Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Escutia	Analyst:	Norman Catelli	Bill Number:	SB 27
Related Bills:	See Legislative History	Telephone:	845-5117	Introduced Date:	12/08/2004
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Credit Carryovers/Aggregate Amount May Not Reduce "Net Tax" for the Taxable Year by More Than 50%/Extend Carryover Period by 2 Years for Credit Limited by Provisions

SUMMARY

This bill would limit certain credits to 50% of the tax.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to limit the revenue loss to the state resulting from tax credits.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment. The bill specifies that it would be operative for taxable years beginning on or after January 1, 2005, and before January 1, 2007.

POSITION

Pending.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake. See Appendix I for a list of California tax credits.

Credits are applied against tax liability. Differing rules apply if the credit exceeds the tax liability. Some credits expire if they are not used in the year acquired while some credits are refunded. Most credits have carryover provisions that allow the amount of the credit that exceeds "tax" to be carried over to offset the "tax" in succeeding taxable years.

Board Position:			Department Director	Date
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THIS BILL

This bill would, for taxable years 2005 and 2006, make the following changes to existing law:

- Reduce the amount of tax credits, except the Low Income Housing Credit, that can be used for any year from 100% of the taxpayer's tax liability to 50%, and
- Extend the carryover period, which vary from four years to unlimited, of the affected credits by two years.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require changes to the following: 1) tax forms and instructions, 2) income tax return processing, including manual verification of the credit computation, and 3) reprogramming information systems . Depending on the impact of other legislation on tax forms during 2005, the requirements of this bill might make the personal income tax return three pages. Neither the federal return nor any state return is three pages. Similarly, the business entities tax forms might increase by one page. These forms are currently four pages. To accommodate an increase in the size of the returns, storage costs of income tax returns would increase since corporate taxpayers do not have the option to e-file. Additional instructions would also be required in the tax booklets, commensurately increasing the size of the booklets for individual and corporate taxpayers. In addition to forms issues, the department's computer systems would need to be reprogrammed. There would be increased public service required for telephone calls and written correspondence. All of these additional activities result in additional costs described below under "Fiscal Impact."

LEGISLATIVE HISTORY

SB 1354 (Escutia, 2003-2004), which was identical to this bill, would have limited certain credits to 50% of the tax. SB 1354 was placed on the inactive file at the request of the author.

OTHER STATES' INFORMATION

The laws of *Florida*, *Illinois, Massachusetts, Michigan, Minnesota*, and *New York* were reviewed because their tax laws are similar to California's income tax laws. Based on a limited review, none of these states limit their credit or credit carryovers to a percentage of tax as proposed by this bill. The review included the individual states' websites, tax forms, and tax handbooks.

FISCAL IMPACT

Based on the implementation considerations noted above, and assuming the personal and business entity tax forms each increase by one page, department costs would be approximately $1.9 million in fiscal year 2005-06 and $1.1 million for fiscal year 2006-07. These costs include increased expenses for printing related to revising existing forms and instructions, return processing, programming changes to information systems, and manual verification of the credits allowed.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue effects.

Estimated Cash Flow Revenue Effects of SB 27 As Introduced 12/8/04 [$ In Millions]				
	2005-06	2006-07	2007-08	2008-09
PIT	$ 40	$ 17	-$3	-$2
Corp	$380	$310	-$28	-$28
Total	$420	$327	-$31	-$30

The credit limitation would be effective with taxable years beginning on or after January 1, 2005, and before January 1, 2007, with enactment assumed after June 30, 2005.

Revenue Discussion

The revenue gains in the first two years are determined by comparing the estimated use of credits limited by this bill with the estimated use of credits under current law. The limitation is repealed after the first two years and credit use would return to 100%. Limited credits would be allowed to be carried over an additional two years. This bill causes a timing difference in the use of certain tax credits and over time is essentially revenue neutral.

For both the PIT and CTL estimates, computer models using sample data (2001 base) were used to simulate the bill's provisions. The models recalculate tax on a taxpayer-by-taxpayer basis.

POLICY CONCERNS

Generally, state law requires taxpayers to make estimated tax payments, made quarterly on a "pay-as-you-go" basis. Taxpayers that reduced estimated tax payments in anticipation of using credits that would be reduced by this bill may be subject to an underpayment penalty. Penalty relief under these circumstances may be warranted. As a convenience, penalty relief language is attached to this analysis.

LEGISLATIVE STAFF CONTACT

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Appendix I

Refundable Credit	
Child and Dependent Care Expenses	
Credits Without Carryover Provisions	
Dependent Parent	Other State Tax
Enterprise Zone Employee	Prison Inmate Labor
Joint Custody Head of Household	Senior Head of Household
Nonrefundable Renter's Credit	Teacher Retention (suspended for the 2004 and 2005 taxable years)
Credits With Carryover Provisions (would be limited by SB 27 unless noted with **)	
Child Adoption *unlimited (u) carryover (c/o)*	Local Agency Military Base Recovery Area Hiring *u*
Community Development Financial Institution Deposits *4 year c/o*	Local Agency Military Base Recovery Area Sales or Use Tax *u*
Disabled Access for Eligible Small Businesses *u*	Low-Income Housing**
Donated Agricultural Products Transportation *u*	Manufacturing Enhancement Area Hiring *u*
Employer Child Care Contribution *u*	Natural Heritage Preservation *7 year c/o*
Employer Child Care Program *u*	Prior Year Alternative Minimum Tax *u*
Enhanced Oil Recovery Area *15 year c/o*	Research *u*
Enterprise Zone Hiring *u*	Rice Straw *10 year c/o*
Enterprise Zone Sales or Use Tax *u*	Solar Energy System *7 year c/o*
Farmworker Housing – Construction *u*	Targeted Tax Area Hiring *u*
Farmworker Housing – Loan *10 installments*	Targeted Tax Area Sales or Use Tax *u*
Joint Strike Fighter – Wages *7 year c/o*	
Joint Strike Fighter – Property Costs *7 year c/o*	
Repealed Credits With Carryover Provisions (would be limited by SB 27)	
Agricultural Products	Manufacturers' Investment
Commercial Solar Electric System	Orphan Drug
Commercial Solar Energy	Political Contributions
Contribution of Computer Software	Recycling Equipment
Employer Ridesharing – Large Employer	Residential Rental & Farm Sales
Employer Ridesharing – Small Employer	Ridesharing
Employer Ridesharing – Transit	Salmon & Steelhead Trout Habitat Restoration
Energy Conservation	Solar Energy
Los Angeles Revitalization Zone – Hiring	Solar Pump
Los Angeles Revitalization Zone – Sale or Use Tax	Technological Property Contribution
Low-Emission Vehicles	Water Conservation
	Young Infant

Appendix II

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 27
As Introduced December 8, 2004

AMENDMENT 1

On page 2, after line 15, insert:

(e) No addition to tax shall be made under Section 19136 for any period before April 17, 2006, with respect to any underpayment of an installment for the 2005 taxable year, to the extent that the underpayment was created or increased by the act adding this section.

AMENDMENT 2

On page 2, after line 30, insert:

(e) No addition to tax shall be made under Section 19142 for any period before April 17, 2006, with respect to any underpayment of an installment for the 2005 taxable year, to the extent that the underpayment was created or increased by the act adding this section.