Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Mendoza	Analyst:	Scott McFarlane	Bill Number:	AB 2481
Related Bills:	AB 3073 (2003/2004)	Telephone:	845-6075	Amended Date:	April 17, 2008
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: LA Unified School District Recovery Act

SUMMARY

This bill would do the following:

- provide employees of the Los Angeles Unified School District certain rights and protections in the event of a payroll dispute,
- require the district to reimburse employees for any tax liability that results from an overpayment, and
- authorize the district to withhold up to one-half of the annual salary of superintendent and assistant superintendents if the district's total payroll error exceeds 1%.

The following analysis is limited to the provisions of the bill that impact income tax and to an explanation of the claim-of-right doctrine.

SUMMARY OF AMENDMENTS

The bill as introduced on February 21, 2008, contained generally the same provisions as the current bill, except that it would apply to any school district and apply only to certified employees.

The bill as amended on April 1, 2008, limits the applicability of the bill to the Los Angeles Unified School District, applies to both certified and classified employees, and prohibits the district from using state funds for the payment of the superintendent's or assistant superintendent's salaries if the error rate of total payroll is greater than 1%.

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

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to help ensure that employees of the Los Angeles Unified School District are not substantially underpaid or overpaid.

EFFECTIVE/OPERATIVE DATE

This bill would become effective and operative on January 1, 2009.

Board Position:			Department Director	Date
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POSITION

Pending.

ANALYSIS

BACKGROUND

How Income Tax on Individuals is Computed

An individual first computes gross income, which is generally all income from all sources. From gross income, certain deductions are allowed to reach adjusted gross income. Next, additional deductions and exemptions are allowed to arrive at taxable income. The tax liability of an individual is generally computed by multiplying the applicable tax rate and taxable income, and this sum is reduced by allowable credits.

Gross Income and Amounts Erroneously Paid

Gross income includes wages and salaries received as an employee, including any amounts paid erroneously that are not repaid by the employee by the end of the year.

Claim of Right

Income received without restriction—income the taxpayer has dominion and control over—must be reported in the year received, even if there's a possibility it may have to be repaid in a later year. This is commonly known as the claim-of-right doctrine. Examples of an individual’s income that may be subject to the claim-of-right doctrine are incorrectly computed wages and excess unemployment compensation payments.

As discussed in more detail below, individuals who are required to repay any amount that was included in income in a previous taxable year are allowed either to deduct the amount repaid from their income for the taxable year in which they repaid it or to claim a credit for the year in which they repaid it.

FEDERAL/STATE LAW

Federal Law

Internal Revenue Code (IRC) section 1341 provides a special relief provision for taxpayers who receive income in one year, report it as income, and are then required to repay that income in a subsequent year. In the year the income is repaid, taxpayers are allowed to take a deduction or a credit, whichever results in the least amount of tax.

Repayments Exceeding $3,000

IRC section 1341 relief is allowed if all three of the following requirements are met:

1) 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,
2) It is established that the taxpayer did not have an unrestricted right to all or a portion of the item of income, and
3) The amount of the repayment exceeds $3,000.

If these requirements are met, the tax for the <u>year of repayment</u> is the lesser of:

- The tax for that year computed with a deduction for the amount of the repayment; or
- The tax for that year computed without the deduction, minus the decrease in tax for the earlier year that would result solely from the exclusion of the deductible repayment.

The purpose of this relief provision is to ensure that the taxpayer's position is not worse than the position the taxpayer would have been in if the taxpayer had not included the amount repaid in gross income in the earlier year (except for the time value of money).

<u>Example A</u>: Due to difficulties attributable to the implementation of a new payroll system, a classified employee of the City School District was overpaid $3,500 in 2007. The overpayment was not repaid by the end of the year and as a result the $3,500 overpayment is included as wages in the employee's 2007 federal Form W-2, Wage and Tax Statement. The employee and the district agree to a repayment plan where the employee will repay the district $3,500 in 2008.

On the employee's 2007 California personal income tax return, the $3,500 overpayment is included in gross income. The amount of the employee's 2007 California personal income tax attributable to the overpayment is $325.

Assuming the employee repays $3,500 to the district in 2008, the employee computes his or her 2008 California personal income tax as the lesser of:

- The tax for 2008 computed with a $3,500 deduction; or
- The tax for 2008 computed without the $3,500 deduction, minus the decrease in tax for 2007 that would result solely from the exclusion of the $3,500 overpayment.

