

SUMMARY ANALYSIS OF AMENDED BILL

Author: Klehs and Machado Analyst: John Pavalasky Bill Number: AB 115
 Related Bills: _____ Telephone: 845-4335 Amended Date: September 2, 2005
 Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Conformity Act of 2005

	DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as amended _____.
X	AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.
	AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as introduced/amended _____.
	FURTHER AMENDMENTS NECESSARY.
	DEPARTMENT POSITION CHANGED TO _____.
X	REMAINDER OF PREVIOUS ANALYSES OF BILL AS AMENDED <u>May 2, 2005, May 27, 2005, June 20, 2005, and August 30, 2005</u> , STILL APPLIES.
X	OTHER – See comments below.

SUMMARY

This bill would change California's specified date of conformity to federal income tax law from January 1, 2001, to January 1, 2005, and thereby, in general, conform to the numerous changes made in federal income tax law during that four-year period.

SUMMARY OF AMENDMENTS

The September 2, 2005, amendments would clarify the child and dependent care credit (CDC) to provide that earned income includes military compensation.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy. Thus, it would be effective immediately, and unless otherwise specified, it would apply to taxable years beginning on or after January 1, 2005. The provisions of this bill that conform to federal provisions that are subject to the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) termination date would apply to taxable years beginning before January 1, 2011. The bill specifically makes the low sulfur diesel fuel credit and expensing provisions apply to taxable years beginning on or after July 1, 2005. Also, the bill makes full conformity to the student loan interest rules apply to taxable years beginning on or after January 1, 2006.

Board Position:	Legislative Director	Date
<u> X </u> S		
_____ NA		
_____ SA		
_____ N		
_____ NP		
_____ O		
_____ NAR	Brian Putler	09/07/05
_____ PENDING		

POSITION

Support.

At its June 15, 2005, meeting the Franchise Tax Board voted 2 – 0, with the representative from the Department of Finance abstaining, to support AB 115.

The ECONOMIC IMPACT portion of the previous analysis of the bill as amended August 30, 2005, has been updated. In addition, an analysis is provided of the provision that would clarify the CDC to provide that earned income includes military compensation. The POSITION, LEGAL IMPACT, and ARGUMENTS/POLICY CONCERNS have not changed but are restated for convenience. The remainder of the analyses of the bill as amended May 2, 2005, May 27, 2005, June 20, 2005, and August 30, 2005, still applies.

ANALYSIS OF PROVISION THAT CLARIFIES THE CDC TO PROVIDE THAT EARNED INCOME INCLUDES MILITARY COMPENSATION

FEDERAL/STATE LAW

Current Federal Law

Existing federal law (IRC Section 21) allows a non-refundable tax credit known as the federal CDC credit. In order to take this credit, a taxpayer must have employment-related child and dependent care expenses for the care of a qualifying individual and qualifying earned income. The base for computing the credit is the lesser of the dependent care expenses or the least amount of earned income as determined for each taxpayer filing a joint return, but not more than \$3,000 per qualifying individual or \$6,000 for two or more qualifying individuals.

A qualifying individual for purposes of this credit is any dependent of the taxpayer who is under the age of 13 or a taxpayer's dependent or spouse who is physically or mentally unable to care for him or herself. Employment-related child and dependent care expenses are generally defined as those expenses incurred to enable gainful employment, e.g., housekeeping, babysitting, and other household services. Earned income is generally wages or other payments for services provided by the taxpayer.

Taxpayers must pay over half the cost of keeping up their primary home for the qualifying individuals. Costs include rent, mortgage interest, real estate taxes, utilities, home repairs, and food eaten at home.

The maximum amount of eligible employment-related expenses is \$3,000 for one qualifying individual and \$6,000 for two or more qualifying individuals. The maximum credit amount will be 35% of the credit base computed under the above rules. Thus, the maximum credit is \$1,050 if there is one qualifying individual and \$2,100 if there are two or more qualifying individuals.

The amount of the credit itself is based on a sliding scale percentage. If adjusted gross income (AGI) is \$15,000 or less, the taxpayer's credit is 35% of their employment related expenses. This percentage is phased down by 1% for each \$2,000 of AGI, or fraction thereof, in excess of \$15,000, but not to a percentage below 20%.

Current California Law

Existing state law allows a credit similar to the federal CDC. The credit is limited to employment-related expenses as defined in federal law, but only for services provided in California and only to the extent of earned income from California sources. For taxable years beginning on or after January 1, 2003, the credit is 50% of the federal CDC for those with an AGI of \$40,000 or less; 43% for those with an AGI between \$40,001-\$70,000; 34% for those with an AGI between \$70,001 -\$100,000; and no credit for those with an AGI over \$100,000.

Unlike the federal CDC, the California CDC is refundable.

