ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Dutton, et. al.	Analyst:	Deborah Barrett	Bill Number:	SB 752
Related Bills:	None	Telephone:	845-4301	Introduced Date:	February 23, 2007
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Exclusion/California Kids Investment & Development Savings (KIDS) Account Earnings, Contributions, or Qualified Distributions

SUMMARY

This bill would establish the California Kids Investment and Development Savings (KIDS) Account Act that would provide a $500 savings account for every child born in California after a specified date.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to help people learn how to save over their lifetimes.

EFFECTIVE/OPERATIVE DATE

This bill would become effective on January 1, 2008, and would be applicable to every child born in California on or after that date. The tax provision of this act would be operative for taxable years beginning on or after January 1, 2008.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Existing federal and state laws provide that gross income includes all income from whatever source derived, including compensation for services, business income, gains from property, interest, dividends, rents, and royalties, unless specifically excluded.

Existing federal and state laws provide that certain types of income are excluded from gross income, such as amounts received as a gift or inheritance, certain compensation for injuries and sickness, qualified scholarships, educational assistance programs, foster care payments, and interest received on certain state or federal obligations.

Board Position:			Department Director	Date
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_______ N	_______ OUA	___X___ PENDING	by Lynette Iwafuchi	

Existing state law imposes tax on the income earned by individuals, estates, trusts, and certain business entities. Tax is imposed on the entire taxable income of residents of California and upon the taxable income of nonresidents derived from sources within California. The tax for individuals is computed on a graduated scale at rates ranging from 1% to 9.3%.

The existing Personal Income Tax Law imposes a tax on the income of a nonresident that is derived from or attributable to sources within this state. "Income from sources within this state" is defined by regulations as income from tangible or intangible property located or having a situs in this state and income from any activity carried on in this state, regardless of whether carried on in intrastate, interstate, or foreign commerce.

THIS BILL

This bill would establish the California KIDS Account Act. Under this act, every child born in California on or after January 1, 2008, would have $500 deposited into an account in the State Treasury by the State. Parents, legal guardians, grandparents, local organizations, corporations, or others would be able to make a voluntary contribution to the child's account. Any individual who is 18 years or older may withdraw funds from the account without incurring a tax liability for the following purposes:

- Pay for his or her postsecondary education, career technical education, or training;
- Buy his or her first home; or
- Fund his or her retirement account.

The KIDS account is exempt from taxation. If the assets of such account are distributed for reasons other than the qualified purpose, then the earnings in the KIDS account are required to be included in the gross income of the accountholder in accordance with federal rules for annuities, as modified. The funds held in a KIDS account may not be taken into account for purposes of determining the eligibility of an individual for a state or federal program intended to provide assistance to low income people.

For each taxable year, beginning on or after January 1, 2008, the following would be excluded from the gross income of an accountholder of a California KIDS account:

- Any earnings in the KIDS account,
- Any contribution to the KIDS account, or
- Any qualified special purpose distribution amount.

If any distribution from a KIDS account is not a qualified special purpose distribution as defined, any earnings in that account are includable in the gross income of the accountholder for the taxable year in which the distribution is made and is subject to a 10% penalty. An amount equal to the amount of initial deposit made by the state to the account ($500) must be paid to the Franchise Tax Board (FTB) by the accountholder for the taxable year in which the nonqualified distribution occurred.

The value of the account, any earnings in the account, and investment in the account would be computed as of the close of the calendar year in which the taxable year begins. No deduction is allowed for contributions to a KIDS account.

This bill would define the terms accountholder, KIDS account, and qualified special purpose distribution for purposes of this section.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

Although the bill would allow individuals other than the account holder to contribute to the account, it is not clear whether the child's parents or guardians that normally have control over the affairs of a minor child would have any control over the funds in the account or could make decisions on behalf of the child relating to the account. To prevent any misunderstanding, it is recommended that the author clarify whether any individual other than the account holder has authority over the funds in the account.

It is not clear what would happen to the funds in the account in the event the child becomes deceased before the funds are distributed. To avoid any disputes with surviving family members, the author may wish to specify whether the funds belonging to the child become a part of their estate or not.

Funds are to be paid to FTB if the withdrawal is not for a qualified purpose. It is not clear whether the author intends for the account holder to repay the initial deposit when funds are distributed for nonqualified purposes by immediately remitting the funds to FTB upon distribution or whether the taxpayer is required to remit the funds as part of its income tax filing for that taxable year of the distribution. It may be prudent for the State Treasurer to deduct the required repayment from the amount distributed, thereby avoiding potential noncompliance with the repayment requirement from the start.

Generally state tax provisions are contained solely within the Revenue and Taxation Code (RTC), rather than in another code as this bill would. It is recommended that the tax provisions be moved to the RTC with appropriate cross references. In addition, the provision in Section 99102 of the Government Code that would authorize the State Treasurer to promulgate rules and regulations to implement the act, which may create uncertainty over which state agency is charged with implementing the tax provisions affecting KIDS accounts.

The bill would provide that funds held in a KIDS account should be disregarded when determining eligibility for state or federal programs for low income assistance. California is unable to compel the federal government legislatively to adhere to this requirement and lacks the authority to preclude non-California colleges and universities from taking such amounts into account.

