

Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Negrete-McLeod Analyst: Jahna Carlson Bill Number: SB 1542
Related Bills: See Legislative History Telephone: 845-5683 Amended Dates: April 10, 2012 May 1, 2012
Attorney: Patrick Kusiak Sponsor:

SUBJECT: Local Educational Advancement Program (LEAP) Contribution Credit

SUMMARY

This bill would create an income and franchise tax credit for contributions made to a local educational advancement program (LEAP) organization.

RECOMMENDATION

No position.

Summary of Amendments

The April 10, 2012, amendments eliminated the bill's provisions related to legislative intent and replaced it with language that would create an income and franchise tax credit for contributions to a LEAP organization.

The May 1, 2012, amendments modified the credit for corporate taxpayers and made technical, non-substantive changes to the provisions discussed in this analysis.

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

REASON FOR THE BILL

It appears that the reason for this bill is to encourage contributions to LEAP organizations to provide educational enrichment programs outside of the schoolday to students in grades kindergarten through 12 via an income and franchise tax credit.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2012.

ANALYSIS

FEDERAL/STATE LAW

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.

Table with Board Position (S, NA, NP, SA, O, NAR, N, OUA) and Department Director (Selvi Stanislaus) and Date (05/09/12).

Existing state and federal law defines “person” as including an individual, a trust, estate, partnership, association, company or corporation.<sup>1</sup> Under federal law, a taxpayer is any person subject to any internal revenue tax.<sup>2</sup> Under the state’s Personal Income Tax Law (PITL), a taxpayer is any individual, fiduciary, estate, or trust subject to the PITL or any partnership.<sup>3</sup>

Existing federal and state laws provide for five filing status types for individual filers: single, married filing jointly, married filing separately, head of household, and qualifying widow(er). Under California law the two status types that may apply to married individuals would also apply to individuals in a Registered Domestic Partnership.

Existing federal and state laws allow individuals to deduct certain expenses, such as medical expenses, charitable contributions, interest, and taxes, as itemized deductions. Also, itemized deductions may be further limited for high-income taxpayers.

Current federal and state law allows a corporation and S-corporation to deduct charitable contributions limited to 10 percent of the taxpayer’s net income. Contributions in excess of 10 percent may be carried over to the following five succeeding taxable years.

### THIS BILL

This bill would, for taxable years beginning on or after January 1, 2012, create an income tax credit for monetary amounts contributed during the taxable year by a taxpayer to a LEAP organization that provides fee assistance to qualified students to receive academic services outside of the regular schoolday.

This bill would define the following terms and phrases:

- Academic services would include, but not be limited to:
  - afterschool programs or summer and vacation school programs at public or accredited private schools
  - tutoring
  - diagnostic evaluations
  - college and career preparation
  - online learning
- Academic services could be provided by a public or private entity, including, but not limited to: a public school, private school, school district, school foundation, county office of education, educational service agency, institution of higher learning, faith-based organization, community-based organization, or private business, including a sole proprietor.
- Fee assistance would mean financial assistance to cover partial or full payment of fees associated with the general cost of academic service, including transportation costs, that is granted on a needs-based, ability to pay, formula demonstrated by household income or extenuating circumstances, or both.

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<sup>1</sup> Internal Revenue Code (IRC) section 7701(a)(1), Revenue and Taxation Code (R&TC) section 17007

<sup>2</sup> IRC section 7701(a)(14)

<sup>3</sup> R&TC section 17004

- Local educational advancement program organization would mean an organization that meets all of the following:
  - Is a federal Internal Revenue Code section 501(c)(3) tax exempt organization or a government entity, including, but not limited to, a school district, school foundation, county office of education, educational service agency, institution of higher education, faith-based organization, or community-based organization.
  - Uses at least 97 percent of the monetary contributions it receives for fee assistance.
  - Makes fee assistance available for students from more than one school.
- Outside the regular schoolday would mean the time before or after regular school hours, on weekends, or in the summer.
- Public school would mean a school, including a charter school, that provides instruction in grades kindergarten through grade twelve, inclusive, established by the Legislature, or by municipal or district authority.
- Qualified students would mean students in kindergarten through grade 12, inclusive, from families with demonstrated financial needs, enrolled at a public school, accredited private school, or home school.
- Recapture event would be defined as occurring when a taxpayer fails to contribute an amount as certified.

Under the PITL, the credit amount would be equal to the monetary amount contributed during the taxable year by a taxpayer up to a maximum of \$500, or \$1,000 for persons making a joint return. The aggregate amount of credits allowed under the PITL would be limited to \$100 million, but could be increased by 25 percent in any taxable year after 90 percent of the total amount of credits, as adjusted, has been allowed.

