ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Committee on Revenue & Taxation	Analyst:	Janet Jennings	Bill Number:	AB 2754
Related Bills:	See Legislative History	Telephone:	845-3495	Amended Date:	June 16, 2014
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Require Certain Business Entities e-File/ Require Dependent Tax Identification Number on Returns/Allow Credit Allocated by GO-Biz to Reduce the Tentative Minimum Tax

SUMMARY

This bill would do the following:

Provision 1: Require certain business entities to e-file their tax return unless a waiver is granted.

Provision 2: Provide that no Dependent Exemption Credit would be allowed unless the dependent's Taxpayer Identification Number (TIN) is included on the respective return.

Provision 3: Allow the specified tax credit allocated by GO-Biz to reduce tax below the tentative minimum tax.

RECOMMENDATION

On December 4, 2013, the Franchise Tax Board voted 2-0 to sponsor the language included in Provisions 1 and Provision 2, with the representative from Department of Finance abstaining. No position has been taken on Provision 3, which was added after the Franchise Tax Board's vote.

Summary of Amendments

The June 16, 2014, amendments added Provision 3, which would add the GO-Biz California Competes Credit to those credits that can reduce tax below the tentative minimum tax. Provision 3 also provides double jointing[1] language that would prevent this bill and AB 1839 from chaptering out[2] section 23036 of the Revenue and Taxation Code that is amended in each bill.

This analysis replaces the department's prior analysis.

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[1] *Double* jointing refers to technical amendments necessary when two or more bills propose to amend the same code section (i.e., Revenue & Taxation Code Section 23036). Double jointing prevents the problem of chaptering out.

[2] Chaptering out means when, during a calendar year, two or more bills amending the same code section become law, and the bill enacted last (with a higher chapter number) becomes law and prevails over the code section in the previously enacted.

Board Position:			Executive Officer	Date
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*Provision 1 & 2 only				

PROVISION 1: REQUIRE CERTAIN BUSINESS ENTITIES TO E-FILE

REASON FOR PROVISION

The reason for provision 1 is to allow the department to process business entity returns more quickly, which would expedite approved refunds and utilize cost-effective technology to meet operational goals.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2015.

Provision 1 would be specifically operative for taxable years beginning on or after January 1, 2014, for returns filed on or after January 1, 2015. The penalty would apply to acceptable returns required to be filed electronically for taxable years beginning on or after January 1, 2017.

ANALYSIS

THIS PROVISION

This provision would, for taxable years beginning on or after January 1, 2014, for returns filed on or after January 1, 2015, require a business entity that files an acceptable return prepared using tax preparation software, to file the return by electronic technology in a form and manner prescribed by the Franchise Tax Board (FTB).

A business entity required to file a return electronically may annually request a waiver of the requirement from the FTB. The FTB may grant a waiver if it determines the business entity is unable to comply with the requirements due to, but not limited to, technology constraints, where compliance would result in an undue financial burden, or due to circumstances that constitute reasonable cause, and not willful neglect as applicable to the penalty imposed by the bill.

This provision would define the following phrases:

- “Acceptable return” means any original return or amended return that is required to be filed, pursuant to Article 2 (commencing with Section 18601), Section 18633, Section 18633.5, or Article 3 (commencing with Section 23771) of Chapter 4 of Part 11, other than the return for unrelated business taxable income as required by Section 23771.
- “Business entity” means a corporation, including an "S" corporation, an organization exempt from tax, pursuant to Chapter 4 (commencing with Section 23701) of Part 11, a partnership, or a limited liability company.
- “Tax preparation software” means any computer software program used to prepare an acceptable return or for use in tax compliance.
- “Electronic technology” includes, but is not limited to, the Internet, cloud computing, or an electronic information delivery system.
- "Technology constraints” means an inability of the tax preparation software used by a taxpayer to electronically file the acceptable return as required by this section as a result of the complex nature of the return or inadequacy of the software.

This provision would apply to an acceptable return that is required to be filed on or after January, 1, 2015.

Additionally, this provision would, for taxable years beginning on or after January 1, 2017, require the imposition of a $100 penalty for an initial failure and a penalty in the amount of $500 for each subsequent failure of a business entity to e-file a return, when required to do so under the requirements added by this bill, unless the failure is due to reasonable cause, and not willful neglect.

In the case of a group return filed on behalf of eligible electing taxpayer members of a combined reporting group, the penalty would apply to the combined reporting group and not to a taxpayer member of the combined reporting group.

The provision would require the FTB to conduct a robust education program advising business entities subject to the requirements of this bill of their e-filing requirement and liberally interpret and grant waivers of the penalty imposed under provisions added by the bill in order to minimize any unnecessary adverse impacts to business entities that experience difficulty complying with the new requirements.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would require the development of procedures and forms, changes to existing tax forms and instructions, and information systems, taxpayer education and outreach efforts, and staff training to respond to questions and requests regarding the e-filing requirement and waiver process.

