Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Correa	Analyst:	Michelle Chan	Bill Number:	SB 693
Related Bills:	See Legislative History	Telephone:	845-6805	Amended Date:	January 6, 2014
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Parent or Guardian Education-Related Expenses Credit/Teacher Unreimbursed Classroom Supplies & Instructional Materials Expenses Credit/Parent or Guardian Exclusion for Education-Related Expenses

SUMMARY

This bill would, under the Personal Income Tax Law, create two income tax credits and an alternative exclusion from gross income for one of the credits for certain education-related expenses.

RECOMMENDATION

No position.

Summary of Amendments

The January 6, 2014, amendments added legislative intent language, added and modified several definitions, made various technical changes, modified the limit of the credit amount, and added a provision that would allow a qualified parent or guardian to elect an exclusion[1] from gross income for certain education-related expenses in lieu of the credit. In addition, the amendments resolved several, but not all, of the department's implementation and policy concerns discussed in the department's analysis of the bill as amended April 11, 2013. Additional concerns were identified. As a result of the amendments, this analysis replaces the department's prior analysis of the bill as amended April 11, 2013.

REASON FOR THE BILL

The reason for this bill is to ease the financial burden of providing a high-quality K-12 education on low and middle income parents and qualified teachers beginning their careers.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2014, and before January 1, 2019.

[1] See the Technical Considerations section for additional discussion.

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ANALYSIS

FEDERAL/STATE LAW

Existing federal and state 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.

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. These are items that the taxpayer has received as economic benefits, but have been specifically excluded by law.

Existing federal and state laws allow individuals to deduct certain expenses, such as medical expenses, charitable contributions, interest, and taxes, as itemized deductions. Certain other expenses for the production of income and certain employee business expenses are considered miscellaneous itemized deductions.[2] Also, itemized deductions may be further limited for high-income taxpayers.

Existing federal and state laws allow for the deduction of certain expenses when calculating adjusted gross income, such as moving expenses and interest on education loans, certain ordinary and necessary trade and business expenses, losses from the sale or exchange of certain property, contributions for pension, profit-sharing and annuity plans of self employed individuals, retirement savings, and alimony. Thus, all taxpayers with this type of expense receive the benefit of the deduction, regardless of whether the taxpayer itemizes deductions or uses the standard deduction. These are known as “above-the-line” deductions.

Current federal law allows eligible educators to deduct up to $250 of the cost to purchase books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom as an adjustment to gross income. This ‘above-the-line’ deduction applies to taxable years beginning on or after January 1, 2002, and before January 1, 2014. California does not conform to this deduction.

There are currently no federal or state credits or exclusions from gross income comparable to the credit and exclusion for parents or guardians for education related expenses that this bill would create.

[2] Only the portion that exceeds 2% of adjusted gross income may be deducted.

THIS BILL

This bill would create two personal income tax credits and an alternative exclusion from gross income for one of the credits as discussed below:

1. Parent or Guardian Education-Related Expenses Credit (Parent or Guardian Credit) and Parent or Guardian Exclusion for Education-Related Expenses (Parent or Guardian Exclusion)

This bill would, for taxable years beginning on or after January 1, 2014, and before January 1, 2019, create a tax credit for the qualified amount that was paid or incurred for qualified education-related expenses for one or more dependent children by a qualified parent or guardian during the taxable year, not to exceed $500 per household. Alternatively, this bill would provide an exclusion[3] from gross income for the qualified amount that was paid or incurred for qualified education-related expenses for one or more dependent children by a qualified parent or guardian during the taxable year, not to exceed $2,500.

For the purpose of determining this credit and the exclusion, the following definitions would apply:

- "Dependent children" means children who attend kindergarten or any of grades 1 to 12, inclusive, in California at a public, charter, or private school that has a current private school affidavit on file with the State Department of Education in the taxable year and who meet the requirements of Section 152(c)(1)(D), and (E) of the Internal Revenue Code (IRC).[4]
- "Household income" has the same meaning as "adjusted gross income," as defined in Section 17072 of the Revenue and Taxation Code.[5]
- "Qualified amount" means the amount paid for incurred for qualified education expenses.
- "Qualified education-related expenses" means the kindergarten or any of grades 1 to 12, inclusive, costs of: textbooks and school supplies, including, but not limited to, pens, paper, pencils, notebooks, calculators, and rulers; the rental or purchase of educational equipment required for classes during the regular school day; school uniforms that are not part of a cocurricular activity; computers, computer hardware, and educational computer software used to learn academic subjects; tuition for a private school with kindergarten or any of grades 1 to 12, inclusive, for college courses at public institutions or independent nonprofit colleges, or for summer school courses that satisfy high school graduation requirements; psychoeducational diagnostic evaluations to assess the cognitive and academic abilities of pupils; special education and related services for pupils who have an individualized education program; out-of-school enrichment programs, tutoring and summer programs that are academic in nature; and public transportation or third-party transportation expenses for traveling directly to and from school.

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[3] See the Technical Considerations section for additional discussion.
[4] The term qualifying child under this section means, an individual, who hasn't provided over one-half of his or her own support for the calendar year, and who must be younger than the claimant and be unmarried; qualifying child benefits restricted to child's parents.
[5] Adjusted gross income under this section is the federal adjusted gross income from all sources reduced or increased by all California income adjustments.

Expenses for items that are used in a trade or business would be specifically excluded from the definition of "qualified education-related expenses."

- "Qualified parent or guardian" means a parent or legal guardian of a full-time pupil who is under 21 years of age at the close of the school year who meets both of the following requirements:
    - Both the pupil and the parent or guardian resides in California when the qualified education-related expenses are paid or incurred.
    - The household income does not exceed 200 percent of the federal Income Eligibility Guidelines published by the Food and Nutrition Service of the United States Department of Agriculture for use in determining eligibility for reduced price meals.

The following rules would apply to determine eligibility and the total amount of credit available:

- If the qualified parent or guardian is a married individual, a credit would be allowed only if the qualified parent or guardian is a married individual and filing a joint return for the taxable year in which the credit is claimed.
- If the qualified parents or guardians file individual returns, the total combined credit amount allowed on both returns cannot not exceed $500.

Any unused credit may be carried over to reduce tax for the following five years, if necessary, until the credit is exhausted.

The Franchise Tax Board (FTB) would have the authority to prescribe rules, guidelines or procedures necessary or appropriate to carry out the purpose of the credit. These rules, guidelines, or procedures would be exempt from the normal rulemaking requirements of the Administrative Procedures Act.

This bill specifies that the credit would be in lieu of any exclusion from gross income allowed under another provision added by the bill that is described below.

Furthermore, this bill would disallow the credit for any expense incurred by a qualified teacher for instructional material and classroom supplies, as defined, whether or not the qualified teacher received a credit for those expenses.

This tax credit would be repealed by its own terms as of December 1, 2019, unless a later enacted statute, that is enacted before January 1, 2019, deletes or extends that date.

2. Qualified Teacher Unreimbursed Classroom Supplies and Instructional Materials Expenses Credit (Teacher Credit)

This bill would, for taxable years beginning on or after January 1, 2014, and before January 1, 2019, create a tax credit in an amount equal to the amount paid or incurred by a qualified teacher during the taxable year for instructional materials and classroom supplies, not to exceed $250 per qualified teacher or $500 for two qualified teachers who are married to each other and filing a joint return.

For the purpose of determining this credit, the following definitions would apply:

- "Instructional materials and classroom supplies" means any unreimbursed expenses, otherwise deductible as a trade or business expense, for books, supplies, computer equipment, including related software and services and other equipment, and supplementary materials used in the classroom, including, but not limited to, supplies for courses in health and physical education.
- "Qualified teacher" means a teacher who meets all of the following requirements:
    A. The individual has worked at least 900 hours in the school year as a teacher, in a school offering instruction in kindergarten or any of grades 1 to 12, inclusive, in California at a public, charter, or private school that has a current private school affidavit on file with the State Department of Education in the taxable year.
    B. The teacher is primarily engaged in the duty of imparting knowledge to pupils by teaching, instructing, or lecturing.
    C. The teacher customarily and regularly exercises discretion and independent judgment in performing the duties of a teacher.
    D. The teacher is not employed as a tutor, teaching assistant, instructional aide, student teacher, day care provider, vocational instructor, or similar position.

