SCS Agency
Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Granlund	Analyst: Jeani Brent	Bill Number: ACA 29
Related Bills: ACA 2, ACA 25, ACA 26, SCA 16 (1997-1998)	Telephone: 845-3410	Introduced Date: 01/07/98
	Attorney: Doug Bramhall	Sponsor:

SUBJECT: Personal Income Tax, Penalties, or Interest Cannot Be Imposed From July1 Until The State Budget Is Enacted

SUMMARY

This constitutional amendment would provide that, if the State Budget is not enacted timely, personal income taxes on earned income may not be imposed between July 1 and the date the State Budget is enacted. Those taxes would not be retroactively assessed or collected for that period. For the period between July 1 and the date the State Budget is enacted, any fine, penalty, or interest in connection with nonpayment of personal income taxes or vehicle registration fees would not be due and owing. Further, this bill provides an extension for certain payments for the same number of days that lapsed between July 1 and the date the budget is enacted.

This constitutional amendment would provide a similar requirement for sales tax and would provide that the State Controller would be authorized to draw funds from the State Treasury to meet outstanding obligations and to continue services. These provisions are not discussed in this analysis as they would not impact the department.

EFFECTIVE DATE

This constitutional amendment must be voted on at the next election following its approval by the Legislature (which could be June 2, 1998, or November 3, 1998). If approved by the voters, this constitutional amendment would take effect on the day after the election.

SPECIFIC FINDINGS

The California Constitution provides that taxes on or measured by income may be imposed on persons, corporations, or other entities prescribed by law.

Existing state law imposes tax on the income earned by individuals, estates, and trusts. 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 is computed on a graduated scale, at rates ranging from 1%

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE ____ GOVERNOR'S APPOINTMENT

Board Position:	Agency Secretary Position:	GOVERNOR'S OFFICE USE
____ S ____ O	____ S ____ O	Position Approved ____
____ SA ____ OUA	____ SA ____ OUA	Position Disapproved ____
____ N ____ NP	____ N ____ NP	Position Noted ____
____ NA ____ NAR	____ NA ____ NAR	
____X____ PENDING	DEFER TO ____________	
Department Director	Agency Secretary Date	By: Date:
Gerald H. Goldberg 2/23/98		

to 9.3%. Corporations, certain partnerships, and other similar entities pay a tax for the privilege of doing business in California. The corporation franchise tax is not imposed on, but is measured by, income.

In computing taxable income, a taxpayer (noncorporate) first computes gross income, which includes all income including compensation, business income, net gains from the sale of property, dividends, rents, interest, and similar items. The taxpayer then subtracts certain allowable deductions to derive adjusted gross income. These deductions include expenses incurred during the taxable year such as those incurred directly in carrying on a trade or business, contributions to an individual retirement plan, moving expenses, contributions to a medical savings account, and like items. A noncorporate taxpayer may deduct capital losses only to the extent of capital gains plus the lower of $3,000 or the excess of the losses over the gains. Next, an individual taxpayer computes taxable income by deducting itemized deductions from adjusted gross income including medical expenses, property taxes, mortgage interest, charitable contributions, and certain miscellaneous expenses, including tax preparation fees, union dues, and similar items incurred during the taxable year. Taxpayers who do not itemize deductions reduce adjusted gross income by the standard deduction. Once the tax is determined by applying the appropriate marginal tax brackets to the taxable income, taxpayers may reduce that tax amount by using various credits including credits for personal and dependent exemptions, child care expenses, adoption costs, and enterprise zone employee wages.

Under existing state law, employers must withhold income tax from all wages paid to California residents and from wages of nonresidents for services performed in California. “Wages” are earned income and include all types of employee compensation including salaries, fees, bonuses, commissions, and fringe benefits. Self-employed individuals and certain partners (i.e., members of partnerships or limited liability companies) also derive earned income from business operations, measured as a portion of the year-end earnings.

Tax returns for individuals must be filed on or before the 15th day of April following the close of the calendar year, or October 15th on extension. The balance of tax shown on the tax return after deducting the amount of income tax withheld during the year and estimated tax payments is required to be paid in full by April 15th.

Existing state law provides for the imposition of an alternative minimum tax (AMT). The AMT is a separately computed tax that is paid only to the extent it exceeds the regular tax. AMT is imposed at 7% for personal income taxpayers. The AMT was established to ensure that no taxpayers with substantial economic income avoid all tax liability by using exclusions, deductions, and credits (tax preference items).

Under existing state law, interest is charged upon underpayments or other delinquent payments of tax. Interest is assessed on the unpaid tax from the date the tax is assessed (whether assessed by the department or the taxpayer) until it is paid, unless the tax is paid within 15 days after notice and demand.

Under existing state law, various penalties are imposed on taxpayers who violate the tax law. Penalties may be assessed for numerous violations, including failure to file a return on time, failure to pay tax by due date, substantial understatement of income tax, filing a fraudulent or frivolous return, and failure to pay estimated tax. Interest is charged on penalties from the date of notice and demand if not paid within 15 days after notice and demand.