In this case, the employee is able to recover on his or her 2008 California personal income tax return the amount of 2007 personal income tax that was solely attributable to the $3,500 overpayment. The employee's position is not worse than it would have been if the employee had not included the overpayment in gross income in 2007, except for the time value of money.

Repayments Not Exceeding $3,000

If the first two IRC section 1341 requirements are met, but the repayment is less than $3,000, then IRC section 1341 does not apply. Instead, the repayment is allowed as a miscellaneous itemized deduction, subject to the 2% floor.[1] In this situation, a taxpayer who does not itemize deductions or who has miscellaneous itemized deductions that do not exceed the 2% floor, would receive no benefit for the repayment of previously taxed income.

<u>Example B</u>: Due to difficulties attributable to the implementation of a new payroll system, a classified employee of the City School District was overpaid $2,500 in 2007. The overpayment was not repaid by the end of the year, and as a result the $2,500 overpayment is included as wages in the employee's 2007 federal Form W-2, Wage and Tax Statement. The employee and the district agree to a repayment plan where the employee agrees to repay the district $2,500 in 2008.

On the employee's 2007 California personal income tax return, the $2,500 is included in gross income. The amount of 2007 California personal income tax attributable to the overpayment is $232.

Assuming the employee repays $2,500 to the district in 2008, the employee would be allowed to claim the $2,500 as a miscellaneous itemized deduction on his or her 2008 California personal income tax return. (IRC section 1341 relief is not allowed because the repayment is less than $3,000.) If the employee does not itemize deductions or cannot benefit from the miscellaneous itemized deduction (because total miscellaneous itemized deductions do not exceed the 2% floor), the taxpayer would receive no benefit from the 2008 repayment of $2,500.

In this case, the employee would have a tax liability of $232 on the $2,500 overpayment in 2007, and would receive no tax benefit for repaying $2,500 in 2008. The employee's position is worse than it would have been if the employee had not included the overpayment in gross income in 2007; that is, the employee will have a tax liability of $232 on wages that the employee repays to the district.

State Law

California Revenue and Taxation Code (R&TC) section 17049 generally provides the same relief as federal law.

<u>THIS BILL</u>

This bill would require the Los Angeles Unified School District to reimburse certified or classified employees for any additional tax liability resulting from an overpayment received from the district.

POLICY CONSIDERATION

Any reimbursement the district pays to an employee for a prior year's overpayment would be includible in the employee's current-year gross income. Unless the first reimbursement is grossed up to account for personal income tax attributable to that first reimbursement, the district may be required to make multiple-year reimbursements from the same overpayment.

[1] The 2% floor means miscellaneous itemized deductions may be claimed only to the extent they exceed 2% of federal adjusted gross income.

Example C: Assume the same circumstances as in Example B above, where an employee's 2007 California personal income tax liability attributable to the 2007 $2,500 overpayment is $232. Also assume that the employee would receive no benefit from claiming the 2008 $2,500 repayment as a miscellaneous itemized deduction. If the district reimburses the employee $232 in taxable year 2008, that reimbursement is included in the employee's 2008 gross income. Assume the employee's 2008 California personal income tax liability attributable to the $232 reimbursement is $22. The district would be required to reimburse the employee $22, and the employee would be required to include $22 in gross income.

The author may want to consider amending the bill to require the district to gross up employee reimbursements to account for the tax liability that would result from the reimbursement itself.

The term "additional tax" is used for specific types of taxes in the R&TC, such as the additional tax assessed for the underpayment of estimated tax. It appears that the use of the phrase "additional taxes payable because of an overpayment error made by that district" in this bill is intended to mean any tax liability that results from an overpayment error made by the district. The specific use of the term "additional taxes" may lead to disagreements between employees and the district over whether or not the tax resulting from an overpayment is an increase to tax or an "additional tax."

The author may want to consider amending the bill to remove the phrase "additional taxes payable because of an overpayment error made by that district" and instead use the phrase "any tax liability that results from an overpayment error made by that district."

LEGISLATIVE HISTORY

AB 3073 (Assembly Revenue and Taxation Committee, 2003/2004) enacted California law (R&TC section 17049) that is similar to the federal claim-of-right provisions in IRC section 1341. That bill was chaptered on August 30, 2004.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This bill would have no impact on state income tax revenue.

Revenue Discussion

This bill would lead to minor increases in compensation for certain taxpayers. Our revenue estimates do not account for changes in compensation or other macroeconomic variables.

LEGISLATIVE STAFF CONTACT

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