

# LEGISLATIVE PROPOSAL D

## EXECUTIVE SUMMARY

### **Title**

Modify Dependent Exemption Credit to Allow Alternate Identifying Information when Dependent Ineligible for Federal Individual Taxpayer Identification Number (ITIN)

### **Problem/Recommended Solution**

Due to recent federal changes, taxpayers who are unable to obtain federal ITINs for their nonresident alien dependents (dependents who are ineligible for a social security number (SSN)) will fail to meet the identification requirement for claiming the California dependent exemption credit. This will result in the denial of the dependent exemption credit for these otherwise qualifying dependents.

This proposal would amend California Revenue and Taxation Code (R&TC) section 17054(d)(2)(A) to allow a taxpayer with a nonresident alien dependent that is ineligible to receive a federal ITIN the option of providing other identifying information, as prescribed by the Franchise Tax Board (FTB), for purposes of the dependent exemption credit. This proposal preserves the identification requirement while providing relief to the affected taxpayers.

### **Fiscal Impact**

Staff estimates that the costs to implement this proposal would be insignificant and absorbable based on information available to estimate the universe of impacted dependents. While unlikely, should the actual universe of impacted dependents significantly differ from the estimated universe, the actual cost may require the department to pursue a budget change proposal.

### **Economic Impact**

This proposal would allow the option of providing relevant documentation for an affected taxpayer claiming the dependent exemption credit, when a nonresident alien dependent is not eligible to receive a federal ITIN. This proposal would not change the computation of income tax or the taxpayer's total tax liability due under current law.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

## **Title**

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## **Problem/Recommended Solution**

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This proposal would amend California R&TC section 17054(d)(2)(A) to allow a taxpayer with a nonresident alien dependent that is ineligible to receive a federal ITIN the option of providing other identifying information, as prescribed by the FTB, for purposes of the dependent exemption credit. This proposal preserves the identification requirement while providing relief to the affected taxpayers.

## **Program History/Background**

California law provides various exemption credits, including a personal exemption credit and exemption credits for dependents. Starting in tax year 2015, the dependent's taxpayer identification number, either an SSN or federal ITIN, must be provided on the California tax return or the dependent exemption credit will be disallowed. The FTB sponsored this legislation to assure that a dependent exemption credit is claimed only once for each identification number.<sup>1</sup>

The FTB recently learned that the Internal Revenue Service (IRS) has ceased granting or renewing federal ITINs for certain nonresident alien dependents.<sup>2</sup> Effectively denying a taxpayer's California dependent exemption credit for an otherwise qualifying nonresident alien dependent.

Taxpayers claiming the California dependent exemption credit are adversely impacted by the IRS's decision because current state law strictly requires a tax return to include either an SSN or ITIN for each dependent for the credit to be allowed.

## **Current Federal Law**

### *Dependent Exemption Deduction*

Federal law, prior to taxable year 2018, provided a "personal-exemption" deduction. An exemption deduction is a reduction to adjusted gross income (AGI) to arrive at taxable income.

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<sup>1</sup> AB 2754 (Chapter 478, Statutes of 2014). R&TC section 17054(d)(2).

<sup>2</sup> See IRS News Release, IR-2019-168, Oct. 10, 2019. <https://www.irs.gov/newsroom/2-million-itins-set-to-expire-in-2019-to-avoid-refund-delays-apply-soon>. This applies to dependents who are residents of Canada or Mexico.

Taxpayers were generally allowed one personal exemption for themselves, and a personal exemption for each claimed dependent. For taxable years beginning on or after January 1, 2018, and before January 1, 2026, federal law suspended the personal exemptions by setting the deduction amount at zero dollars (\$0).<sup>3</sup>

Federal law provides that a “dependent” includes a qualifying child or qualifying relative, including an individual who is not a citizen or national of the U.S. if that individual is a resident of the U.S., Mexico, or Canada.<sup>4</sup> The dependent’s identification number, either an SSN or federal ITIN, must be included on the return for the exemption to be allowed.