Generally, credits allowed to nonresident and part-year resident taxpayers are prorated using the ratio of AGI from sources within California to AGI from all sources. Pursuant to the federal *Servicemembers Civil Relief Act*, the military compensation of a servicemember stationed in this state but not domiciled in this state is not considered earned income from a California source. The consequence is that the servicemember has zero earned income from California sources for purposes of the CDC, and since the CDC is based on the lower of earned income or qualified expenses, the servicemember cannot claim the CDC. In addition, under existing state law, the military compensation of a servicemember domiciled in California but performing service at a permanent duty station outside the state is not considered earned income from a California source.

THIS BILL

This bill clarifies that the "earned income" requirement will be defined with reference to earned income taxable for California purposes rather than earned income from sources within this state. In addition, this bill specifies that the active duty pay of members of the armed forces are considered earned income for purposes of qualifying for the CDC, regardless of whether the member is domiciled in this state or elsewhere. These changes would permit military families in California with members domiciled in California but stationed outside of California to qualify for the CDC if the other requirements are met. In addition, members of the armed forces on active duty in California but domiciled elsewhere would qualify for the CDC, if the other requirements are met.

SUMMARY OF ECONOMIC IMPACT

Revenue Estimate AB 115 September 2, 2005 – Changes to Table in Bold

Conformity to Provisions Changed in Federal Law Before 2004
 Applies to Taxable Years Beginning On Or After January 1, 2005, Except as Noted

Federal Act Section	Description	(In millions)		
		2005-06	2006-07	2007-08
	IRC Section 179 – Corporation small business expense deductions	-\$10	-\$12	-\$9
412	PL 107-16 (Economic Growth and Tax Relief Act of 2001) Student Loan Interest	-\$8	-\$15	-\$15
404	JCWAA of 2002 (P.L. 107-147) - Expansion of the exclusion from income for qualified foster care payments.	-\$4	-\$3	-\$3
	Child and dependent care credit clarified to provide that earned income includes military compensation.	-\$2	-\$2	-\$2

Conformity to the WFTRA of 2004 (PL 108-311)
 And The AJCA (PL 108-357)
 Applies to Taxable Years Beginning On Or After January 1, 2005

Federal Act Section	Provisions	(In millions)		
		2005-06	2006-07	2007-08
WFTRA 201-208	Uniform definition of child, etc.	-\$10	-\$7	-\$7
320	Disclosures relating to terrorist activities	-	-	-
322	Extension of expiring provisions- Availability of medical savings accounts	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
401-408	Technical amendments	-	-	-
AJCA	Members of family treated as 1 shareholder	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
231				
232	Increase in number of eligible shareholders to 100	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
233	Expansion of bank S corporation eligible shareholders to include IRAs	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
234	Disregard of unexercised powers of appointment in determining potential current beneficiaries of ESBT	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
235	Transfer of suspended losses incident to divorce, etc.	b/	b/	b/

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236	Use of passive activity loss and at-risk amounts by qualified subchapter S trust income beneficiaries	b/	b/	b/
237	Exclusion of investment securities income from passive income test for bank S corporations.	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
238	Relief from inadvertently invalid qualified subchapter S subsidiary elections and terminations	b/	b/	b/
239	Information returns for qualified subchapter S subsidiaries.	b/	b/	b/
240	Repayment of loans for qualifying employer securities	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
243	Improvements related to real estate investment trusts	b/	b/	b/
247	Modification of unrelated business income limitation on investment in certain small business investment companies	b/	b/	b/
311	Special rules for livestock sold on account of weather-related conditions	-\$1	-\$1	f/
312	Payment of dividends on stock of cooperatives without reducing patronage dividends.	b/	b/	b/
315	Capital gain treatment under Section 631(b) to apply to outright sales by landowners.	b/	b/	b/
318	Certain expenses of rural letter carriers	b/	b/	b/
320	Exclusion for payments to individuals under National Health Service Corps loan repayment program and certain State loan repayment programs	b/	b/	b/
321	Modification of safe harbor rules for timber REITs.	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
322	Expensing of certain reforestation expenditures	-\$1	-\$1	f/
331	Net income from publicly traded partnerships treated as qualifying income of regulated investment companies	b/	b/	b/
335	Charitable contribution deduction for certain expenses incurred in support of Native Alaskan subsistence whaling	b/	b/	b/