Generally, the amount included in taxable income would be limited to the amount distributed within a given year. The bill appears to require that the entire amount of the investment earnings be included in gross income if there is a nonqualified distribution in any year, without explicitly ending the qualification of the account as a nontaxable account for future years. To remain consistent with general tax law, the author may want to amend the language to specify that the amount of the nonqualified distribution would be the amount subject to tax in a given year, and a nonqualified distribution would revert any funds remaining in the account from a nontaxable account to a taxable account.

If a nonqualified distribution of the funds occurs, the accountholder would be required to repay the initial deposit to the account. It is unclear whether that repayment would be required each time a nonqualified distribution occurs or only in the first instance of a nonqualified distribution. The author may want to amend the language to clarify under what conditions the repayment would be required.

The bill would provide that the Treasurer establish an account for this program but is silent about who would be responsible for investing the account an investment mechanism. It is unclear how earnings are to be actualized or who would provide the administrative support for these accounts, such as earning statements or 1099 reports required by state and federal statutes. The author may want to amend the language to clarify what functions the Treasurer or other entity would be required to perform in relation to these accounts.

The bill would establish an account at the Treasurer’s office that could have no additional deposits or activity other than the initial deposit. It is not clear whether the inactive accounts would be subject to the Unclaimed Property laws administered by the State Controller. The author may wish to amend the language to prevent the account from being escheated to the state for lack of activity.

The bill would provide that all earnings will be taxed under Internal Revenue Code (IRC) section 72, as modified by RTC section 17085. Section 17085 provides rules for individual retirement accounts, annuities, and employee trust or annuity accounts. The accounts established under this bill’s provisions would be regular bank accounts for federal purposes and do not meet the requirements of accounts identified in Section 17085. The author may wish to amend the language to reflect provisions of IRC section 61 related to gross income.

FISCAL IMPACT

This bill would require FTB to develop a separate accounting and collection system to manage the repayment of the funds for nonqualified purposes. In addition, this bill would require the development of a data match process between the State Treasurer and FTB to identify those taxpayers who would owe the repayment amount for FTB to initiate collection efforts for the repayment of the funds. An estimate of the costs that would be incurred to develop and implement the new systems will be developed as the bill progresses through the legislative process.

ECONOMIC IMPACT

Based on data and assumptions discussed below, this bill would result in the following inconsequential revenue losses beginning in 2008-09.

Estimated Revenue Impact of SB 752 As Introduced 2/23/07		
2007-08	2008-09	2009-10
No Impact	< -$150,000	< -$150,000

This bill would have an impact on the state's General Fund in addition to the tax revenue impact indicated in the table. In addition to the exclusion of earnings, the bill proposes a one-time deposit of $500 to an account with the State Treasury for each child when born in California.

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

Tax Revenue Discussion

The revenue impact of the bill would be determined by the amount of otherwise taxable earnings on account balances each year and the marginal tax rate of accountholders.

Based on data from the California Statistical Abstract, the number of births in California for 2006 totaled 552,000. The number of births per year tends to fluctuate but has averaged slightly less than a 1% increase a year for the last five years. Applying this average growth rate, the number of births is increased to 561,500 in 2008.

At $500 per child born, the state's initial deposits for 2008 would total $281 million (561,500 births x $500 deposit = $281 million). Absent this bill, these deposits would not otherwise exist; therefore, excluding the earnings attributed to the state's initial deposits from income does not result in a revenue loss that is attributable to the bill.

As this is a state only income exclusion, it is assumed that less than 2% of existing accounts would also receive additional contributions from other sources of $500 a year (561,500 accounts x 2% = 11,000 accounts). For 2008, this would be an additional $6 million in deposits (11,000 accounts x $500 = $6 million). It is assumed that nearly all of these additional deposits would have been otherwise deposited in taxable accounts. Excluding the earnings attributed to the additional deposits that would otherwise be deposited in taxable accounts does result in a revenue loss attributable to the bill.

In the first year, deposits would total approximately $287 million ($281 million + $6 million = $287 million). However, it is only the earnings exclusion on additional deposits of $6 million that result in a revenue loss attributable to the bill. Assuming a 5% rate of return and a mid-year deposit date, earnings are projected at $0.1 million ($6 million x 5% rate of return x 50% mid-year deposit = $0.1 million). Applying a marginal tax rate of 1% would result in an inconsequential loss in 2008. As deposits are assumed made at mid-year, the impact for 2008 is reflected in the cash flow fiscal year estimate for 2008-09.

POLICY CONSIDERATION

This bill would create differences between federal and California tax law, thereby increasing the complexity of California tax return preparation.

This bill contains provisions that would target certain incentives to residents of California while denying the same incentive to nonresidents. The U.S. Supreme Court in *Lunding Et Ux. v. New York Appeals Tribunal et al.* (1998) 118 S. Ct. 766, found that New York's denial of an alimony deduction to nonresident taxpayers, while allowing such a deduction to resident taxpayers, was discriminatory and thus unconstitutional. Thus, targeted tax incentives that are conditioned on residency in California may be subject to constitutional challenge.

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