### *Federal ITINs*

The IRS issues federal ITINs for tax administration purposes to certain nonresident and resident aliens, their spouses, and dependents who are ineligible for an SSN. To obtain a federal ITIN, an individual must file IRS Form W-7, *Application for ITIN* and provide specified documentation. The IRS recently ceased granting or renewing ITINs for nonresident alien dependents who, as a result of the personal exemption deduction amount being set to zero, no longer have a federal purpose for the ITIN.<sup>5</sup>

### **Current State Law**

State law allows a dependent exemption credit, rather than a deduction, for each dependent as defined under federal law.<sup>6</sup> For taxable years beginning on or after January 1, 2015, a dependent exemption credit is only allowed if the dependent’s identification number, either an SSN or federal ITIN,<sup>7</sup> as defined under federal law, is included on the return.

### **Effective/Operative Date of Solution**

If this proposal were enacted as a tax levy during the 2020 legislative session, it would be effective upon enactment and retroactively operative for taxable years beginning on or after January 1, 2018.

### **Justification**

This proposal would allow the department to provide affected taxpayers additional options to meet the identification number requirement for claiming the California dependent exemption credit. Absent a legislative change, the department would be required to deny the dependent exemption credit for otherwise qualified dependents that will be unable to obtain a federal ITIN as a result of the recent change by the IRS.

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<sup>3</sup> On December 22, 2017, H.R. 1, Public Law (PL) 115-97, known as the Tax Cuts and Jobs Act of 2017 was signed. Under PL 115-97, the personal exemption deduction for 2018 through 2025 is set at zero dollars (\$ 0), and then resumes for taxable years beginning on or after January 1, 2026. (IRC section 151(d)(5)).

<sup>4</sup> IRC section 152.

<sup>5</sup> See IRS instructions for form W-7. <https://www.irs.gov/instructions/iw7>

<sup>6</sup> R&TC section 17054(d). IRC section 152.

<sup>7</sup> Identification number as defined under IRC section 6109.

## **Implementation**

Implementation of this proposal would require changes to existing forms and instructions and information systems and reviewing and approving relevant documentation provided by affected taxpayers.

This proposal would require education and outreach regarding the availability of a California alternative to the current identification number requirement.

## **Fiscal Impact**

Staff estimates that the costs to implement this proposal would be insignificant and absorbable based on information available to estimate the universe of impacted dependents. While unlikely, should the actual universe of impacted dependents significantly differ from the estimated universe, the actual cost may require the department to pursue a budget change proposal.

## **Economic Impact**

This proposal would allow the option of providing relevant documentation for an affected taxpayer claiming the dependent exemption credit, when a nonresident alien dependent is not eligible to receive a federal ITIN. This proposal would not change the computation of income tax or the taxpayer's total tax liability due under current law.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

## **Policy Considerations**

This proposal would promote equitable treatment amongst similarly-situated taxpayers fostering an equitable tax system.

## **Other States**

The states surveyed include 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, Massachusetts, Michigan, Minnesota, and New York tax laws allow a dependent exemption deduction rather than an exemption credit. All of the states surveyed lack a provision comparable to this proposal.

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## Franchise Tax Board's Proposed Amendments for LP D

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### **Subject: Dependent Exemption Modified to Allow FTB to Receive Identifying Information when Dependent Ineligible for Federal ITIN**

#### **Amendment 1**

Section 17054 of the Revenue and Taxation Code is amended to read:

In the case of individuals, the following credits for personal exemption may be deducted from the tax imposed under Section 17041 or 17048, less any increases imposed under paragraph (1) of subdivision (d) or paragraph (1) of subdivision (e), or both, of Section 17560.

In the case of a single individual, a head of household, or a spouse making a separate return, a credit of fifty-two dollars (\$52).