The credit would be available for qualified teachers based upon the years of employment as a qualified teacher. The credit allowed would be available as follows:

Taxable Years	Years of Employment
January 1, 2014 – January 1, 2015	No more than one year
January 1, 2015 – January 1, 2016	No more than two consecutive years
January 1, 2016 – January 1, 2019	No more than three consecutive years

Any unused credit may be carried over to reduce tax for the following five years if necessary, until the credit is exhausted.

The FTB would be authorized to prescribe rules, guidelines or procedures necessary or appropriate to carry out the purpose of the credit. These rules, guidelines, or procedures would be exempt from the normal rulemaking requirements of the Administrative Procedures Act.

This bill specifies that no other credit for dependent care expenses[6] would be allowed for the same expenses for which the credit was allowed.

This tax credit would be repealed by its own terms as of December 1, 2019, unless a later enacted statute, that is enacted before January 1, 2019, deletes or extends that date.

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.

[6] Revenue and Taxation Code section 17052.6.

It is unclear how the department would verify whether a teacher meets the requirements of this bill and would therefore eligible for the credit. The author may wish to consider requiring the proper local agency to certify that the teacher met the requirements of this bill and requiring the taxpayer to obtain, retain and provide to the FTB, upon request, evidence of that certification.

This bill provides that if the qualified parents or guardians file individual returns, under the Parent and Guardian Credit, the total combined credit amount allowed on both returns cannot exceed $500 and under the Parent or Guardian Exclusion the total combined exclusion amount allowed on both returns cannot exceed $2,500. It is unlikely that the parents or guardians would be aware of the others qualified expenses, and at the time returns are being processed, the department would be unable to determine if the taxpayers have exceeded the total combined limit of the credit or exclusion amount. To avoid conflicts between taxpayers and the department, the bill should be amended.

This bill uses terms that are undefined, i.e., “parent or legal guardian” and “full-time pupil.” The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of the credit allowed to parents and guardians for education-related expenses.

This bill would allow a credit for qualified teachers based upon the years of employment as a qualified teacher. However, this bill fails to specify as to when or how recently that employment as a qualified teacher must have occurred. To avoid conflicts between taxpayers and the department, the bill should be amended.

TECHNICAL CONSIDERATIONS

This bill would provide an exclusion from gross income for qualified education-related expenses. The bill calls the amount an exclusion. Exclusions are items that would otherwise be included in gross income, except they have been specifically excluded from gross income by law. Education-related expenses can't be an exclusion because an exclusion must first be an item of income. SB 693 is trying to create a deduction from gross income or perhaps allowing the taxpayer to exclude from their other income an amount equal to their education-related expenses. This is really a deduction, rather than an exclusion. The author may wish to amend the bill to resolve this technical consideration.

This bill would allow a credit or an exclusion for a qualified parent or guardian who has a household income that does not exceed 200 percent of the federal Income Eligibility Guidelines published by the Food and Nutrition Service of the United States Department of Agriculture. This income limitation would apply equally to the credit or exclusion. Tax credits are used to reduce the taxpayer’s tax liability dollar-for-dollar. One benefit of allowing tax credits rather than deductions or an exclusion is that tax credits are claimed after taxable income has been calculated and, therefore, do not create differences between the taxable income amounts shown on the federal and state income tax returns. It is possible that a qualified parent or guardian will always claim the credit over an exclusion, which is more beneficial to the taxpayer. If the author intends to prevent this result, the author may wish to amend this bill.

LEGISLATIVE HISTORY

SB 413 (Knight, 2013/2014) would have created a personal income tax credit for qualifying science, technology, engineering, or mathematics (STEM) teachers. SB 413 failed passage out of the Senate Governance and Finance Committee.

AB 1071 (Fuentes, 2011/2012) would have created an income tax credit for the purchase of qualified school supplies by a credentialed teacher. AB 1071 failed passage out of the Assembly Revenue and Taxation Committee.

AB 2088 (Bonilla, 2011/2012) would have created a personal income tax credit for qualifying science, technology, engineering, or mathematics (STEM) teachers. AB 2088 failed passage out of the Assembly Revenue and Taxation Committee.

