Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

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Related Bills: | Telephone: 845-3036 | Introduced Date: 2/25/99

Attorney: Doug Bramhall | Sponsor: Franchise Tax Board

SUBJECT: Include Effect of Exemption Credits in Filing Requirement Income Threshold Amounts

SUMMARY

Under the Personal Income Tax Law (PITL), this bill, sponsored by the Franchise Tax Board, would incorporate the recent increases in the dependent exemption credit to raise the income threshold below which taxpayers are not required to file an income tax return.

EFFECTIVE DATE

This bill would apply to 1999 calendar year tax returns filed during the year 2000.

BACKGROUND

Persons having a gross income or an adjusted gross income (AGI) under certain statutory filing thresholds are not required to file either a federal or state tax return. However, many people file tax returns every year unnecessarily. Reasons for unnecessary filings include habit and misunderstanding of filing requirements. According to the Internal Revenue Service (IRS), unnecessary filer groups include: taxpayers with no withholding or tax payment liability, elderly taxpayers who file to receive a refund of pension withholding, and taxpayers who file only to claim a refund of withholding from wages. Returns filed unnecessarily cost time and money for both taxpayers and tax agencies.

Under its Reduce Unnecessary Filings (RUF) program, the IRS analyzes returns to find people who needlessly file returns and sends letters explaining that they are not required to file unless they meet certain income criteria. In 1994, the RUF program resulted in 750,000 contacts with taxpayers, informing them that they do not need to file a return. According to IRS data, nearly 200,000 of the 750,000 recipients of the RUF letters were California residents.

According to estimates by Franchise Tax Board (FTB) staff, of the 12.7 million PITL returns filed, 3.9 million filers (31.5%) reported zero tax liability. This figure has been constant for the past three years despite the fact that gross income triggers for required filing increased from $6,000 to $10,000 from 1994 to 1996. Of the 2 million filers with zero tax liability and no state income filing requirements, 1.3 million also were below federal filing requirements. Thus, many taxpayers continue to file returns without any requirement that they do so.

Board Position:

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Department Director: **Gerald Goldberg** | Date: **4/5/1999**

SPECIFIC FINDINGS

Under **existing federal and state law,** individuals with gross and adjusted gross income below the applicable filing thresholds are not required to file an income tax return since the standard deduction and personal exemption deduction or credit would eliminate any tax liability.

The **federal standard deduction** for 1998 varied from $3,550 to $7,100, depending on filing status and additional deductions allowed. Personal exemption deductions, allowed for individuals and dependents, were $2,650 for each exemption, subject to phase-out as described below. An additional standard deduction is available to senior or blind individuals, as well as an additional $800 for each married individual or surviving spouse and $1,000 for each head of household or single individual. These amounts are all indexed annually for inflation.

To qualify for additional deductions allowed to the blind or seniors, taxpayers either must be at least 65 years old before the close of the taxable year or meet certain levels of impairment for visual acuity. The chart below shows the filing status and gross income thresholds for the 1998 taxable year.

Federal filing requirements for most people

Filing Status	Age at end of 1998	Must file if Gross Income was at least…
Single	Under 65 65 or older	$6,950 $8,000
Married Filing jointly	Under 65 (both Spouses) 65 or older (one spouse) 65 or older (both spouses)	$12,500 $13,350 $14,200
Head of household	Under 65 65 or older	$8,950 $10,000
Qualifying widower with dependent child	Under 65 65 or older	$9,800 $10,650

Current federal law provides that the additional deduction allowed to seniors may be taken into account when calculating the filing threshold, thereby allowing those seniors to have more income before they are required to file a return and reducing the number of taxpayers who must file a return. However, **federal law** does not provide that additional deductions for blind individuals or dependent exemptions may be taken into account when calculating the filing threshold.

1998 State filing requirements for most people

Filing Status	Must file if Gross Income was at least	Must file if adjusted Gross Income was at least…
Single or Head of Household	$10,623	$8,498
Married Filing jointly	$21,246	$16,996

Under **current state law**, wages subject to withholding under the PITL include all compensation paid to an employee performed for an employer, subject to certain limitations.

California taxpayers can use either a California Form DE-4 or federal Form W-4 to declare the number of withholding exemptions to which he or she is entitled. An employee who claims few or no exemptions, especially those who work full-time for only a portion of a year, may have personal income tax withheld even though they have no tax liability for the year and have earnings below the filing threshold. In order to receive a refund, these taxpayers must file a return.

State law generally conforms to federal law with respect to the rules for allowance for blind and senior exemptions. However, where federal law allows a deduction against AGI, under state law, personal, blind, senior and dependency exemptions are allowed as credits against tax. For 1998, the amount of the personal exemption credit and blind and senior exemption credit is $70. This amount is indexed annually for inflation. **Current state law** does not allow the senior, blind or dependent exemption credits to be taken into account when calculating the filing threshold for returns.

AB 2797 (Ch. 322, Stats. 1998) increased the dependent exemption credit amount to $253 for the 1998 taxable year and to $227 beginning in the 1999 taxable year. The increased credit will be adjusted for inflation for taxable years after 1999. These increased credit amounts will continue to be subject to the limitations described below.

