BILL ANALYSIS

Analyst: Gail Hall
Work Phone: 845-6111

Department, Board, Or Commission	Author	Bill Number
Franchise Tax Board	**Migden**	**SB 105**

SUBJECT

Registered Domestic Partnerships/Tax Treatment Same As Married Couple Except Where Treatment Would Result In Specified Treatment Under Federal Law

SUMMARY

This bill would clarify and resolve issues relating to the new California Registered Domestic Partner (RDP) personal income tax filing requirement.

This bill includes language to prevent chaptering issues with AB 1561 (Calderon, 2007/2008).

PURPOSE OF BILL

The author's staff has indicated the purpose of the bill is to clarify and resolve issues relating to SB 1827 (Stats. 2006, Ch. 802), which enacted the requirement that RDPs use the same filing status as married persons, to ensure an effective implementation of the enacted law.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and apply to taxable years beginning on or after January 1, 2007.

ANALYSIS

FEDERAL/STATE LAW

Current federal law treats RDPs as single individuals instead of spouses who are married or members of the same family.

Current state law requires RDPs to file a personal income tax return jointly or separately by applying the standards applicable to married couples under federal income tax law. RDPs are treated as spouses for state income tax purposes.

S Corporation

An S Corporation is a form of a corporation that enables the company to enjoy the benefits of incorporation but is taxed similar to a pass-through entity (i.e. partnership). A corporation may elect to be treated as an S Corporation if certain requirements are met. One of those requirements is that the S Corporation's total shareholders must be less than or equal to 100. Spouses and all members of a family are treated as one shareholder.

A corporation may qualify as an S corporation under California law only if it has a valid federal S corporation election in effect. In other words, the federal S corporation requirements must also be met for California purposes. There is no independent California election allowed that would permit a federal S corporation to elect to be taxed as a regular corporation for California purposes. Similarly, current law does not allow a corporation to be an S corporation only for California purposes.

In meeting the less than or equal to 100 shareholder S corporation requirement, RDPs will be treated as one shareholder for state purposes versus two shareholders for federal purposes. This could result in a corporation that was not eligible to be an S corporation for federal purposes to be an S corporation for California purposes. Similar issues arise in connection with the classification of business entities based on whether the entity is owned by one person or by more than one person.

Federally-Qualified Deferred Compensation Plans (ERISA)

Current federal law allows an employer that participates in a federally-qualified deferred compensation plan to deduct contributions paid to the qualified plan on behalf of employees even though these contributions are not currently taxable to the employees. These provisions are also applicable for California purposes. The federal tax rules parallel provisions of the Employee Retirement Income Security Act (ERISA), which affirmatively preempts state law.

Current federal law known as the "Defense of Marriage Act" prohibits RDPs from being treated as spouses. Consequently, RDPs are treated as single individuals for federal purposes instead of spouses that are married or members of the same family. However, RDPs are required to be treated as spouses under current state law. An administrator of a federally qualified deferred compensation plan covered by ERISA would be prevented from treating an RDP as a spouse because ERISA preempts state law. The California Constitution[1] provides that the department has no power to refuse to enforce any California statute that is preempted by federal law unless an appellate court has made a determination that enforcement is prohibited by federal law. If California law required federally qualified plans to treat RDPs as spouses, the plan could not be qualified for federal and state purposes.

[1] Article 3, Section 3.5.

Tax-Favored Accounts

Current federal law has established several tax-favored special purpose accounts that include Archer Medical Savings Accounts (MSAs), Individual Retirement Accounts (IRAs), education savings accounts (529 accounts), and Coverdell education savings accounts. These tax-favored accounts allow taxpayers to get special tax treatment for amounts accumulated to pay for particular expenses. Contributions to some accounts are deductible and tax on income earned on amounts in these accounts may be deferred or avoided. In some cases, eligibility is limited to certain taxpayers and may depend on the circumstances of a spouse or provide special rules for married individuals. In general, current state law conforms to the federal treatment for these tax-favored accounts.

Current state law treats RDPs as spouses; however, current federal law treats RDPs as single taxpayers. An RDP who is an eligible account owner for state tax purposes may not be eligible as an account owner for federal purposes. For example, the transfer of a tax-favored account from one RDP to another RDP incident to dissolution of a domestic partnership would continue to be treated as a tax-favored account under current state law but would no longer be treated as a tax-favored account under current federal law, creating a California-only tax favored account.

