800	Amended Date:	September 6, 2005
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SUBJECT:	FTB May Provide For The Filing Of Group Returns By Corporations For Electing Nonresident Directors

SUMMARY

This bill would allow a corporation to file a tax return on behalf of certain nonresident directors.

SUMMARY OF AMENDMENTS

The September 6, 2005, amendments struck the previous provisions relating to levy transactions and use taxes and replaced them with the provisions to expand the availability of group returns to electing nonresident directors of corporations.

This is the department's first analysis of the bill.

PURPOSE OF THE BILL

It appears that the purpose of this bill is to provide administrative convenience for both individuals and the Franchise Tax Board (FTB) by reducing the number of returns required to be filed.

EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative January 1, 2007.

POSITION

Pending.

ANALYSIS

STATE LAW

Existing state law imposes tax on the entire taxable income of residents of California and upon the taxable income of nonresidents derived from sources within California.

California statute does not explicitly establish rules to source income. Instead, the relevant California statute delegates to FTB authority to prescribe sourcing rules by regulation.

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These regulations provide that services are sourced to California to the extent the services are performed in this state. When nonresidents perform services in California and other states, compensation for these services is sourced to California by using various apportionment methods that reasonably reflect the value of the California services as compared to the total services performed. These regulations are consistent with federal statutes that limit or preempt California's ability to tax the California source income of nonresidents***.***

California allows certain nonresident individuals that receive a distributive or prorated share of income from a pass-through entity (partnership or S corporation) that derives income from California sources or is doing business in California to elect to file a *group nonresident return* (Revenue & Taxation Code (R&TC) Section 18535).

To be eligible to be included in a group nonresident return:

- The partner/member/shareholder must be an individual. Estates, trusts, partnerships, LLCs, C corporations, S corporations, or other business entity cannot be included in the group nonresident return;
- The individual must be a full-year nonresident of California; and
- The individual's only California source income must be from the pass-through entity. A nonresident individual can be included on more than one group nonresident return.

Assuming these requirements are satisfied, the pass-through entity files the group nonresident return and pays the tax on behalf of the electing nonresident individuals. The return must be for a calendar year and, except in the case of a shareholder of an S corporation, must include at least two electing nonresident individuals. An S corporation may file a group nonresident return on behalf of one shareholder. The business entity must use Form 540NR, California Nonresident or Part-Year Resident Income Tax Return, for the group nonresident return. A nonresident individual can be included on more than one group nonresident return.

Proposition 63 approved by voters in the November 2004 General Election provides a dedicated funding source for the expansion of mental health treatment options for children, adults, and seniors as follows:

- Starting with the 2005 tax return, it imposes an additional 1% tax, not subject to reduction by credits, on the portion of a taxpayer's taxable income that exceeds $1,000,000.
- The estimated revenue from that additional 1% tax is deposited in the Mental Health Services (MHS) Fund on a monthly basis, subject to an annual adjustment.

Nonresidents subject to the mental health tax are not allowed to be included in a group nonresident return.

Under current state law, income paid by a corporation for services performed in California for a nonresident corporate director for services, including attendance at a board of director's meeting is exempted from withholding.

<u>THIS BILL</u>

This bill would authorize FTB to provide for the filing of a group return for electing nonresident directors of a corporation. Electing nonresident directors would be those individuals that receive California source wages, salaries, fees, or other compensation from that corporation for director services, including attendance of board of directors' meetings that take place in this state. The rate applicable would be the highest marginal rate or rates provided for under the Personal Income Tax Law.

<u>IMPLEMENTATION CONSIDERATIONS</u>

Implementing this bill would not significantly impact the department's programs and operations.

LEGISLATIVE HISTORY

SB 3 (Greene, Stat. 1993, Ch. 31) authorized nonresident individuals that receive a distributive share of income from a pass-through entity to file a group nonresident return.

SB 298 (Campbell, Stat. 1995, Ch. 475) exempted withholding income paid by a corporation for services performed in California to a nonresident corporate director for services.

OTHER STATES' INFORMATION

New York, Illinois, and *Connecticut* allow group nonresident returns to be filed by pass-through entities, and they all require the electing partners to be individuals (the same as current California law).

FISCAL IMPACT

The department's costs to administer this bill cannot be determined at this time, but are anticipated to be minor. This bill would require the temporary redirection of personnel to revise and reproduce certain forms, instructions, and manuals and to provide the necessary training. As the implementation plan is further developed, an estimate of department costs will be completed.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Nonresident Directors Filing group returns			
Fiscal Year	2005-2006	2006-2007	2007-2008
PIT	*	*	*

*less than $500,000 revenue gain

Revenue Discussion

This bill would simplify how nonresident directors of corporations report California source income and pay the corresponding tax. Many corporate directors have complicated returns and may not file nonresident returns for California source income until contacted by FTB. Additional revenue would be collected under this bill because the corporation would pay the tax on behalf of the nonresident director at the 9.3% marginal tax rate with no deductions or credits. Individuals filing nonresident returns may have a lower marginal tax rate when deductions and credits are applied; however, because the corporation would be paying the tax, there would be no tax increase to the individual.

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