Current state law imposes an estimated tax penalty on taxpayers who during the year either fail to make sufficient estimated tax payments or fail to withhold a sufficient amount from their wages. However, current state law also provides safe harbors for taxpayers who pay less in estimate payments, or who have less withheld during the taxable year, than is ultimately owed in tax. Among other safe harbors, state law provides that no estimate penalty will be owed if a taxpayer meets any of the following conditions:

1. The amount of tax liability for the taxable year (less credits but not including estimated tax payments for the taxable year or the preceding taxable year) was $200 or less, or $100 or less if married filing a separate return;
2. The prior year return was for a full 12 months and no tax was owed on that return; or
3. The amount of tax withholding plus estimated tax payments, if timely paid, is at least 80% of the tax shown on the return for the taxable year, or 100% of the tax show on the prior year return.

Under the PITL, **this bill** would eliminate the requirement to file a tax return for an additional 400,000 taxpayers by raising the income threshold below which taxpayers are not required to file an income tax return. The higher threshold would take into account the increased exemption credits, as well as the senior exemption credit.

Revised filing thresholds attributable to this bill are provided in Addendum 1.

Policy Considerations

This bill would raise the filing threshold without significantly increasing the complexity of determining whether a taxpayer has a requirement to file a return. However, this bill does not attempt to raise the filing thresholds for every possible combination of filing status and number of dependents, so that the filing threshold chart does not become excessively complicated and difficult to read.

The department will monitor the number of taxpayers filing unnecessary returns and will suggest additional changes, if needed, to reduce the filing of unnecessary returns.

Since current state law provides safe harbors from imposition of estimated tax penalties for taxpayers who did not owe tax for the prior year, and who do not make sufficient estimate payments or withhold sufficient amounts of tax for the current year (provided certain tests are met), this bill should not cause new penalties due to underpayment of estimated tax for taxpayers who do not make estimate payments or withhold from their wages, but who may later owe tax. However, this bill may cause an individual to incur the failure to file or failure to pay tax penalty in the event that the individual erroneously determines a return is not required as a result of the filing thresholds.

Implementation Considerations

Since experience has shown that raising filing thresholds does not, by itself, reduce unnecessary filing, the department recognizes an education campaign is needed if this bill is to be successful at reducing filings and related state and taxpayer burdens.

By increasing the filing thresholds for affected taxpayers, this bill could reduce the compliance burden for those taxpayers no longer required to file a return. Moreover, this bill could result in lower costs to the department for printing booklets, storing tax returns, and answering the calls of those taxpayers who would no longer be required to file a return, assuming the related education campaign is successful.

The increased filing threshold amounts could be implemented during annual updates of the department’s forms and procedures. Education may take several years to effectively change taxpayer behavior. Education would make the public aware through updates to tax forms, press releases, public service announcements, information sent to taxpayers and tax practitioners, and other educational outreach to groups (such as the elderly) who may have high concentrations of people filing unnecessary returns.

FISCAL IMPACT

Departmental Costs

Implementation of this bill is not expected to significantly impact the department’s costs. The costs arising from the educational program are not yet determined. In the long run, the combination of the statutory change and the educational program should save departmental costs by eliminating unnecessary filings.

Tax Revenue Estimate

This bill is not expected to impact state income revenues.

BOARD POSITION

Support. At its December 15, 1998, meeting, the Franchise Tax Board voted to sponsor the language in this bill.

ADDENDUM 1

Based on a senior exemption credit amount of $70 and a dependent exemption amount of $227, the adjusted gross income filing thresholds, based on 1998 tax tables would be approximately:

	Single/MFS	MFJ	HOH
No senior credit, 1 dependent	$ 16,000	$ 25,000	$ 25,000
No senior credit, 2 dependents	$ 19,000	$ 30,000	$ 30,000
1 senior credit, no dependents	$ 10,000	$ 16,000	N/A
1 senior credit, 1 dependent	$ 18,000	$ 27,000	$ 27,000
1 senior credit, 2 dependents	$ 22,000	$ 31,000	$ 31,000
2 senior credits, no dependents	N/A	$ 19,000	N/A
2 senior credits, 1 dependent	N/A	$ 30,000	N/A
2 senior credits, 2 dependents	N/A	$ 35,000	N/A

(married filing separate (MFS), married filing joint (MFJ), head of household (HOH))

According to calculations by department staff, it is expected that this bill would eliminate the filing requirement for an additional 400,000 taxpayers in addition to the approximately 2 million taxpayers who currently file a tax return even though they are not required to do so. However, any reduction in the number of returns filed would be limited by the number of taxpayers who continue to file returns when none is required.

Departmental staff also estimate that limiting to two the number of dependent exemption credits that could be included in calculating filing thresholds would affect fewer than 5% of taxpayers with dependents. Many taxpayers with fewer than three dependents and many with more than three either would still be required to file a return or would not have sufficient liability to require that a return be filed.