Federal AGI

Federal AGI is defined under current federal law for personal income taxpayers as gross income from all sources not specifically excluded, minus certain "above the line"[2] deductions such as moving expenses, alimony paid, and IRA deductions. Federal AGI is used as a basis for various calculations, including determining the limitation on certain itemized deductions such as medical expenses and miscellaneous deductions. Current state law requires that, for limitation purposes, taxpayers use the AGI as reflected on their federal return. In addition, many California personal income tax returns start its calculation at the amount of AGI reported on the federal tax return.

Last year, California law was amended[3] to require RDPs to file their California income tax returns using the same rules applicable to married individuals. Effective January 1, 2007, RDPs are required to file personal income tax returns as either: (1) married filing joint, or (2) married filing separate. Because RDPs are not allowed to file a joint federal return, this law also provided a rule for calculating joint federal AGI for limitation purposes. The rule provides that RDPs shall combine the amounts reflected as AGI on the federal income tax return of each RDP to determine their joint federal AGI for limitation purposes.

---

[2] Tax deductions, other than the standard deduction or itemized deductions that are subtracted from income to calculate AGI.
[3] SB 1827 (Migden, Stats. 2006, Ch. 802).

Underpayment Penalty

Under current state and federal laws, taxpayers generally are subject to a penalty for any underpayment of estimated tax. The penalty is an amount equal to the underpayment rate[4] multiplied by the amount of the underpayment. State and federal laws have historically allowed exceptions to the estimated tax underpayment penalty when the underpayment resulted from a specified legislative change.

THIS BILL

This bill would clarify that an RDP or former RDP be treated as a spouse or former spouse, respectively, for personal income tax and corporation tax purposes. In addition, this bill would provide the following technical exceptions to RDPs being treated as spouses for California purposes:

1. Where treatment would result in the classification of a business entity for California purposes differently than for federal purposes. For example, this exception would avoid an S corporation meeting the 100 shareholder requirement for state purposes and not for federal purposes because there were two RDP shareholders that for federal purposes put the total amount to 101 shareholders, disqualifying the S corporation status under federal law.
2. Where treatment would result in the disqualification of a federally qualified deferred compensation plan under the rules established by the Internal Revenue Code (IRC).
3. Where treatment would result in the creation of a California only tax-favored account that would not be qualified for federal income tax purposes. A “tax favored account” means an individual account, plan, or arrangement that is exempt from tax under federal law and includes an Archer MSA, IRA, qualified tuition program, and a Coverdell education savings account.

This bill would revise current law for how RDPs calculate their joint federal AGI used for state limitation purposes. The revised rule would calculate joint federal AGI for state limitation purposes as the amount that would have been computed if RDPs were required to 1) file a joint or separate federal tax return, 2) use the same filing status on a federal return that was used on the California tax return, and 3) be treated as spouses or former spouse for federal purposes.

This bill would prohibit RDPs from being assessed an underpayment of estimated tax penalty for the 2007 taxable year to the extent the underpayment was created by the provisions of this bill and/or the new California tax filing requirement for RDPs (SB 1827).

[4] The underpayment rate is the sum of the Federal short-term rate, as determined by the Secretary, and three percentage points.

LEGISLATIVE HISTORY

SB 11 (Migden, 2007/2008) would amend the Family Code to eliminate the requirement that to become an RDP the persons must either be of the same-sex or be over 62 years of age. SB 11 is currently at the Assembly Appropriations Committee.
SB 1827 (Migden, Stats. 2006, Ch. 802) requires RDPs to file as either married filing joint or married filing separate for state income tax purposes for taxable years beginning on or after January 1, 2007.

AB 205 (Goldberg, Stats. 2003, Ch. 421) as introduced on January 28, 2003, would have allowed domestic partners to file personal income tax returns as either: (1) married filing joint, or (2) married filing separate. The bill as chaptered made changes to various California laws regarding domestic partners, including the creation of community property rights. It also added language that required the same filing status on a state income tax return as used on the federal income tax return and provided that earned income is not community property for state income tax purposes. The August 18, 2003, amendments to the bill removed the provisions of the bill that would have allowed domestic partners to file personal income tax returns as either: (1) married filing joint, or (2) married filing separate.

