

ANALYSIS OF AMENDED BILL

Author: Dutton Analyst: Norman Catelli Bill Number: SB 217
 Related Bills: See Legislative History Telephone: 845-5117 Amended Date: March 17, 2005
 Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Claim of Right Deduction Clean-UP/ Retroactive Application

SUMMARY

This bill would conform current law to federal law on what is known as the claim of right deduction. This relief would be retroactive.

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

PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to remedy inequities resulting from complex and confusing language in the original statute and to conform the state claim of right relief provisions to federal law retroactively.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. Specific language would make the bill operative for all taxable years for which a claim for refund may be filed and for any taxable year for which an individual has a pending claim for refund that has not been finally adjudicated.

POSITION

Pending.

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.

Board Position:

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

Department Director

Date

Gerald H. Goldberg

4/22/05

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.

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 repayment exceeds \$3,000.

California law generally conforms to federal claim of right provisions for taxpayers subject to the Personal Income Tax Law for taxable years beginning on or after January 1, 2004.

THIS BILL

This bill revises current law to delete a requirement that limits relief for state purposes to taxpayers that obtained relief for federal tax purposes. Additionally, it makes the claim of right provision retroactive for any taxable year for which a claim for refund may be filed and for any taxable year for which an individual has a pending claim for refund that has not been finally adjudicated.

IMPLEMENTATION CONSIDERATIONS

FTB generally discourages retroactive legislation because it causes confusion and presents administrative challenges for both taxpayers and the department. Where retroactive legislation presents the issue of a “gift of public funds,” the department defers to the Legislative Counsel’s opinion about the necessity and sufficiency of a “public purpose” statement.

There are other parts of the existing statute that are complex and potentially confusing to taxpayers. Making the statute more closely resemble IRC Section 1341 would reduce confusion and more closely affect the original conformity intent of the statute. Department staff is available to work with the author’s office to resolve this or other issues that may be identified.

LEGISLATIVE HISTORY

AB 3073 (Assembly Revenue and Taxation Committee, Stats. 2004, Ch. 354) generally conforms California law to the federal claim of right provisions, and is operative January 1, 2004.

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:

Based on data and assumptions discussed below, the PIT and Corporation Tax revenue loss from this bill would be as follows:

Estimated Revenue Impact of SB 217 Effective On Or After January 1, 2005 Enactment Assumed After June 30, 2005 (\$ Millions)		
2005-06	2006-07	2007-08
-\$5	--	--

This bill does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

The 2005-06 fiscal year impact would be due to a one-time payment attributable to a case in litigation. Accordingly, there would be an estimated loss of approximately \$5 million in the 2005 tax year from taxpayers who would be eligible to file an amended return under the claim of right provision of this bill.

There is no way to predict what future revenue loss impact there may be. Outside of this one known case, it cannot be known what future events may trigger the claim of right provision.

LEGISLATIVE STAFF CONTACT

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