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338	Expensing of capital costs incurred in complying with Environmental Protection Agency sulfur regulations. Revenue same as AB 810 (Parra) as introduced. [2]	d/	b/	a/
339	Credit for production of low sulfur diesel fuel. Revenue same as AB 810 (Parra) as introduced. [2]	d/	-\$1	-\$1
702	Exclusion of gain or loss on sale or exchange of certain brownfield sites from unrelated business taxable income	b/	b/	b/
703	Civil rights tax relief	-\$1	-\$1	-\$1
704	Modification of class life for certain track facilities	-\$1	-\$1	-\$1
706	Certain Alaska natural gas pipeline property treated as 7-year property	\$0	\$0	\$0
708	Method of accounting for naval shipbuilders	-\$4	-\$7	-\$6
709	Modification of minimum cost requirement for transfer of excess pension assets.	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
811-820	Provisions relating to reportable transactions and tax shelters	Baseline gain [1]	Baseline gain [1]	Baseline gain [1]
831	Treatment of stripped interests in bond and preferred stock funds, etc.	e/	e/	c/
833	Disallowance of certain partnership loss transfers	e/ +Baseline gain [1]	e/ +Baseline gain [1]	e/ +Baseline gain [1]
834	No reduction of basis under Section 734 in stock held by partnership in corporate partner	e/	e/	e/
835	Repeal of special rules for FASITS	a/	a/	a/
836	Limitation on transfer or importation of built-in losses	e/ +Baseline gain [1]	\$1 +Baseline gain [1]	\$1 +Baseline gain [1]
838	Denial of deduction for interest on underpayments attributable to nondisclosed reportable transactions	a/	a/	a/
839	Clarification of rules for payment of estimated tax for certain deemed asset sales.	\$2	\$1	-

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840	Recognition of gain from the sale of a principal residence acquired in a like-kind exchange within 5 years of sale	\$1	\$1	\$1
841	Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons	\$2	\$3	\$1
842	Deposits made to suspend running of interest on potential underpayments	-\$2	d/	d/
843	Partial payment of tax liability in installment agreements.	\$1	c/	f/
845	Expanded disallowance of deduction for interest on convertible debt	\$3	\$3	\$3
847-849	Reform of tax treatment of certain leasing arrangements	\$3 +Baseline gain [1]	\$4 +Baseline gain [1]	\$5 +Baseline gain [1]
882	Treatment of charitable contributions of patents and similar property	e/	e/	e/
883	Increased reporting for noncash charitable contributions	a/	a/	a/
884	Donations of motor vehicles, boats, and airplanes	\$7	\$8	\$8
885	Treatment of nonqualified deferred compensation plans	Baseline gain [1]	Baseline gain [1]	Baseline gain [1]
886	Extension of amortization of intangibles to sports franchises	\$3	\$3	\$1
888	Modification of straddle rules	\$1	\$1	\$1
896	Recognition of cancellation of indebtedness income realized on satisfaction of debt with partnership interest	\$2	\$1	\$1
897	Denial of installment sale treatment for all readily tradable debt.	\$2	\$1	e/
898	Modification of treatment of transfers to creditors in divisive reorganizations	e/	e/	e/
899	Clarification of definition of nonqualified preferred stock	c/	c/	c/
902	Consistent amortization of periods for intangibles	\$5	\$15	\$15
903	Freeze of provisions regarding suspension of interest where Secretary fails to contact taxpayer [2]	\$2	\$2	\$1

905	Treatment of sale of stock acquired pursuant to exercise of stock options to comply with conflict-of-interest requirements	Baseline gain [1]	Baseline gain [1]	Baseline gain [1]
907	Limitation of employer deduction for certain entertainment expenses	\$6	\$6	\$7
TOTAL (excluding baseline estimates and footnoted estimates)		-\$4	-\$1	\$0
[1] For baseline estimates see revenue impact discussion in the individual sections.				
[2] Estimates based on State data. Otherwise, all estimates are based on Federal pro-rations.				
a/ Insignificant gains of less than \$150,000				
b/ Insignificant losses of less than \$150,000				
c/ Negligible gains of less than \$250,000				
d/ Negligible losses of less than \$250,000				
e/ Minor gains of less than \$500,000				
f/ Minor losses of less than \$500,000				

LEGAL IMPACT

This bill contains provisions that would target certain provisions relating to low-sulfur diesel fuel to California.

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 effects 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.

Recently introduced federal legislation titled the "Economic Development Act of 2005," S. 1066 and H. R. 2471, would authorize state tax incentives for economic development purposes that may otherwise be subject to constitutional challenge as discriminatory.

ARGUMENTS/POLICY CONCERNS

Conforming to federal tax law is generally desirable because it is less confusing for the taxpayer. With conformity, the taxpayer is required to know only one set of rules. Additionally, the taxpayer needs to maintain only one set of books. Conformity also eases the burden of the Franchise Tax Board to administer the law by utilizing many federal forms, instructions, and regulations. In addition, whenever possible the department uses federal information to verify that taxpayers pay the proper amount of tax. This eliminates the need for the taxpayer to submit the same information to both the IRS and the department.

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