OTHER STATES' INFORMATION

The states surveyed include *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. The laws of these states were reviewed because their tax laws are similar to California's income tax laws. Only *Massachusetts* allows domestic partners to file tax returns as married filing joint or married filing separate.

For tax periods ending on or after May 16, 2004, *Massachusetts* recognizes the right of same-sex couples to be married. As a consequence, same-sex spouses that marry shall file *Massachusetts's* income tax returns as married filing joint or married filing separate.

Massachusetts is not a community property state. Research found that certain expenses limited by federal AGI for same-sex marriages use a combined AGI rule, similar to California's current RDP joint AGI rule, to calculate allowable expenses. Research found no discussion relating to the treatment of S corporation shareholders, federally-qualified deferred compensation plans, or tax-favored accounts.

New Jersey, Connecticut, and *Vermont* have civil unions similar to California's domestic partnership law. Research was performed to identify the rules these states use for calculating joint federal AGI for state purposes. *New Jersey* lacks any provisions that utilize joint federal AGI for state purposes, *Connecticut* requires civil union partners to recalculate their joint federal AGI as if they were allowed to file as married filing joint for federal purposes, and *Vermont* requires civil unions to complete a joint federal tax return as if they were allowed to file as married filing joint or separate and use the recomputed joint federal AGI reported to complete their *Vermont* individual tax return.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

The revenue impact for the provisions under SB 105 would be inconsequential.

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

Revenue Discussion

Clarify RDPs Treated As Spouses

The provision that would treat RDPs as spouses or former spouses is declaratory of existing law and would have no impact on state income tax revenue.

Shareholders/S Corporations

The provision that would exclude RDPs from being treated as spouses for S corporation purposes would have no revenue impact. There could be circumstances under which a particular business entity classification type would be allowed under state law but not under federal law (e.g., an S-corporation that would exceed the limit on the number of owners if RDPs were counted separately, but not if they are counted jointly). The department is unaware of any specific entities that would be classified differently for state purposes because shareholders are RDPs. This estimate assumes that taxpayers generally follow federal law when choosing an entity type because federal law is more restrictive with respect to entity types. It is anticipated that businesses will not suffer adverse consequences from entity reclassifications under current state law.

Federally-Qualified Deferred Compensation Plans and Tax-Favored Accounts

The provisions that would exclude RDPs from being treated as spouses for purposes of a federally qualified deferred compensation plan or a tax-favored account would have no revenue impact. Treatment of RDPs as spouses for California purposes could result in a plan being disqualified by the administrator for federal purposes or require an administrator to create a "California only" tax favored account. It is assumed that RDPs generally would follow federal requirements, therefore, no revenue impact for these provisions are anticipated.

RDPs' Federal AGI

Under state current law, federal AGI for RDPs is calculated by summing the AGI reported on the federal tax return of each partner. Under this provision, the Federal AGI would be calculated as if the partners were married. Under limited circumstances, these two methods could result in a different calculation of AGI. Typically, this could happen with the capital loss limitation or when netting capital losses and capital gains. The calculation of AGI also has a ripple effect with respect to itemized deductions subject to an AGI threshold (e.g., medical expenses). Circumstances exist where some will have an advantage and some will have a disadvantage as a result of changing how AGI would be calculated. Although the revenue impact cannot be quantified, any net revenue effects are anticipated to be inconsequential because the estimated number of registered domestic partnerships affected is 250, the California average tax rate is 5%, and the dollar amount change due to the proposed joint AGI rule would generally be an insignificant amount.

Penalty

There would be no revenue impact from this provision.

Under current law, RDPs are required to use the filing status married filing joint or married filing separate for the 2007 tax year. To date, no underpayment penalties have been assessed that are associated with this provision. Under this provision, potentially fewer penalties would be assessed than otherwise.

VOTES

Senate Floor – Ayes: 37, Noes: 2
Assembly Floor – Ayes: 47, Noes: 31
Concurrence – Ayes: 35, Noes: 4

LEGISLATIVE STAFF CONTACT

Gail Hall
Franchise Tax Board
(916) 845-6111
gail.hall@ftb.ca.gov

Brian Putler
Franchise Tax Board
(916) 845-6333
brian.putler@ftb.ca.gov