Under the Corporation Tax Law (CTL) the credit amount would be equal to 50 percent of the monetary amount contributed by a taxpayer during the taxable year up to a maximum of 50 percent of the taxpayer's total tax liability before the allowance of this credit and not to exceed \$300,000.

The maximum corporate credit amount would be increased, from 50 percent to 75 percent, of the monetary amount contributed by a taxpayer during the taxable year up to a maximum of 75 percent of the taxpayer's tax liability before the allowance of this credit, with a maximum credit not to exceed \$300,000, if the taxpayer certifies that in each of the following two succeeding taxable years that the taxpayer will contribute an amount that is at least 80 percent of the amount contributed in the current taxable year. The certification would be required to be made in a form and manner determined by the Franchise Tax Board (FTB). The increased credit percentage would only apply to contributions made in one consecutive three-taxable-year period. A corporate taxpayer that failed to meet the certified contribution amounts would be required to recapture the amount of any credits used by increasing their taxable income for the taxable year that the recapture event occurred.

The credit would be allowed in addition to any deduction allowable.

Taxpayers subject to the PITL could carry forward unused credits up to five years. The bill is silent on a corporate carryover period.

The FTB would be authorized to promulgate rules and regulations as necessary or appropriate to implement the credit.

### IMPLEMENTATION CONSIDERATIONS

Department staff has identified the following implementation considerations for purposes of a high level discussion; additional concerns may be identified as the bill moves through the legislative process. In order for the FTB to implement this provision, clarification is necessary for the following issues.

The bill lacks administrative details that must be determined to implement the bill and determine its impacts to the department's systems, forms, and processes. For example, the bill is silent on the following issues:

- Would the total aggregate credit amount limitation as applicable to the PITL and CTL credits<sup>4</sup> be applied on an annual basis, or over the life of the credit? If on an annual basis, would the period be a fiscal year? Taxable year? Calendar year?
- How would credits reported on a return other than a timely-filed, original return affect the calculation of the aggregate total? Would credits disallowed, for example, as a result of an audit, trigger a recalculation of the aggregate total?
- How would the aggregate total amount of contributions be tracked and by whom? Would the information be made available to the public? How, by whom, and when?
- How, by whom, and when would the determination be made that the total aggregate credit amount would be increased by the additional 25 percent this bill would allow? Would notification of the increase be publicized? How, by whom, and when?
- How would claimed credits in excess of the aggregate total be treated?

It is recommended that the bill be amended to clarify these conditions and rules to eliminate confusion as to the author's intentions.

This bill uses terms that are undefined, e.g., "accredited private schools," "extenuating circumstances," "families with demonstrated financial need," "home school," "monetary amount," "needs-based, ability to pay, formula demonstrated by household income." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this credit.

The definition of "outside the regular schoolday" fails to include school breaks other than a break "in the summer." If is the author's intent that the definition include academic services that occur during all school breaks, e.g., Thanksgiving week, winter holidays, president's week, spring break, etc., this bill should be amended.

A corporate taxpayer would be allowed to self-certify eligibility for the enhanced 75 percent corporate credit percentage once during the lifetime of this credit and would be allowed to select the consecutive three-taxable-year period for purposes of certifying and claiming the enhanced percentage. If this is contrary to the author's intent, this bill should be amended.

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<sup>4</sup> The bill would allow a total aggregate credit amount of \$100 million under the PITL and \$200 million under the CTL.

This bill would require that the entire corporate credit amount used, without regard to the credit percentage, be recaptured if a taxpayer fails to meet the terms of the certification. If the author intends for the recapture amount to be less than the entire credit amount, e.g., the excess of the enhanced credit amount over the amount calculated at 50 percent, this bill should be amended.

The department lacks the data and the expertise to determine whether an organization would qualify as a "local educational advancement program organization." Typically, credits involving areas for which the department lacks programmatic expertise are certified by another agency or agencies that possess the relevant expertise. The certification language would specify the responsibilities of both the certifying agency and the taxpayer.

A certified credit that is specifically allocated by another agency could also eliminate any uncertainty as to the availability of the credit. For example, because the credits would be allowed based on the filing of a return claiming the credit rather than the date a contribution is made, a taxpayer that made the earliest contribution during a taxable year could be denied the credit if the aggregate total credit amount had been reached at the time the taxpayer filed that year's return. Uncertain tax consequences could lead to disputes between taxpayers and the department. If this is contrary to the author's intent, the author may wish to consider a credit that is certified at the time a contribution is made.