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 law provides that a taxpayer required to e-file a federal corporate income tax return is required to file their *Florida* corporate income tax returns electronically via the IRS's MeF Fed/State Program using approved software.

Illinois and the IRS have developed the Illinois Business Income Tax MeF Program. *Illinois* requires any corporation, S corporation, and partnership that e-files its federal income tax to file its equivalent *Illinois* income tax return for the same taxable year electronically. *Illinois* does not require e-filing of amended returns.

A *Massachusetts* S corporation that has income from customers or clients of $100,000 or more is required to e-file a corporation tax return. A *Massachusetts* partnership with 25 or more partners must e-file, and a partnership with less than 25 partners that has income or loss of $50,000 or more is required to e-file.

Michigan has an enforced e-file requirement for Michigan Business Tax (MBT) and Corporation Income Tax (CIT). All eligible MBT and CIT returns prepared using tax preparation software or a computer-generated form are required to be e-filed. *Michigan* participates in the IRS MeF program: accepting both MBT and CIT Federal/State e-file returns.

Minnesota accepts e-filed corporate franchise, fiduciary, S corporation, and partnership returns through participating tax software providers. *Minnesota* will begin its transition to the Federal/State MeF program. An internet based e-filing platform allows a tax preparer to transmit both federal and *Minnesota* state returns through the IRS system.

New York requires a corporation and a partnership to e-file if they self-prepare tax documents without the assistance of a tax professional, utilize approved e-file tax software to prepare the return, or utilize a computer to prepare, document, or calculate an extension or estimated tax payment; and the corporation and partnership has broadband internet access.

FISCAL IMPACT

To the extent that this provision would increase the number of taxpayers filing electronic returns versus paper, it would generate cost savings in the earlier years of implementation. The department estimates a cost savings of approximately $935,000, for fiscal year 2014-15 attributable to a reduction in personnel and equipment needed to key the business entity returns that convert from paper to e-filing and assumes that in the first year of requiring a business to e-file, a 76 percent e-file rate would be achieved. The fiscal year 2014-15 savings would be offset by a onetime implementation cost of approximately $95,000, for a net savings of approximately $840,000.

In addition, assuming achievement of a 90 percent e-file rate, approximately $510,000 in aggregate cost savings is estimated for fiscal years two through four (2015-16 through 2017-18); and cost savings in fiscal year five (2018-19) of approximately $1.2 million, by reducing work performed by vendors as the work transitions back to the department and through the elimination of maintenance support contracts. The cost savings that would result from this bill would allow staff to work higher priority workloads.

ECONOMIC IMPACT

This provision would not accelerate revenue because:

- The timing or amount of estimated tax payments made by a business entity would remain unchanged.
- The department does not prioritize e-filed returns over paper returns.
- The fact that refunds would be expected to reach taxpayers faster if they choose to e-file is estimated as having an insignificant impact on revenue.

Although this provision would impose an initial penalty of $100, increasing to $500 thereafter on a business entity that fails to e-file when required to do so, the estimated revenue associated with this penalty would be negligible because the department anticipates business entities that would be required to e-file would comply with the requirement or obtain a waiver under the provisions of the proposal.

This has been the department's experience with current law's mandated e-file for certain tax preparers preparing individual tax returns. Although certain tax preparers have been subject to the penalty, the department has been able to work with the tax preparers to either comply with the law or obtain a waiver of the e-file requirement.

SUPPORT/OPPOSITION

Support: The Franchise Tax Board.

Opposition: None on file.

ARGUMENTS

Proponents: Some may say that requiring e-filing for certain business entities would improve taxpayer service and governmental efficiency.

Opponents: Some may say that it will be costly for certain software providers to implement e-filing because they may absorb the cost of developing e-filing for California purposes.

PROVISION 2: REQUIRE DEPENDENT TAX IDENTIFICATION NUMBER ON RETURNS

REASON FOR PROVISION

The reason for this provision is to allow the department to confirm that a dependent's TIN is used only once, which would increase the integrity of the returns, reduce inaccurate returns and the issuance of erroneous Dependent Exemption Credits.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2015. Provision 2 would be specifically operative for taxable years beginning on or after January 1, 2015.

FEDERAL LAW

Under federal law, no dependent exemption is allowed unless the TIN of the dependent is included on the federal return.[3]

A TIN is an identification number used by the Internal Revenue Service (IRS) in the administration of tax laws. The Social Security Administration issues a social security number whereas the IRS issues all other TINs. Examples of TINs are as follows:

- Social Security Number "SSN"
- Individual Taxpayer Identification Number "ITIN"
- Taxpayer Identification Number for Pending U.S. Adoptions "ATIN"

[3] Internal Revenue Code section 151 (e).