In the case of a surviving spouse (as defined in Section 17046), or spouses making a joint return, a credit of one hundred four dollars (\$104). If one spouse was a resident for the entire taxable year and the other spouse was a nonresident for all or any portion of the taxable year, the personal exemption shall be divided equally.

In addition to any other credit provided in this section, in the case of an individual who is 65 years of age or over by the end of the taxable year, a credit of fifty-two dollars (\$52).

(1) A credit of two hundred twenty-seven dollars (\$227) for each dependent (as defined in Section 17056) for whom an exemption is allowable under Section 151(c) of the Internal Revenue Code, relating to additional exemption for dependents. The credit allowed under this subdivision for taxable years beginning on or after January 1, 1999, shall not be adjusted pursuant to subdivision (i) for any taxable year beginning before January 1, 2000.

(2) (A) (i) For taxable years beginning on or after January 1, 2015, and before January 1, 2018, a credit shall not be allowed under paragraph (1) with respect to any individual unless the identification number, as defined in Section 6109 of the Internal Revenue Code, relating to identifying numbers, of that individual is included on the return claiming the credit.

(ii) For taxable years beginning on or after January 1, 2018, a credit shall not be allowed under paragraph (1) with respect to any individual unless either of the following occurs:

The identification number, as defined in Section 6109 of the Internal Revenue Code, relating to identifying numbers, of that individual is included on the return claiming the credit.

In the event an individual, who is included on the return claiming the credit, is ineligible for an identification number required in subclause (I), the taxpayer shall provide information to identify the individual in the form and manner as prescribed by the Franchise Tax Board.

(B) A disallowance of a credit due to the omission of a correct identification number required under this paragraph, may be assessed by the Franchise Tax Board in the same manner as is provided by Section 19051 in the case of a mathematical error appearing on the return. A claimant shall have the right to claim a credit or refund of adjusted amounts within the period provided in Section 19306, 19307, 19308, or 19311, whichever period expires later.

(3) (A) For taxable years beginning on or after January 1, 2009, the credit allowed under paragraph (1) for each dependent shall be equal to the credit allowed under subdivision (a). This subparagraph shall cease to be operative for taxable years beginning on or after January 1, 2011, unless the Director of Finance makes the notification pursuant to Section 99040 of the Government Code, in which case this subparagraph shall cease to be operative for taxable years beginning on or after January 1, 2013.

(B) For taxable years that subparagraph (A) ceases to be operative, the credit allowed under paragraph (1) for each dependent shall be equal to the amount that would be allowed if subparagraph (A) had never been operative.

A credit for personal exemption of fifty-two dollars (\$52) for the taxpayer if he or she is blind at the end of his or her taxable year.

A credit for personal exemption of fifty-two dollars (\$52) for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse is blind and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.

For the purposes of this section, an individual is blind only if either (1) his or her central visual acuity does not exceed 20/200 in the better eye with correcting lenses, or (2) his or her visual acuity is greater than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.

In the case of an individual with respect to whom a credit under this section is allowable to another taxpayer for a taxable year beginning in the calendar year in which the individual's taxable year begins, the credit amount applicable to that individual for that individual's taxable year is zero.

For each taxable year beginning on or after January 1, 1989, the Franchise Tax Board shall compute the credits prescribed in this section. That computation shall be made as follows:

The Department of Industrial Relations shall transmit annually to the Franchise Tax Board the percentage change in the California Consumer Price Index for all items from June of the prior calendar year to June of the current calendar year, no later than August 1 of the current calendar year.

The Franchise Tax Board shall add 100 percent to the percentage change figure which is furnished to them pursuant to paragraph (1), and divide the result by 100.

The Franchise Tax Board shall multiply the immediately preceding taxable year credits by the inflation adjustment factor determined in paragraph (2), and round off the resulting products to the nearest one dollar (\$1).

In computing the credits pursuant to this subdivision, the credit provided in subdivision (b) shall be twice the credit provided in subdivision (a).