Compliance with the provisions of the Administrative Procedures Act (APA) regarding regulations could affect the FTB's ability to promptly implement the credit. In order to provide timely guidance to taxpayers, it is suggested that this bill be amended to include an exemption from APA regulatory requirements.

### TECHNICAL CONSIDERATIONS

The bill would allow a credit under the PITL of \$500 or \$1,000 for "persons making a joint return." If the author intends to limit the enhanced credit amount to joint filers, the phrase "persons making a joint return" should be replaced with "married couples filing a joint return." Additionally, the author may wish to include individuals using the head of household or surviving spouse filing status for consistency with existing credits.

The language that would allow the credit in addition to any allowable deductions is unnecessary since existing state law already provides this result. On page 3, delete lines 21 and 22.

This bill uses the terms "certifies," "certification," and "certified" with respect to a corporate taxpayer's ability to choose to claim an enhanced credit percentage for one taxable year during the life of the credit, as specified. The author may wish to consider replacing these terms with "elects," "election," and "elected" to more accurately reflect the nature of the "certification" as a voluntary promise to take future action.

On page 5, delete line 37, and insert "of subparagraph (B) of paragraph (2) of subdivision (a) when the" to correct spacing errors.

### **LEGISLATIVE HISTORY**

AB 2582 (Nestande, 2011/2012) would create an income tax credit for contributions to public schools for support of cocurricular activities or to an educational improvement organization that supports innovative programs in public school, and would create a corporate tax credit for contributions to an education scholarship-granting organization, as specified. AB 2582 is currently pending before the Assembly Revenue and Taxation Committee.

AB 279 (Duvall, 2009/2010) would have created an income tax credit for contributions to a scholarship granting organization. AB 279 failed passage out of the Assembly Revenue and Taxation Committee.

AB 1262 (Haynes, 2005/2006) would have created a 75 percent credit for donations to a nonprofit organization that provides scholarships to elementary and secondary school students. AB 1262 was held in the Assembly Revenue and Taxation Committee.

### OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

*Florida* has a corporate tax credit scholarship program known as the Step Up for Students. The tax credit allows corporations to receive a dollar-for-dollar tax credit of up to 75 percent of their state income tax liability for donations made to Scholarship Funding Organizations. *Florida* does not have personal income tax.

*Illinois, Massachusetts, Michigan, Minnesota, and New York* do not provide a credit comparable to the credit allowed by this bill.

### FISCAL IMPACT

This bill would require a calculation for the credit and certification of the enhanced corporate credit percentage that would require a new form or worksheet to be developed. Additionally, the department would need to track the certifications to determine whether recapture of the credit is triggered. As a result, this bill would impact the department's printing, processing and storage costs for tax returns. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

### ECONOMIC IMPACT

#### Revenue Estimate

| Estimated Revenue Impact of SB 1542 <sup>5</sup><br>For Taxable Years Beginning On or After January 1, 2012<br>Assumed Enactment After June 30, 2012<br>(\$ in Millions) |         |         |
|--|---------|---------|
| 2012-13  | 2013-14 | 2014-15 |
| -\$250   | -\$130  | -\$56   |

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

<sup>5</sup> For purposes of this revenue estimate it has been assumed that the \$100 million cap on the PITL credit and the \$200 million cap on the corporate credit would apply over the lifetime of the credit.

## **SUPPORT/OPPOSITION<sup>6</sup>**

Support: None identified.

Opposition: None identified.

## **ARGUMENTS**

Proponents: Some could argue that this credit would provide funding to support educational enrichment programs offered outside of school hours to students in grades kindergarten through 12.

Opponents: Some could argue that with the state's current fiscal crisis, additional tax expenditures should be avoided.

## **POLICY CONCERNS**

This bill would allow a credit for contributions that are currently deductible as charitable contributions. Generally, a credit is allowed in lieu of a deduction in order to eliminate multiple tax benefits for the same item of expense.

The credit would be allowed for contributions to LEAP organizations located inside and outside California. Additionally, the fee assistance provided by a LEAP organization could be provided to students located inside and outside the state.

This bill lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of the credit by the Legislature.

## **LEGISLATIVE STAFF CONTACT**

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<sup>6</sup> As reported on the Legislative Counsel's website at <[http://www.leginfo.ca.gov/cgi-bin/postquery?bill\\_number=sb\\_1542&sess=CUR&house=B&author=negrete\\_mcleod](http://www.leginfo.ca.gov/cgi-bin/postquery?bill_number=sb_1542&sess=CUR&house=B&author=negrete_mcleod)> [as of May 3, 2012].