Under existing state law, the department is charged with the responsibility of collecting delinquent vehicle license fees, related penalties, and parking tickets. The department has the authority to collect these delinquencies as though they were personal income tax delinquencies, using the department's administrative collection remedies. The department has the authority to delegate collection activities to the Department of Motor Vehicles (DMV). Under this delegated authority, the DMV currently uses its automated system to send a series of notices of delinquency to registered owners. The notices seek voluntary compliance before the account is forwarded to the department for collection. DMV also uses its existing system to distribute the department's collections to the appropriate funds or accounts.

Assembly Constitutional Amendment 29 would provide that, if the State Budget is not enacted timely, personal income taxes on earned income may not be imposed between July 1 and the date the State Budget is enacted. Those taxes would not be retroactively assessed or collected for that period.

In addition, **this amendment** would provide that, for the period between July 1 and the date the State Budget is enacted, any fine, penalty, or interest in connection with nonpayment of personal income taxes (whether on earned or non-earned income) or vehicle registration fees would not be due and owing.

Further, **this amendment** provides an extension for certain payments for the same number of days that lapsed between July 1 and the date the budget is enacted.

Policy Considerations

This amendment may motivate some taxpayers to reclassify non-earned income to earned income during nontaxed periods. For instance, an individual could reclassify interest income as income from a trade or business.

Implementation Considerations

The department has identified the following implementation considerations that would be raised by this constitutional amendment. The department will continue to assess the impact of this amendment as it moves through the legislative process:

1. This amendment states that the personal income tax may not be imposed during the specified nontaxed period. Taxes generally are imposed on the entire taxable income of the taxpayer, as computed at the end of the tax year, but this bill uses the term "imposed" in a context relating to a portion of a tax year, possibly a few days. It would appear that the prohibition is intended to refer to the imposition of income taxes for earned income attributable to the nontaxed period. However, the prohibition also could refer to the imposition of income tax on any earned income during the specified period.

Self-employed individuals who work on extended contracts for which they may be paid only at certain stages of the job may have a difficult task in determining how much income to apply as earned income to the nontaxed period. The result may be that taxpayers and the department may arrive at differing income amounts for the nontaxed period.

2. It is unclear whether this amendment would preclude the department from issuing assessments during the nontaxed period for amounts of tax determined to be underpaid during review and audit of tax returns filed for prior years.

3. This amendment does not alter the requirements for employers to withhold personal income taxes from wages during the periods in which personal income tax would not be imposed.

4. This amendment leaves unclear how taxpayers should treat items of expense incurred during the nontaxed periods for which the taxpayer otherwise would receive a deduction from income or a tax credit. For instance, it is unclear whether trade or business expenses incurred by a sole-proprietor during a nontaxed period would continue to qualify for a business expense deduction or would be considered related to nontaxed income.

5. The amendment refers to earned income as defined by statute. The Personal Income Tax Law does not contain a definition for "earned income." Consequently, enabling statutes would be required. Also, separating earned income from other types of income could significantly complicate the tax return and create a burden for taxpayers.

6. The phrase "due and owing" as it relates to fines, penalties, and interest is not defined. The lack of definition would raise the following concerns:

   A. It is unclear whether the provision would apply to amounts due as a result of statutory mandate or resulting from assessment by the department, or both.

   B. If a taxpayer has personal income taxes or vehicle registration fees delinquent before July 1 and has been assessed penalties and interest, it is unclear whether the department could impose and collect additional penalties and interest during the specified period.

7. Currently, the department's automated system that computes interest has the capability of computing interest from the due date to the date billed or paid. Until a new automated system could be developed, the department may need to compute interest manually for periods covered by the bill.

8. The amendment states that the personal income taxes <u>may</u> not be imposed for the specified period and states that fines, penalties, and interest <u>shall</u> not be due and owing during the nontaxed period. It is unclear whether the distinction between the use of "may" and "shall" is intended to provide a different level of authority between the two provisions.

9. This amendment states that the "date that <u>those payments</u> are due and owing shall be extended . . . " It is unclear whether the extension would apply to the payment of the fines, penalties, or interest or to the payment of personal income taxes or vehicle registration fees.

FISCAL IMPACT

Departmental Costs

The department's costs to administer this constitutional amendment cannot be determined until implementation concerns have been resolved.

Tax Revenue Estimate

Revenue losses <u>per</u> <u>day</u> are estimated to be $49 million from excluding personal income tax on earned income and $2 million <u>per</u> <u>day</u> for not accruing penalties and interest for the time the budget is not enacted.

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

Tax Revenue Discussion

The above estimate for not imposing a tax on earned income, for the period of time the budget is not enacted, was based on the department’s personal income tax model. The earned income exclusion would be taken for adjusted gross income rather than taxable income purposes. This estimate uses definition of earned income provided in the Internal Revenue Code Section 32(c)(2)(A), but limited to earned income included in gross income.

The estimate for not accruing penalty and/or interest in connection with nonpayment of personal income taxes was based on departmental data on accrued penalties and interest as of July 1997.

Because of the lack of definitions discussed above in Implementation Considerations, the department is not able to determine to what extent this constitutional amendment would affect the collections by the department of delinquent vehicle registration fees, or penalties or interest on those fees.

BOARD POSITION

Pending.