SB 87 (Senate Budget Committee, Chapter 180, Statutes of 2007) repealed the provision authorizing the Teacher Retention Credit that was allowed to credentialed teachers in specified amounts depending on the number of service years as a credentialed teacher in a qualifying educational institution.

SB 1438 (Railey, 1999/2000) would have established a credit of 100 percent of the costs, to a maximum of $200, for qualified educational expenses paid or incurred by a parent or teacher. SB 1438 failed to pass out of the Senate Revenue and Taxation Committee by the constitutional deadline.

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.

Illinois allows a credit in an amount equal to 25 percent of qualified education-related expenses paid or incurred by a parent or legal guardian on behalf of qualifying pupils. The maximum amount of the credit is $500.

Minnesota allows a credit in an amount equal to 75 percent of education-related expenses and a subtraction from taxable income for certain education-related expenses for a qualifying child in kindergarten through grade 12 (K-12). The maximum credit that can be claimed is based on the taxpayer's household income and the number of qualifying children the taxpayer has in grades K-12. The maximum subtraction that can be claimed is $1,625 per child for a dependent in grades K through 6 and $2,500 for a dependent in grades 7 through 12.

New York allows a full-year resident taxpayer to choose between a refundable credit or an itemized deduction for qualified college tuition expenses, and all other taxpayers (i.e., nonresidents and part-year residents) may be entitled to an itemized deduction for these expenses.

Massachusetts and *Michigan* do not offer tax credits or an exclusion for education-related expenses.

Florida only has a corporation income tax therefore this personal income tax credit or exclusion is not applicable.

FISCAL IMPACT

Department staff is unable to determine the costs to administer this bill until the implementation concerns have been resolved. As the bill continues to move through the legislative process and the implementation concerns are resolved, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of SB 693 As Amended January 6, 2014 For Taxable Years Beginning On or After January 1, 2014 Assumed Enactment After June 30, 2014 ($ in Millions)		
2014-15	2015-16	2016-17
-$210	-$270	-$310

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

LEGAL IMPACT

The Parent and Guardian credit and exclusion would require both the pupil and the parent or guardian to reside in California at the time the qualifying expenses were paid or incurred. In addition, this credit defines “dependent children” as children who attend kindergarten or any grades 1 to 12 in California and defines “qualified teacher” as an individual who has worked at least 900 hours in the school year as a teacher, in a school offering instruction in kindergarten or any of grades 1 to 12, inclusive, in California. This could raise constitutional concerns under the Commerce Clause of the United States Constitution because it could appear to improperly favor in-state activity over out-of-state activity. On August 28, 2012, (*Cutler* v. Franchise Tax Board), the Court of Appeal issued a unanimous opinion holding that California’s Qualified Small Business Stock statutes were unconstitutional. Specifically, the Court of Appeal held that the statutory scheme's requirement of a large California presence in order to qualify for an investment incentive discriminated against interstate commerce, and therefore violated the federal dormant commerce clause. While no court decision has yet invalidated, as a general matter, state income tax credits that provide an incentive for in-state activity, i.e., property placed in service in the state, employees employed in the state, or employers located in the state, etc., targeted tax credits such as the ones proposed by this bill may be subject to constitutional challenge.

SUPPORT/OPPOSITION

Support: California Catholic Conference, California Association of Private School Organizations, California State Firefighters Association, Concerned Women for America of California, Orange Chamber of Commerce.

Opposition: California Teachers Association

ARGUMENTS

Proponents: Supporters could argue that this bill would provide some needed financial assistance to teachers and parents who reach into their own pockets to fund vital education resources and services.

Opponents: Some could argue that while providing tax credits for teachers and parents to assist with expenses associated with educating the state's children, this bill would result in revenue losses, which have to be paid for with higher taxes on others or reductions in services.

POLICY CONCERNS

This bill would allow a credit under the Teacher Credit for specified classroom purchases that may currently be deductible as employee business expenses. Generally, a credit is allowed in lieu of a deduction in order to eliminate multiple tax benefits for the same item of expense.

The bill lacks a recapture period. A teacher could spend $250 on school supplies and claim a $250 credit, then in a later year return the $250 in supplies, and still claim the entire credit. The author may wish to add language to require that those supplies be provided to, or used by, the pupils or used by teacher in the classroom.

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

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