STATE LAW

Existing state law prohibits the disallowance of the Dependent Exemption Credit if the return lacks a TIN.[4]

Additionally, state law provides that a return information notice (RIN) that includes any amount of tax that is more than the amount reported on the tax return due to a mathematical error, e.g., an inaccuracy in computation, is not a deficiency assessment and the taxpayer lacks protest or appeal rights for the adjustment shown on that RIN. However, the department may choose to collect the amount inaccurately omitted via a Notice of Proposed Assessment (NPA).[5]

THIS PROVISION

This provision would, for taxable years beginning on or after January 1, 2015, provide that no Dependent Exemption Credit would be allowed unless the TIN of that individual is included on the return claiming the credit. Any disallowance of the Dependent Exemption Credit due to the omission of a TIN would be treated as a math error by the department. A taxpayer would have the right to subsequently provide the TIN and receive a credit or refund if provided prior to the expiration of the statute of limitations.

PROGRAM BACKGROUND

In order to claim the federal dependent exemption, a taxpayer is required to provide the name and relationship of the related individual. Conversely, for each dependent exemption reported, the IRS requires the name, relationship, and, since 1987, the TIN.

Requiring the TIN has allowed the federal government to verify the dependent TIN against the social security database during return processing, and deny the dependent exemption when an inaccurate TIN is provided, or the same TIN has been reported on another return. Federal law was amended to require dependent TINs on individual tax returns because Congress viewed the TIN requirement as an enforcement mechanism for ensuring the same dependent was not claimed on multiple returns. As a result of this new requirement, seven million fewer dependent exemptions were claimed on the 1987 federal tax returns than on the 1986 federal tax returns.

Recently, the department conducted a study that confirms that failing to require the dependent TIN on the California personal income tax return (return) results in substantial noncompliance. Specific examples are situations where the same dependent is claimed three or more times on different returns, and usually this turns out to be a wholly fictitious dependent. Another common situation is where a Dependent Exemption Credit is claimed by the primary or secondary filer. The most prevalent error is the same dependent claimed exactly twice, which may indicate two parents have improperly claimed the same child, such as separated parents, or a parent has claimed their child as a dependent and that child has filed a return and claimed himself or herself.

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[4] Revenue and Taxation Code section 17054 (d) (2).
[5] Revenue and Taxation Code section 19051.

Because state law lacks a requirement to include a dependent TIN on the return, the majority of disallowed Dependent Exemption Credits are identified when the department receives shared information from the IRS. On average, this information is received 18 months after the return's due date and includes information on the federal disallowance of dependent exemptions for failure to provide or validate the accuracy of the dependent's TIN. The remaining disallowed Dependent Exemption Credits are identified during the department's audits of the Head of Household filing status or the Child and Dependent Care Credit. Taxpayers are notified via an NPA when the Dependent Exemption Credit is proposed to be disallowed.

The department is currently implementing the Enterprise Data to Revenue (EDR) project that uses new technologies with the department's current systems with a projected goal to facilitate the validation and correction of data reported on returns through the return analysis process. This process will be performed upfront when returns are filed. If this proposal's requirement to include a dependent's TIN is enacted into law, inaccuracies identified on a taxpayer's return, such as a dependent's TIN that has been claimed on multiple returns or that do not exist, could be adjusted immediately. Requiring dependent TINs on the return would increase the department's accuracy and customer service as the adjustments could be completed at the time of return processing instead of many months later.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would require the development of procedures and forms, changes to existing tax forms and instructions, and information systems, taxpayer education and outreach efforts, and staff training to respond to questions and requests regarding the disallowed dependent credits.

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 only has a corporation income tax; therefore, a comparison with *Florida* law is irrelevant.

Generally*, Illinois* does not require a TIN to be reported on the return in order to claim a dependent exemption. However, a Nonresident Alien is required to attach the federal 1040 NR or the 1040 NR-EZ when filing the state return.

Massachusetts has a Dependent Information Schedule that requires the dependent's name, relationship, TIN, and date of birth.

Michigan does not require a TIN to be reported on the return or an attached federal return in order to claim a dependent exemption.

Minnesota has a Child and Dependent Care Credit Schedule, Minnesota Working Family Credit Schedule, and a K-12 Education Credit Schedule that requires, among other information, the dependent's name, TIN, and date of birth.

New York requires a dependent's name, relationship, TIN, and date of birth to be reported on the return in order to claim the dependent exemption.

FISCAL IMPACT

This provision would require the department to respond to and resolve taxpayer contacts when their Dependent Exemption Credit has been disallowed resulting in additional costs of approximately $512,000 for the first year, fiscal year 2014-15, and $504,000 for each subsequent year. Any costs attributable to system changes are expected to be absorbable.

ECONOMIC IMPACT

Estimated Revenue Impact of AB 2754 Provision 2 As Amended June 16, 2014. Enactment Assumed After June 30, 2014 ($ in Millions)		
2014-15	2015-16	2016-17
+ $10	+ $10	+ $11

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

SUPPORT/OPPOSITION

Support: The Franchise Tax Board.

Opposition: None on file.

ARGUMENTS

Proponents: Some may say that requiring taxpayers to provide TINs for dependents would reduce inaccurate Dependent Exemption Credit claims and increase compliance.

Opponents: Some may say that increasing the information on the return by requiring the TIN for each dependent credit could add to the complexity of the return and increase the perception of the return as a more cumbersome document.

<u>PROVISION 3: INCLUDE THE SPECIFIED TAX CREDIT ALLOCATED BY GO-BIZ AS A CREDIT ALLOWED TO REDUCE TAX BELOW THE TENTATIVE MINIMUM TAX.</u>

REASON FOR PROVISION

The reason for this provision is to allow taxpayers to fully utilize the GO-Biz credit by allowing the credit to reduce the corporate tentative minimum tax.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2015.

Provision 3 relating to the tax credit allocated by Go-Biz would be effective January 1, 2015, and specifically operative for taxable years beginning on or after or after January 1, 2014.

BACKGROUND

The so-called “regular tax” that individuals and corporations are generally subject to allows specified exclusions, deductions and credits to reduce that “regular-tax” tax liability. A federal alternative minimum tax (AMT) was enacted in 1969 in an attempt to ensure that individuals and corporations that benefit from exclusions, deductions and credits pay at least a minimum amount of tax. California subsequently enacted its own AMT.

The AMT is the excess of the tentative minimum tax over the regular tax. The tentative minimum tax is calculated separately from the regular tax. In general, tentative minimum taxable income is calculated by starting with taxable income for regular tax purposes, and eliminating or reducing certain exclusions, deductions and credits that are generally allowed in computing the regular tax. An exemption amount is subtracted from the tentative minimum taxable income, and the balance is multiplied by the tentative minimum tax rate to compute the tentative minimum tax. California generally conforms to the federal AMT rules, with modifications, such as the allowable exemption amount and the tentative minimum tax rate.

FEDERAL/STATE LAW

Federal Law

General business credits allowed for any tax year are limited to the excess of a taxpayer's “net income tax” over the greater of: (1) the tentative minimum tax for the tax year, or (2) 25 percent of the amount of the taxpayer's “net regular tax” that exceeds $25,000. In addition, the empowerment zone employment credit, the New York Liberty Zone business employee credit, “specified credits,” and eligible small business credits have various rules for limiting the usage of credits[6].

State Law

Under state law, the general rule is that tax credits imposed under the Personal Income Tax Law (PITL) or the Corporation Tax Law (CTL) may not reduce regular tax below tentative minimum tax, unless specifically provided otherwise.

THIS PROVISION

This provision would allow the GO-Biz credit to reduce the regular tax below tentative minimum tax under the PITL and CTL for taxable years beginning on or after January 1, 2014.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

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[6] IRC section 38(c).

LEGISLATIVE HISTORY

AB 1173 (Bocanegra, Chapter 536, Statutes of 2013) among other things, allowed the movie credit to reduce the regular tax below tentative minimum tax under the CTL for taxable years beginning on or after January 1, 2011.

AB 1413 (Assembly Revenue and Taxation Committee, 2013/2014) would allow the movie credit to reduce tentative minimum tax under the CTL for taxable years beginning on or January 1, 2011. AB 1413 is currently in the Senate Appropriations 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 and *Minnesota* impose corporate AMT, and *Illinois, Massachusetts, Michigan,* and *New York* does not.

FISCAL IMPACT

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

ECONOMIC IMPACT

Estimated Revenue Impact of AB 2754 Provision 3 As Amended June 16, 2014 Enactment Assumed After June 30, 2014		
2014-15	2015-16	2016-17
- $400,000	- $1,300,000	- $2,200,000

SUPPORT/OPPOSITION

Support: None on file.

Opposition: None on File.

ARGUMENTS

Proponents: Some would argue that allowing GO-Biz credits to reduce the tentative minimum tax enhances the effectiveness of the Go-Biz Credit.

Opponents: Some would argue that allowing Go-Biz credits to reduce the tentative minimum tax is contrary to the intent of the AMT and is an overly generous tax benefit.

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